11 U.S.C. § 1129(a)(1)
11 U.S.C. § 101(5)
11 U.S.C. § 507(a)(8)
11 U.S.C. § 1122(a)
11 U.S.C. § 510
11 U.S.C. § 1123(a)(5)(G)
11 U.S.C. § 1129(b)

<u>In re Carolina Tobacco Company</u>, Case No. 05-34156

2/1/2006 ELP Unpublished

Memorandum opinion on issues relating to confirmation of chapter 11 plan of debtor tobacco company. Discusses various confirmation issues. Concludes that the obligation of debtor to make escrow deposits under the states' tobacco settlement legislation is a "claim" of the various states in which debtor sold its product. The states had argued that it was not a claim, because the payments are not made directly to the states, but instead are required to be made into an escrow account, where the funds stay for 25 unless the states obtain a judgment against the tobacco manufacturer for wrongdoing. The court concludes that, under the tobacco legislation, the tobacco manufacturer's obligation to make the escrow deposits is an enforceable obligation, for the sole benefit of the states, and so is a claim under the Bankruptcy Code. Rejects debtor's argument that the obligation is a claim because it is a right to an equitable remedy.

Court rejects debtor's attempt to define the states' claims as including the states' litigation in various states over whether debtor is a tobacco product manufacturer as defined by the tobacco legislation. Whether the debtor is a tobacco product manufacturer under state law is a question of status, which is a regulatory matter; it is not a claim under the Bankruptcy Code.

The court also rejects debtor's attempt to treat the escrow deposits as priority tax claims under § 507(a)(8). Discusses test for determining whether an obligation to make a payment is a tax.

The opinion discusses various claim classification issues, including whether claims are properly classified under § 1122(a), and addresses whether claims are substantially similar.

Also discusses various issues relating to claims for penalties arising from debtor's prepetition failure to make the required escrow deposits. Concludes that debtor's proposed treatment of the penalty claims is not subordination under § 510.

The court finds that certain arguments about whether certain classes of claims are allowable are premature, and concludes that those issues should be addressed in objections to claims, not objections to confirmation.

Sets out standard for “good faith” under § 1129(a)(3). Also rejects the states’ argument that debtor cannot comply with the state regulatory obligation to make the prepetition escrow deposits by paying them over time under the plan.

Analyzes whether the plan meets the best interests test of § 1129(a)(7), and discusses whether there is a consenting impaired class as required by § 1129(a)(10). Also discusses feasibility under § 1129(a)(11).

Discusses cram down under § 1129(b), and requires debtor to make certain changes in its plan in order to obtain confirmation. Discusses the right to interest on claims under § 1129(b)(2). The court concludes that debtor must pay interest at the prime rate on the prepetition escrow deposits.

Finally, the opinion addresses disputes about particular language that the states proposed for inclusion in the plan.

U.S. BANKRUPTCY COURT
DISTRICT OF OREGON
F I L E D
February 01, 2006
Clerk, U.S. Bankruptcy Court

Below is an Opinion of the Court.

ELIZABETH PERRIS
U.S. Bankruptcy Judge

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

In Re:	)	Bankruptcy Case
	)	No. 05-34156-elp11
CAROLINA TOBACCO COMPANY,	)	
	)	MEMORANDUM OPINION RE
Debtor.	)	CONFIRMATION OF PLAN

This matter came before the court for hearing on confirmation of debtor Carolina Tobacco Company's plan of reorganization. After the confirmation hearing held on September 26, 2005, debtor filed a Third Amended Plan, which is the plan that is currently before the court for confirmation. The court held a continued hearing on October 25, 2005, to hear evidence with regard to the Third Amended Plan. Based on the parties' agreement that they wanted time to attempt to negotiate a consensual plan, the confirmation hearing was again continued. At the hearing held on November 29, 2005, the parties informed the court that negotiations have failed, and asked the court to rule on confirmation.

At the request of the states, the court required debtor to supplement the evidentiary record by providing actual financial performance data though November 30, 2005 and requiring debtor to provide an affidavit from Edward Hostmann, debtor’s expert, regarding whether his opinion regarding the plan’s feasibility was altered by the additional performance data for October and November 2005. Debtor supplied the required items on December 12, 2005.

The states thereafter filed a supplemental memorandum in opposition to confirmation, which caused this court to question whether debtor had the ability to set aside funds for the escrow deposits monthly through the life of the plan. Debtor submitted a supplemental declaration from Mr. Hostmann addressing those concerns. The parties completed their briefing of confirmation issues on January 24, 2006, at which time the matter was taken under advisement.

For the reasons set out below, I will confirm the plan if it is modified to make certain changes, which are outlined below.

FACTS

Carolina Tobacco Company (debtor) is a Virginia corporation with its principal place of business in Oregon. Debtor manufactures cigarettes at a production facility in Johannesburg, South Africa, for sale in the United States.

In 1998, 46 states plus the District of Columbia and the territories entered into a Master Settlement Agreement (MSA) with several major tobacco companies, to settle claims brought against the tobacco companies by the states. Tobacco companies that were not originally parties to the MSA can become parties to the MSA under certain circumstances. Those tobacco product manufacturers (TPMs) that were not original parties to the MSA but join it later are known as Subsequent Participating

Manufacturers (SPMs).

TPMs that do not join the MSA as SPMs are known as Non-Participating Manufacturers (NPMs). Debtor is an NPM.

Parties to the MSA, either original parties or SPMs, are required by the agreement to make yearly payments to the states based on the number of cigarettes sold in the state. The MSA required states to enact legislation, called “qualifying statutes,” which require NPMs, as a condition of their sale of cigarettes in the states, to make payments into escrow accounts based on the number of cigarettes sold in the state. The funds held in the escrow accounts serve as an asset from which the states can obtain payment if they obtain a judgment or settlement against an NPM based on the NPM’s operations in the state. The funds remain in escrow for 25 years, subject to release only if the states obtain a judgment or settlement. After 25 years, the funds may be released to the NPM.

NPMs that fail to make the escrow deposits are prohibited from selling cigarettes in the state for which deposits were not made, and any of the NPM’s cigarettes that are in the stream of commerce become contraband. Most of the settling states maintain a directory of TPMs that are authorized to sell cigarettes in the particular state. If a TPM is not listed in a state’s directory, wholesalers and distributors are prohibited from tax stamping the cigarettes for sale in that state.

Escrow deposit payments are due in April of each year for sales made in the state in the previous year. Debtor failed to make its NPM escrow payments on April 15, 2005 as required for its 2004 sales. It filed a chapter 11[1] petition on April 18, 2005, to stop states from delisting it as an NPM authorized to sell cigarettes in the particular states. Debtor has obtained a preliminary injunction prohibiting the states from delisting debtor pending the trial on a complaint it has filed for a permanent injunction.

Debtor has proposed a plan of reorganization; the states object to its confirmation.[2]

DISCUSSION

The court shall confirm a chapter 11 plan if the 13 requirements of § 1129(a) are met. Even in the absence of an objection to confirmation, the court is required to satisfy itself that the requirements for confirmation have been met. In re Ambanc La Mesa Ltd. P'ship, 115 F.3d 650, 653 (9th Cir. 1997); In re Perez, 30 F.3d 1209, 1214 (9th Cir. 1994); 7 Lawrence P. King, Collier on Bankruptcy ¶ 1129.02[5] (15th ed. Rev. 2000)(court has mandatory, independent duty to review plan and ensure that it complies with requirements of § 1129). The states argue that debtor's proposed plan fails to comply with various provisions of the Code. I will discuss only the requirements that I understand to be in dispute. As to the requirements that are not discussed below, I find that either the plan meets the requirements or the requirements do not apply to this plan.

[1] Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

[2] After the confirmation hearing, the state of Oregon filed an objection to confirmation of the plan. It has since withdrawn that objection.

1. <u>§ 1129(a)(1)</u>

Section 1129(a)(1) requires that the plan of reorganization comply with the applicable provisions of the Bankruptcy Code. § 1129(a)(1). “The legislative history suggests that the applicable provisions are those governing the plan’s internal structure and drafting[,]” such as compliance with §§ 1122 and 1123, governing classification and contents of the plan. 7 <u>Collier on Bankruptcy</u> at ¶ 1129.03[1].

The states raise a number of arguments for why debtor’s plan fails to comply with applicable provisions of the Code.

A. <u>Escrow deposit obligations as claims</u>

Debtor classifies the unpaid prepetition NPM escrow deposits as claims. The states argue that the escrow deposit requirements are not claims under the Bankruptcy Code, and therefore debtor cannot classify them or pay them over time, and they cannot be discharged in bankruptcy.

A “claim” is a

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured[.]

§ 101(5).

The states argue that, although debtor is obligated by state statute to make escrow deposits in order to comply with state law and continue to do business in the states, that obligation to pay is not a “claim,” because the states do not have a current right to payment from the escrow account.[3] They argue that these escrow payment requirements are no different from other methods the states could have used to accomplish the goals of the tobacco litigation, such as requiring surety bonds or a demonstration of minimum financial net worth, which obligations are enforceable in bankruptcy.

The states' view of "claim" under the Bankruptcy Code is too narrow. A "claim" is a right to payment, even one that is unliquidated, disputed, or contingent. § 101(5). This definition is intended to be extremely broad: "This 'broadest possible definition' of 'claim' is designed to ensure that 'all legal obligations of the debtor, *no matter how remote or contingent*, will be able to be dealt with in the bankruptcy case.'" In re Jensen, 995 F.2d 925, 929 (9th Cir. 1993)(citations omitted; emphasis supplied by 9th Circuit). The Supreme Court has held that "[t]he plain meaning of a 'right to payment' is nothing more nor less than an enforceable obligation[.]" Pennsylvania Dep't of Public Welfare v. Davenport, 495 U.S. 552, 559 (1990). "In short, a debt is a debt, even when the obligation to pay is also a regulatory condition." Fed. Comm. Com'n v. Nextwave Personal Comm. Inc., 537 U.S. 293, 303 (2003). In view of this broad definition and the broad interpretation given that definition, the court should "rebuff virtually all attempts to characterize obligations as outside the scope of the definition due to

[3] Debtor says that the states rest their argument at least in part on the fact that the obligations are statutory, not contractual, and then cite Ohio v. Kovacs, 469 U.S. 274 (1985), to refute that argument. The states do not argue that the obligation to make escrow deposits is not a claim because it is a statutory obligation, therefore I will not address that argument.

‘special’ or unique characteristics of those obligations.” 2 Collier on Bankruptcy at ¶ 101.05[3].

There is no dispute that debtor is subject to an enforceable obligation to pay the escrow deposits. Although the states’ argument seems to be that the obligation is not a “claim” because the money is not paid to the states and the states have no current right to payment from the escrow fund, there is also no dispute that the states may enforce that obligation to pay. Because the escrow obligations are legal obligations of debtor to pay that the states are entitled to enforce, those obligations are “claims” as defined in the Bankruptcy Code, and may be dealt with in the bankruptcy case.

The cases on which the states rely are inapposite. None addresses the question of whether a particular obligation is a “claim” under the Code. In Safety-Kleen, Inc. v. Wyche, 274 F.3d 846 (4th Cir. 2001), for example, the issue was whether the state’s regulatory financial responsibility requirements, which required the debtor to provide a surety bond, were excepted from the automatic stay under the police and regulatory power exception. A similar issue was before the court in Bickford v. Lodestar Energy, Inc., 310 B.R. 70 (E.D. Ky. 2004). The question in Duffey v. Dollison, 734 F.2d 265 (6th Cir. 1984), was whether the state’s enforcement of a prepetition obligation to provide proof of financial responsibility before the debtor could regain his driver’s license was a violation of the § 525 anti-discrimination provision of the Code. Finally, Cumberland Farms, Inc. v. Fla. Dep’t of Envtl. Protection, 116 F.3d 16 (1st Cir. 1997), addressed whether a fine imposed for the debtor’s failure, during the bankruptcy case, to comply with a state’s environmental laws constituted an administrative expense entitled to priority under the Bankruptcy Code. Because none of these cases discussed whether the obligations were “claims,” they are not helpful to the analysis here.

Further, the escrow deposits required by the tobacco statutes are solely for the benefit of the states; no other party has any right to draw on those escrow funds. This makes the escrow deposits different from surety bonds or requirements that a debtor provide proof of financial responsibility, which are for the benefit of unspecified third parties who might be harmed by a debtor’s conduct. They also differ from bonds in that the cost of a bond is based on the amount of potential liability to the public, while the amount of required escrow deposits is determined solely by the number of cigarettes sold in a state, without regard to the extent of risk of harm those sales create.

The escrow obligations are claims for another reason. The MSA, which set up the structure for the states to impose statutory obligations on TPMs’ right to sell cigarettes in the states, split what is essentially a claim into two parts for NPMs: one part is the states’ right to sue and obtain judgment or settlement for claims against NPMs based on the NPM’s operations in a state, and the other is a separate requirement that, in order to do business in a state, an NPM must make escrow deposits that then serve as an asset that can be used to pay any judgment or settlement that the states may obtain. Payment of any claims that the states may have against debtor for its 2004 operations is assured by the amounts debtor is obligated to pay into escrow for 2004 sales.

The states argue that the right to sue on the claims arises out of a different statute than the NPM's obligation to make escrow deposits to secure those claims. However, the states cannot split a claim into two pieces, the obligation to provide payment assurance and the liability on the claim, so as to make the escrow obligation fall outside the bankruptcy definition of "claim." The court must look at the MSA scheme as a whole. Doing that shows that the escrow obligation is part of the claim.

Viewing the MSA scheme as a whole, it is also apparent that the escrow obligation provides another benefit to the states. By requiring NPMs to pay money into escrow based on sales, NPMs must adjust their market price for cigarettes to cover the cost of the escrow deposit payments. Thus, the escrow payment obligation helps to level the playing field between SPMs, who must pay the states directly a certain amount per cigarette sold, and NPMs who have not joined the MSA, who do not pay money directly to the states. Thus, the escrow payment obligation helps keep the original and subsequent parties to the MSA from losing market share to NPMs who do not have the obligation to make payments directly to the states.

The states argue that a right to payment that is a claim under the Bankruptcy Code does not mean simply that the debtor has to pay something (such as a minimum wage requirement), but requires that the debtor has to pay something to the creditor. As I have just explained, however, viewing the MSA scheme as a whole, I conclude that the escrow obligations are a right to payment that benefits the states and assures payment of any liability that debtor may have to the states for its 2004 cigarette sales operations in the states. Thus, I conclude that the obligations are claims under the Bankruptcy Code.

Debtor also argues that the escrow obligations are claims under § 101(5)(B), because they are a “right to an equitable remedy for breach of performance” which “breach gives rise to a right to payment[.]” § 101(5)(B). It says that “[t]he States’ ‘equitable remedy’ to compel payment of Escrow Deposits is one for breach of performance, the breach of which gives rise to a right to payment - both the payment of the Escrow Deposits themselves and payment of penalties.” Debtor’s Response to States’ Opposition to Debtor’s Second Amended Chapter 11 Plan at 4.

I disagree that the escrow deposit obligation is a claim under that definition. Debtor’s obligation to make escrow deposits is not an equitable remedy; it is a statutory obligation imposed on NPMs to allow them to sell cigarettes in the state. The breach of that obligation can result in delisting, which may be an equitable remedy, or the imposition of penalties, which the states do not deny is a claim. But the obligation to make the escrow payments themselves is the original obligation, not a remedy for breach of some other obligation.

This distinction was explained in <u>In re Chateaugay Corp.</u>, 944 F.2d 997 (2d Cir. 1991), in which the court considered whether certain environmental clean-up obligations of the debtor were “claims.” In discussing § 101(5)(B), the court gave a clear example of an equitable remedy that would constitute a claim:

> A seller of a unique property has an enforceable duty to convey the property to a buyer. For breach of that duty, a court may order the remedy of specific performance. In some states, however, the specific performance obligation may be satisfied by an alternative right to payment, in which event the specific performance creditor

has a “claim” in bankruptcy.

944 F.2d at 1007-08.

Applying that example to this case, debtor has an enforceable duty to make escrow deposits. For breach of that duty, the states may delist debtor, thereby making it unlawful for debtor to sell its cigarettes in the state. The state may also bring a civil action against debtor to impose a monetary sanction for failure to comply (technically, it is the failure to certify compliance with the escrow deposit obligation, and not the failure to make the deposits, that gives rise to the remedies). The duty to make escrow deposits is not the equitable remedy for the breach of some other duty; it is the duty itself. Delisting and penalties are the remedies for breach of the duty.

Debtor’s prepetition obligation to make escrow deposits is an enforceable obligation of debtor and, therefore, a “claim” under § 101(5)(A).

B.   Debtor’s status as a tobacco manufacturer

The plan defines “States’ Allowed Claims” as “the States’ Claims for Prepetition Escrow Deposits and includes any claim, remedy or cause of action the States may have based upon a State’s assertion that CTC was not the TPM for the Riga Cigarettes, for the AAT Cigarettes or for the Mastermind Cigarettes.” Debtor’s Third Amended Chapter 11 Plan at § 1.02. The plan then provides that debtor’s discharge will create an injunction against the States taking any action against debtor “regarding or relating to the enforcement of their Prepetition Escrow Deposit Claims or the States’ Allowed Claims (including Delisting or any other action to prohibit CTC from selling product in such States due to Debtor’s failure to pay the Prepetition Escrow Deposits) so long as the Reorganized Debtor makes the payments to the States required under this Plan." Id. at § 6.04.

Debtor asserts that the litigation over debtor's status as a TPM is a "claim" under § 101(5)(B). It argues that some states have filed proofs of claim asserting that debtor failed to comply with the certification requirement applicable to NPMs,[4] which failure to certify gives rise to the states' rights to delist and sue debtor for penalties. This right to delist based on failure to certify compliance with the escrow requirements is, according to debtor, an equitable remedy the breach of which gives rise to a right to payment.

The flaw in this argument is that it is not debtor's assertion, which some states dispute, that it is a TPM that gives rise to the right to sue for deposits and penalties. Debtor claims to be a TPM, and does not assert that it is immune from the requirements imposed by statute on TPMs. It is debtor's failure to make the deposits and failure to certify that it has made the deposits that gives the states the right to delist and sue for money, not debtor's status as a TPM.

Some states, however, challenge debtor's status as a TPM, and those challenges are in various stages of litigation. Whether or not debtor is a TPM does not provide the states with an equitable remedy the breach of which gives rise to a right to payment. The status merely defines what debtor's obligations are. Its compliance or failure to comply with any obligations then can give rise to equitable or money remedies.

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[4] The statutes require NPMs to certify that they have complied with the escrow requirement for the year.

As I explained at an earlier hearing and in my correspondence of January 27, 2006, I view the issue of whether debtor was the TPM for particular cigarettes to be a regulatory matter that must be resolved, if necessary, in the appropriate state courts or administrative agencies, not through the plan. The dispute over whether or not debtor was the TPM is not a "claim" within the meaning of the Bankruptcy Code. Because it is not a claim, debtor's plan cannot be confirmed unless debtor revises its definition of "States' Allowed Claims" to mean only the states' claims for prepetition escrow deposits.

C. Escrow deposits as priority tax claims

In its plan, debtor seeks to treat the escrow deposits as priority tax claims under § 507(a)(8)(E). The states argue that, if the escrow requirements are claims, they are not tax claims entitled to priority under that statute. Debtor responds that the escrow deposits fit within the test for "tax" set out in In re Lorber Indus. of Cal., Inc., 675 F.2d 1062 (9th Cir. 1982).

The Bankruptcy Code gives eighth priority to

> an excise tax on --
>
> (i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or
>
> (ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition[.]

§ 507(a)(8)(E). In a chapter 11 case, § 507(a)(8) priority tax claims may be paid over six years. § 1129(a)(9)(C).

Whether an assessment is a tax entitled to priority under the

Bankruptcy Code is a question of federal law. Lorber, 675 F.2d at 1066. The Bankruptcy Code does not define "tax" or "excise tax." As a very general proposition, "[t]he term 'taxation' defines the power by which the sovereign raises revenue to defray the necessary expenses of government." 71 Am.Jur.2d "State and Local Taxation" § 1 (2001)(footnote omitted). The court is to look behind the characterization of the exaction given by the legislature to examine the function of the charge. United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 224 (1996).

In Lorber, the Ninth Circuit said that charges made by a governmental agency "can be classified as a tax only if they constitute 'a pecuniary burden laid upon individuals or property for the purpose of supporting the Government' or to support 'some special purpose authorized by it.'" 675 F.2d at 1066 (quoting New Jersey v. Anderson, 203 U.S. 483, 492 (1906)). In distinguishing between taxes and non-taxes, the court set out a four-part test for what is a tax:

> (a) An involuntary pecuniary burden, regardless of name, laid upon individuals or property;
>
> (b) Imposed by, or under authority of the legislature;
>
> (c) For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it;
>
> (d) Under the police or taxing power of the state.

675 F.2d at 1066.

I agree with the states that a statutorily required payment into an escrow account, which may be reached by a state only to pay its damages, and which is not otherwise available to the states for any use, is distinguishable from all of the cases that discuss whether or not an exaction is a tax. The cases discussing whether a payment required to be made to a state or other governmental entity is a tax or a fee or something else are not helpful in determining whether a payment that is required by statute and enforceable by the state, but not paid directly to the state, is a tax.

Debtor points to statements of certain experts who have studied the tobacco litigation and statutes, who observe that, for example, "[t]he Qualifying Statute[5] is essentially a tax to consumers of tobacco products manufactured by NPMs." Declaration of Kip Viscusi, Adv. Docket No. 32, at 10 ¶ 23 (quoted in Debtor's Response to States' Opposition to Debtor's Second Amended Chapter 11 Plan at 6). Whether or not the cost of escrow deposits made by NPMs is passed on to the consumer, thereby increasing the cost to the consumer of the cigarettes, is irrelevant to whether the escrow deposit requirements are taxes imposed on debtor. Even under the experts' view, the "tax" is on the consumer, not on the NPM. Further, the experts were not considering whether the obligation meets the definition of tax as used in the Bankruptcy Code, so their use of the term "tax" is not useful to the analysis here.

Debtor also argues that it does not matter that the escrow deposits are not paid to the states directly, because the NPM escrow deposits are part of an overall scheme that includes payments by participating manufacturers directly to the states. According to debtor, "enforcing the Qualifying Statutes' requirement that NPMs make escrow deposits ensures that payments under the MSA from the OPMs [Original Participating

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[5] The Qualifying Statutes are the statutes that impose the escrow payment obligations on the NPMs.

Manufacturers] get made to them -- payments that the States cannot contest they receive directly and can use in any manner they see fit -- just like taxes." Debtor's Response to States' Opposition to Debtor's Second Amended Chapter 11 Plan at 7. Debtor does not explain, and I cannot discern, how a payment that does not go directly to the states but merely encourages others to pay their taxes makes the NPM's escrow deposit requirement a tax.

Even under the test set out in Lorber to distinguish between a tax and a fee or other non-tax obligation, the escrow deposits are not taxes. Whether the first part of the test is met, that the exaction is an involuntary pecuniary burden, is disputable, but likely is met here. The Ninth Circuit's guidance on this test is not clear, but seems to hold that, when an entity cannot do business without paying the exaction, it is involuntary.

For example, the Ninth Circuit held that a state's judgment lien for the state's cost of paying workers compensation benefits to an injured worker, after the debtor failed to obtain workers compensation insurance as required by statute, was an involuntary pecuniary burden and so was a tax. In re Camilli, 94 F.3d 1330 (9th Cir. 1996). In a case seemingly to the contrary, the court held in In re George, 361 F.3d 1157 (9th Cir. 2004), that a claim of California's Uninsured Employers Fund against an employer who failed to purchase workers' compensation insurance was not a tax. The court questioned whether Camilli was correctly decided, but then distinguished the California statutory scheme from the Arizona statutory scheme that had been at issue in Camilli. 361 F.3d at 1161-62. It relied on the distinction between the two state's statutes. In

Arizona, payments by the state's workers compensation fund to employees whose employers are not insured are considered judgments against the employer that have the same priority as to assets of the employer as claims for taxes. Id. at 1162. In California, in contrast, the state's action against an uninsured employer for the state's costs in providing compensation to the employer's injured worker is considered a "liquidated claim for damages." Id. That suggests that the state is intended to be in the same position as other claimants, including non-governmental claimants, who hold an entitlement to liquidated damages. According to the court, this indicates that the state does not intend to treat the employer's obligation to the state as a tax.

There does not seem to be a dispute for purposes of confirmation that the escrow payment requirement in this case was imposed by legislative authority, or that it was imposed under the state's police power. Where the escrow deposit requirements fail the test for a tax is in the third factor, that the payments be "[f]or public purposes, including the purposes of defraying expenses of government or undertakings authorized by it." Lorber, 675 F.2d at 1066. Under the tobacco statutory scheme, the escrow deposits do not serve to defray expenses of government, either in regulating the industry or in providing governmental services to the public. Instead, the escrow deposits assure the payment of damages that might be awarded in litigation the states may commence against an NPM for wrong-doing connected with its sale of cigarettes. If the NPM does not engage in any conduct that gives rise to liability, or if the state chooses not to bring an action against an NPM for any such misconduct, the fund will never benefit the state by defraying the expenses of government or the undertakings authorized by it and, in fact, eventually will be returned to the NPM. The NPM is nonetheless required to make the deposits into escrow as a condition of doing business in the states.

The escrow deposits are merely part of the states' claims, and do not immediately add to the states' coffers simply by virtue of their existence. As the states point out, damages the states may incur from misconduct of an NPM, which may include the costs of providing health care to persons injured by the products the NPM sells, may be collected from any assets of the NPM, not just the escrow fund. The fund provides assurance of payment for possible liability. It is not a payment to the states to help the states defray their costs of government or their undertakings.

Holding that the escrow deposits are not excise taxes entitled to priority under the Code is consistent with the purpose of priorities for taxes.

> The reason for according priority treatment to taxing authorities is because taxing authorities, unlike most other creditors, did not voluntarily extend credit to the debtor. As the legislative history notes:
>
> > A taxing authority is given preferred treatment because it is an involuntary creditor of the debtor. It cannot choose its debtors, nor can it take security in advance of the time that taxes become due.

4 <u>Collier on Bankruptcy</u> at ¶ 507.10[1][b] (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 190 (1977)). Under the tobacco statutes, the states set up a system under which they are assured of payment for obligations NPMs might have to the state, if the NPMs are found liable for damages for misconduct. Thus, the purpose of priority does not exist

for the escrow deposits.

I conclude that the claim for escrow deposits is not an excise tax under § 507(a)(8)(E).

D. Classification of claims

The states argue that debtor has improperly classified claims in order to obtain the consent of one class of impaired claims. Section 1122(a) provides:

> 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.

Subsection (b) relates to administrative convenience classes, and is not applicable here. The plan of reorganization must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest[.]" § 1123(a)(4).

Section 1122 says that only claims that are substantially similar may be classified together; it does not say that all substantially similar claims must be included in a single class. A debtor may not separately classify substantially similar claims "absent legitimate business or economic justification[.]" In re Barakat, 99 F.3d 1520, 1526 (9th Cir. 1996). Nor may it "classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." Id. at 1525 (quoting In re Greystone III Joint Venture, 995 F.2d 1274, 1279 (5th Cir. 1991)).

i. Escrow deposit obligations

Anticipating that the court might not allow treatment of the escrow deposits as tax claims, debtor in the alternative classifies those claims in Class 4, separate from the other unsecured claims. The states argue that the plan improperly classifies the escrow deposits in its own class, rather than classifying them with the other unsecured claims. According to the states, the only reason to separately classify the escrow deposits is because presumably Class 3 (general unsecured claims) will vote in favor of the plan, and the addition of the states' escrow deposit claims to the class would result in the class voting against the plan.

Debtor argues that separate classification of the escrow deposit requirements from other unsecured claims is permissible, because the types of claims are not substantially similar. It says that the Class 3 general unsecured claims are those of trade creditors or providers of services, while the claims of the states are for statutory obligations imposed on debtor under a regulatory scheme. It also asserts that the claims differ with regard to debtor's assets; the states have recourse to the escrow fund if they obtain judgments against debtor, while the other unsecured creditors do not.

The Code does not define "substantially similar," but the term has been "construed to mean similar in legal character or effect[.]" 7 Collier on Bankruptcy at ¶ 1122.03[3]. Even though the claims of trade creditors and service providers are unsecured claims, as are the escrow payment requirements, the two types of claims are not substantially similar. The escrow funds accumulated by debtor's payment of the escrow obligations provide assurance of payment of judgments the states may obtain against debtor. The other unsecured creditors would not have access to that fund for payment of any judgment they might obtain against debtor. Therefore, they are different in legal character and can be classified separately.

Even if the two types of claims are considered to be substantially similar, separate classification may be upheld if the debtor can prove a business or economic justification for the separate classification. Debtor has a business justification for the separate classification, because it cannot operate postpetition without complying with state law, which includes the requirement that it make the escrow payments. Therefore, classifying the prepetition escrow deposit claims separately so that debtor can adequately deal with them and therefore continue to operate is a legitimate business reason for the separate classification.

ii. Penalty claims

The states make several arguments about their penalty claims arising from debtor's failure to make the 2004 escrow deposits. Although the arguments may not all technically fall under § 1129(a)(1), I will discuss them all in this section.

a. Subordination

Debtor places allowed penalty claims of the states in Class 5,[6] and proposes to pay those claims in full after all other claims are paid in full. Debtor's Third Amended Plan at ¶ 4.05. The states object to this provision, asserting that there is no basis for subordination of the penalty claims under § 510, and that debtor cannot subordinate merely because the claims are for penalties.

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[6] Debtor includes in this class penalties for failure to make prepetition escrow deposits "or any other penalty assessable against the Debtor prepetition, including the penalty asserted by the State of West Virginia." Debtor's Third Amended Plan at ¶ 4.05.

Debtor argues that it does not propose to subordinate the penalty claims, if any, under § 510; instead, it argues that subordination is appropriate, because penalty claims are paid after other general unsecured claims in a chapter 7 distribution. § 726(a)(4). Under the best interests of creditors test of § 1129(a)(7), payment of penalty claims after payment of other claims is acceptable, because the states will receive at least as much for their penalty claims in chapter 11 as they would in chapter 7.[7]

Debtor's proposed treatment is not subordination under § 510; it is merely a different treatment for the penalty claims, which will be paid in full but only after all other claims are paid in full. The plan provides that all claims, including penalty claims, will be paid in full. The penalty claims will just be paid later than the other claims.

b. States' right to penalties

The penalty claims are based on debtor's failure to make prepetition escrow deposits. Debtor argues that the states will not be entitled to any penalties, because it proposes to cure the non-payment default, thereby eliminating the basis for the penalties.

This argument is premature. Under debtor's plan, allowed penalty

[7] Under the best interests of creditors test, each creditor must receive at least as much in the reorganization as it would have received in a chapter 7 liquidation. § 1129(a)(7). In a chapter 7 case, non-compensatory penalty claims are in the fourth level of distribution, receiving nothing unless all claims set out in § 726(a)(1) - (3) are paid in full. § 726(a)(4). Debtor says that, under its liquidation analysis, non-compensatory penalty claims would receive nothing. Therefore, because the plan proposes to pay the penalty claims, but only after all other claims are paid in full, the plan meets the best interests test.

claims will be paid in full after all other claims are paid. Debtor's Third Amended Plan at ¶ 4.05. Any argument that the states are not entitled to allowed claims for penalties because of cure under the plan is one that debtor can raise in objections to the claims. It is the plan provisions, not whether there will in fact be any allowable penalty claims, that are at issue at this time.

c. Classification of penalty claims

Debtor separately classifies the penalty claims, giving them different treatment from that of other general unsecured claims, including the claims for prepetition escrow deposits. The states argue that there is no justification for separately classifying penalty claims, since such claims cannot be subordinated.

As I explained above, a debtor may not separately classify substantially similar claims "absent legitimate business or economic justification[,]" In re Barakat, 99 F.3d 1520, 1526 (9th Cir. 1996), and it cannot "classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." Id. at 1525 (quoting In re Greystone III, 995 F.2d 1274, 1279 (5th Cir. 1991)).

Penalty claims can be paid after all other claims are paid in full, in accordance with § 726(a)(4). Paying penalty claims last will allow debtor to pay its prepetition obligations more quickly, thereby bringing it into compliance with state law more quickly. Coming into compliance with state law provides a legitimate business justification for the separate classification.

iii. Claim of CPI-NV

Debtor originally classified the claim of CPI-NV in Class 3 with other, non-state general unsecured claims. The claim is in the approximate amount of EUR 300,000. The states objected to the payment of the CPI-NV claim in accordance with payment of Class 3 claims, because payment in Class 3 resulted in the CPI-NV debt repayment being accelerated. The CPI-NV note provides for payment over 10 years; the plan called for payment sooner than that.

In response to the states' concern, debtor placed the CPI-NV claim in its own class, Class 3A, and provided for deferral of the currently due payment until 2006 and payment pursuant to the terms of the note thereafter.

The states now argue that the CPI-NV claim should not be included in debtor's plan at all, because the claim is not an obligation of debtor. Instead, the debt is owed by Tideline, which is an affiliate of debtor. The states argue that the only reason to include the CPI-NV debt in debtor's plan is to inflate the value of unsecured claims that consent to the plan.

Debtor has not provided evidence that it has a legal obligation to pay the CPI-NV note. The CPI-NV note was signed by Tideline. Mr. Redmond's testimony at the hearing was that the work that CPI-NV did in locating House of Prince to produce cigarettes for debtor benefitted debtor, and so debtor proposes to pay the CPI-NV debt through the plan. He could not locate any written documentation showing that this is a debt of debtor.

A party cannot raise an objection to plan confirmation as a substitute for objecting to a claim. I agree that there are serious questions about whether the claim of CPI-NV is allowable. If there is an objection filed to CPI-NV’s claim, I will consider whether to allow it. The claims objection process exists precisely to resolve such disputes. Plan confirmation is not the appropriate time to resolve such issues. Because there has not been an objection filed to the claim, the states’ objection to confirmation based on including the claim in the plan is overruled.

2. § 1129(a)(3)

Under § 1129(a)(3), a plan must be “proposed in good faith and not by any means forbidden by law.” “Good faith” is not defined in the Bankruptcy Code. “A plan is proposed in good faith where it achieves a result consistent with the objectives and purposes of the Code.” In re Sylmar Plaza, LP, 314 F.3d 1070, 1074 (9th Cir. 2002). Accord In re Madison Hotel Assoc., 749 F.2d 410, 425 (7th Cir. 1984)(good faith “is generally interpreted to mean that there exists ‘a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code’”). It “requires a fundamental fairness in dealing with one’s creditors.” In re Jorgensen, 66 B.R. 104, 109 (9th Cir. BAP 1986). In making that determination, the court considers the totality of the circumstances. Sylmar Plaza, LP, 314 F.3d at 1074. Purposes of the Code “include facilitating the successful rehabilitation of the debtor, and maximizing the value of the bankruptcy estate.” In re Gen. Teamsters, Warehousemen and Helpers Union, Local 890, 265 F.3d 869, 877 (9th Cir. 2001).

The states argue that the plan fails to meet the good faith requirement, because it artificially impairs the Class 3 claims so they will vote in favor of the plan and create an accepting class that will allow cram down under § 1129(b). Of the approximately $64,000 in claims in Class 3, the holder of claims totaling $60,000 is an insider whose vote is not counted for purposes of determining whether there is an impaired consenting class under § 1129(a)(10). That leaves only $4,000 in claims in this class, which the states argue, and debtor acknowledges, could be paid in full on confirmation of the plan.

The question is not whether the $4,000 in claims that count for purposes of plan confirmation could be paid in full, but whether the entire class of claims could be paid in full. Debtor's expert testified that debtor could pay the $4,000 on confirmation; he also testified that, if on confirmation of the plan debtor paid the CPI-NV 2005 payment plus the Class 3 unsecured claims of $64,000, debtor would be left with a $500,000 cash cushion. That is less than the $1 million cushion debtor proposes to maintain and that I conclude is reasonable. I am not aware of testimony about the effect on debtor's cash reserve if it were to pay the entire $64,000 on confirmation, but not pay the CPI-NV payment. However, the CPI-NV payment was approximately EUR 33,000, or about $40,000. Thus, not paying that amount would add only $40,000 to the cash reserve, which would still leave the cash reserve far below the $1 million provided for in the plan.

I conclude that debtor has not artificially impaired the Class 3 claims in order to obtain a consenting class to vote on the plan. Its impairment of the Class 3 claims does not demonstrate lack of good faith.

The states also argue that the plan is proposed by means forbidden by law, because under the plan, debtor will be out of compliance with state law until the 2004 escrow deposits are paid in full, which could be as late as December 2009. It argues that the escrow deposit obligations are not claims that can be discharged or deferred for payment. I have already determined that the obligation to make the escrow deposits is a claim. Therefore, the fact that debtor proposes to pay that claim over time is not unlawful.

The question then becomes whether debtor can comply with the regulatory obligation to make the prepetition escrow payments by paying them over time, while still complying with state law that requires the escrow deposits to have been made and to remain in escrow until either the states have a right to some of the funds or 25 years have passed.

The answer lies in § 1123(a)(5)(G), which provides that, "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall" "provide adequate means for the plan's implementation, such as" "curing or waiving of any default." In Pacific Gas & Elec. Co. v. State of California, 350 F.3d 932 (9th Cir. 2003), the court concluded that the "notwithstanding any otherwise applicable nonbankruptcy law" language served to preempt otherwise applicable nonbankruptcy laws "relating to financial condition." Id. at 935.

The states argue that "relating to financial condition" means only "provisions that are triggered by a bankruptcy filing or the debtor's insolvency." Memorandum of Points and Authorities in Opposition to Confirmation of Second Amended Plan at 22 n.21. The PG&E case does not say what "relating to financial condition" means. In that case, the debtor was attempting to use a chapter 11 plan to engage in certain transactions that were subject to state regulation, such as transferring assets from the utility to another company, without having to obtain regulatory approval. The court rejected the debtor's broad reading of § 1129(a)(5) to include essentially all nonbankruptcy law, limiting the notwithstanding clause to those nonbankruptcy laws and regulations that relate to financial condition.

The cases the states cite for its view of financial condition are bankruptcy court cases from outside this circuit, and so are not particularly helpful. Although the meaning of financial condition is not clear, I conclude that making escrow deposits relates to financial condition, and therefore the requirement that escrow deposits have been made can be overcome by a plan that provides for paying that financial obligation over time.[8] Debtor's proposal to pay the prepetition escrow deposits over time is not forbidden by law, even though it means that debtor will be out of compliance with state law until the prepetition escrow deposits are made.

3. <u>§ 1129(a)(7)</u>

With regard to each impaired class of claims, the plan must guarantee that each creditor "will receive at least as much in reorganization as it would in liquidation." 7 <u>Collier on Bankruptcy</u> at ¶ 1129.03[7]. Thus, unless an impaired class consents to the plan, each nonconsenting member must receive under the plan "property that has a present value equal to that participant's hypothetical chapter 7 distribution if the debtor were liquidated instead of reorganized on the plan's effective date." <u>Id.</u> at ¶ 1129.03[7][b]. The plan proponent must

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[8] I am not making any comment on debtor's argument that, if it pays the prepetition escrow deposits in full, it will have cured the default that gave rise to the imposition of penalties, and will thus be relieved of any obligation to pay penalties.

perform a liquidation analysis so the court can determine what the nonconsenting impaired creditor would receive in a chapter 7. Id. at ¶ 1129.03[7][b][iii].

Debtor provided Exhibit 2 to its Second Amended Disclosure Statement, which is attached to its Second Amended Plan. That exhibit is a liquidation analysis that indicates that, in a liquidation, general unsecured creditors would not be paid in full.[9] The plan proposes to pay the general unsecured creditors in full over time, which is more than they would receive in a liquidation. Therefore, the plan meets the best interest test.

The states do not seem to argue that the plan fails the best interests test, but only that debtor could propose to pay substantial penalties before all other claims are paid in full, while still being able to meet the best interests test. That is not a best interests question. In any event, as I explain later in this Memorandum Opinion, it is reasonable for debtor to maintain a $1 million cash reserve, and if there are excess funds available, debtor must accelerate its payment of the escrow deposits. Debtor should apply any excess funds to achieving compliance with state law, before paying penalty claims.

4. § 1129(a)(10)

If a plan proposes to impair a class of claims, the plan cannot be

[9] The liquidation analysis indicates that general unsecured creditors would receive 26.4%, which assumes that the escrow deposit claims are priority tax claims. Because I have rejected that assertion, the priority tax claims would be lower and the general unsecured claims would be higher, resulting in a higher percentage distribution to general unsecured claims. This would not be enough to pay the claims in full.

confirmed unless at least one class of impaired claims accepts the plan. § 1129(a)(10). Debtor argues that it has obtained consent from three consenting impaired classes: Class 2, which is the House of Prince claim; Class 3, which is the general unsecured claims of creditors other than the states; and Class 3A, which is the claim of CPI-NV.

The states argue that debtor cannot rely on the CPI-NV claim to provide a consenting class, because it is not a claim against debtor and therefore is not properly included in the plan. As I explained above, the states have not objected to the claim, and so it may be included in the plan, for payment if the claim is allowed. Debtor may rely on the vote of that Class 3A creditor to provide a consenting class.

Debtor also has the consent of the Class 3 creditors, which provides a consenting impaired class. However, only the vote of claims in that class valued at $4,000 can be counted for confirmation purposes. The states have millions of dollars of claims against debtor. I agree with the states that there would be a real question of whether the plan could be confirmed over their objection, if this were the only consenting class. An attempt to obtain confirmation based on the vote of claimants holding only $4,000 in claims could, in the context of this case, be considered a lack of good faith.

However, debtor has the consent of Class 3A as well as the consent of Class 2, which is comprised of the claim of House of Prince for $105 million.[10] The states argue that debtor cannot rely on the consenting

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[10] House of Prince is the predecessor in interest to Scandinavian Tobacco S.I.A. In this Memorandum Opinion, I will refer to the creditor (continued...)

vote of House of Prince, because its claim must be disallowed under § 502(e). Therefore, it does not have an allowed claim that is entitled to vote on the plan.

House of Prince filed a proof of claim in this case for $105 million. Debtor objected to that claim. The court entered an order on August 30, 2005, providing that any creditor whose claim was subject to a pending objection could seek temporary allowance of that claim for purposes of accepting or rejecting the plan. Order Regarding Request for Estimation Hearing at 1. Thereafter, debtor and House of Prince entered into a stipulation to the amount of House of Prince's claim for purposes of voting, stipulating that the claim was $105 million for purposes of voting on the plan. Stipulation to Amount of Class Two Claims for Purposes of Voting. The states did not object to that stipulation.

Claims that are subject to objection may be temporarily allowed for purposes of accepting or rejecting a plan. Fed. R. Bankr. P. 3018(a). That is what occurred with the stipulation to the amount of House of Prince's claim for purposes of voting; that claim was temporarily allowed in the amount of $105 million for purposes of accepting or rejecting the plan.

The plan provides for settlement of the dispute with House of Prince, under which House of Prince will not only receive less than the $105 million set out in its claim, but also will have to pay approximately $17 million to the states. Therefore, Class 2 is impaired, and acceptance of the plan by Class 2 is sufficient to provide a

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[10](...continued) as House of Prince.

consenting impaired class under § 1129(a)(10).

The states' § 502(e) argument is the basis for a claim objection, not for an objection to confirmation. The states did not object to the House of Prince claim, and debtor's objection was not grounded in § 502(e).

The states also argue that, if the settlement is approved and becomes part of debtor's confirmed plan, the claim of House of Prince will not be impaired, because House of Prince will be paid everything that it has agreed to under the settlement. The court has now approved the settlement. Approval of the settlement does not, in my view, make House of Prince's claim unimpaired. At the time the votes were cast, House of Prince was asserting a claim for $105 million; the settlement agreement and the plan do not propose to pay the full amount of that claim. I do not think that House of Prince's agreement to settle its claim against debtor for substantially less than the $105 million it asserted it was owed make it unimpaired for purposes of voting on the plan. Class 2 is therefore impaired and its vote in favor of the plan provides the consenting impaired class for confirmation purposes.

Even if there were no other accepting impaired class, acceptance of the plan by Class 2, which is impaired, meets the requirement under § 1129(a)(10) that there be at least one consenting impaired class.

5. <u>§ 1129(a)(11)</u>

Section 1129(a)(11) requires that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." "Feasibility has been defined as whether the things which are to be done after confirmation can be done as a practical matter under the facts." In re Jorgensen, 66 B.R. 104, 108 (9th Cir. BAP 1986). The purpose of this requirement is "to prevent confirmation of visionary schemes which promise creditors and equity security holders more under a proposed plan than the debtor can possibly attain after confirmation." In re Pizza of Hawaii, Inc., 761 F.2d 1374, 1382 (9th Cir. 1985)(quoting 5 Collier on Bankruptcy at ¶ 1129.02[11] (15th ed. 1984)). "Success need not be guaranteed." In re Monnier Bros., 755 F.2d 1336, 1341 (8th Cir. 1985). The court may consider various factors, including the debtor's earning power, the sufficiency of the debtor's capital structure, economic conditions, managerial efficiency, and whether the same management will continue to operate the debtor. In re Clarkson, 767 F.2d 417, 420 (8th Cir. 1985); In re WCI Cable, Inc., 282 B.R. 457, 486 (Bankr. D. Or. 2002)("Factors that the court should consider in evaluating evidence as to feasibility include '(1) the adequacy of the financial structure; (2) the earning power of the business; (3) economic conditions; and (4) the ability of management.'" (quoting In re Agawam Creative Marketing Assoc. Inc., 63 B.R. 612, 619-20 (Bankr. D. Mass. 1986), which was quoting from In re Merrimack Valley Oil Co., Inc., 32 B.R. 485, 488 (Bankr. D. Mass. 1983))).

The states argue that debtor's plan is not feasible because debtor says it is impossible to make the required escrow payments immediately, which would bring it in compliance with the law, and therefore as soon as the plan is confirmed the states will delist debtor and it will be unable to operate lawfully post-confirmation.[11]

This argument presupposes that, if debtor does not immediately make all of the 2004 escrow deposit payments, the states may delist debtor for its non-compliance. However, the plan contains a provision that enjoins the states from delisting debtor based on its failure to make the prepetition escrow deposits. Debtor's Third Amended Plan at ¶ 6.04. Therefore, the states would not be free upon confirmation to delist debtor based on its failure to make the prepetition escrow deposits.

Debtor provided evidence from its expert that debtor will be able to perform under the plan. There is no evidence to the contrary. I find that debtor has established that the plan is feasible.

6. <u>§ 1129(b) - cram down</u>

If any impaired class does not accept the proposed plan, a plan can be confirmed only by meeting the requirements of § 1129(b).

§ 1129(b)(1). In order for a plan to be crammed down under this

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[11] In their reply brief, the states say that they "are unaware of any time in which they have asserted that the Plan is not feasible. To the contrary, their Opposition notes that the Plan provides far more time and money to the Debtor and its owner than is needed in order for them to come into compliance with the law." States' Reply to Debtor's Brief in Support of Confirmation of Second Amended Plan at 21 n.14. In fact, they specifically raised feasibility in their opening brief, in a section headed "The Plan is 'Proposed by a Means Forbidden by Law' and Is Not Feasible." Memorandum of Points and Authorities in Opposition to Confirmation of Second Amended Plan at 21. Under that heading, they argued that, in the absence of a proposal for present compliance with the tobacco statutes, "the Plan as proposed by the Debtor is not feasible, because it will not allow the Debtor to operate legally post-confirmation." <u>Id.</u> at 22:15-16. At the outset of the September 26, 2005 confirmation hearing, the states indicated that they did not object to the plan on feasibility grounds, but would not stipulate that the plan was feasible. After they received debtor's updated financial performance data, however, they specifically challenged feasibility.

provision, all the requirements of § 1129(a) must be met, except for the requirement in § 1129(a)(8) that all impaired classes have accepted the plan. Id.

A plan can be confirmed under § 1129(b) "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims" that is impaired and has not accepted the plan. § 1129(b)(1).

A. Unfair discrimination

The states argue that debtor's plan unfairly discriminates against the states, because it proposes to pay unsecured claims, other than the claims of the states, in full no later than September 30, 2006, while requiring the states to wait until that date to even begin payments, with full payment occurring by December 31, 2009. They argue that there is no justification for discriminating against the states' claims, other than to coerce their agreement to debtor's SPM application.

> Discrimination between classes must satisfy four criteria to be considered fair under 11 U.S.C. § 1129(b): (1) the discrimination must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without the discrimination; (3) the discrimination is proposed in good faith; and (4) the degree of the discrimination is directly related to the basis or rationale for the discrimination. Moreover, separate classification for the purpose of securing an impaired consenting class under § 1129(a)(10) is improper.

In re Ambanc La Mesa Ltd. P'ship, 115 F.3d 650, 656 (9th Cir. 1997).

Debtor argues that the discrimination in treatment between the class comprised of the states' escrow deposit claims and the class made up of other general unsecured creditors is not discriminatory, as both classes will be paid in full. However, the plan does propose to pay the Class 3 claims in full before it even starts to pay the states' claims, subjecting the states to increased risk that the payments will not be made or that the plan will fail, while allowing debtor to operate in states where it otherwise would be precluded by its non-payment from doing so.

Debtor's plan provides for payment of the prepetition escrow deposits in four installments, "to the extent the cash flow of the Debtor permits such deposits to be made while allowing the Debtor to maintain" a $1 million cash reserve. Debtor's Third Amended Plan at ¶ 4.04. Debtor has a reasonable basis for proposing to pay the escrow deposits over time; it needs to accumulate the cash with which to make the payments. The $1 million reserve is not an unreasonable floor. Although debtor operated with a smaller cash reserve prepetition, debtor's evidence convinces me that a $1 million cash reserve is reasonable on a going-forward basis.

The evidence does not establish that debtor could pay the entire prepetition escrow on the same schedule as the payments to the Class 3 claims. The discriminatory treatment of Class 4 escrow deposit claims is directly related to the basis for the different treatment.

The states argue that the discrimination is not in good faith, but that debtor proposes to pay less than it could pay to come into compliance with state law as a means to coerce the states into accepting debtor's application to become an SPM. I find that the evidence does not support that argument. Debtor proposes to pay over time because it does not have the financial means to pay immediately.

I agree with the states that debtor must include a provision in the plan that, if revenues are better than projected, and debtor has the financial means to do so while still maintaining the $1 million cash reserve, debtor must pay more in each installment than the percentage set out in ¶ 4.04 of the plan. The plan provides that debtor can pay less if it does not have the financial ability to pay the amount set out in the plan; the plan must also provide for paying more if debtor is able. Until the prepetition escrow deposits are made, debtor is operating out of compliance with state law. It must make those escrow deposits as soon as it is reasonably able to do so without jeopardizing debtor's business operations.

I will also require the plan to provide that, during the life of the plan, debtor set aside monthly the amounts necessary to meet the escrow deposit requirements for postpetition sales. This will provide additional assurance to the states that debtor will not use funds necessary to satisfy the postpetition escrow deposit requirements as working capital or to pay prepetition claims.

B. Fair and equitable

Section 1129(b)(2) provides specific requirements for fair and equitable treatment, depending on whether the objecting impaired class contains secured or unsecured claims. If the class contains unsecured claims, the plan cannot be confirmed unless it meets the "absolute priority rule," which is set out in § 1129(b)(2)(B). That rule requires that each holder of a claim receive or retain property of a value, as of the effective date, equal to the allowed amount of such claim, or that holders junior to the claims of such class will not receive or retain any property under the plan. This means that unsecured creditors must be paid in full before equity holders can retain any interest. 7 Collier on

Bankruptcy at ¶ 1129.04[4][a].

The plan proposes to treat the states’ escrow claims as Class 4 general unsecured claims. Debtor’s Third Amended Chapter 11 Plan at ¶ 2.05.[12] Under the plan, Class 4 claims “shall be paid without interest or penalties of any kind[,]” unless the court requires that interest be paid. Debtor’s Third Amended Plan at ¶ 4.04. If interest is required, debtor proposes to pay a rate of 3 percent, or whatever rate the court requires. Id.

Debtor argues that its plan meets the absolute priority rule because, even though the owner of debtor is retaining his equity in debtor, see Debtor’s Third Amended Chapter 11 Plan at § 4.06, all unsecured creditors are being paid in full on their claims. The states counter that the plan’s failure to require the payment of interest on their unsecured claims results in a failure to pay the claims in full, thereby violating the absolute priority rule.

Section 1129(b)(2)(B)(i) requires that holders of unsecured claims “receive . . . on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim[.]” This means that, if the creditor is not to be paid cash as of the effective date of the plan, the debtor must pay the present value of its

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[12] The plan provides:

> In the event the court finds that the States’ claim for Prepetition Escrow Deposits is not a Priority Tax Claim, such claim shall be treated as a Class Four general Unsecured Claim under paragraph 4.04 of this Plan, and shall be entitled to payment as set forth therein.

Debtor’s Third Amended Chapter 11 Plan at ¶ 2.05.

claims. In re Ambanc La Mesa Ltd. P'ship, 115 F.3d 650, 654 (9th Cir. 1997); 7 Collier on Bankruptcy at ¶ 1129.04[4][a][C]. "'Present value' is a term that reflects the time value of money . . . ." 7 Collier on Bankruptcy at ¶ 1129.06[1][a]. Thus, in order for debtor to pay the full value of the states' claims, "the Plan must provide for payment of interest for the post-confirmation time-value of the amount of [the states'] unsecured claim[s]." Ambanc La Mesa Ltd. P'ship, 115 F.3d at 654. Accord In re Perez, 30 F.3d 1209 (9th Cir. 1994)(creditors paid over time must be paid interest for the time-value of their money). That entails applying an objective standard, starting with the prime rate (which reflects the opportunity costs of a loan, the risk of inflation, and a relatively slight risk of default), and then adjusting upward depending on risk. Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004).

Debtor argues that it need not follow the general rule that it pay interest on the unsecured claims, because the states' claims are unique in that the escrow deposit payments are not made to the states themselves, but instead are paid into debtor's escrow account. Any interest that accrues on the escrow funds is returned to debtor, so the states are not losing the use of the money over time.

The states' claims based on enforcement of the escrow deposit requirement are unique. The escrow deposits are made into an escrow account. Debtor is entitled to all interest earned on the escrow account. Exhibit 2 to States' Memorandum of Points and Authorities in Opposition to Confirmation.

It is true that, with an ordinary unsecured claim, the payment of interest is compensation to the creditor for the time value of money that the creditor is receiving over time. The idea is that the creditor is losing the use of that money during the repayment period, for which it should be compensated. In this case, the money does not go directly to the states, but instead goes into an escrow account that is available to the states only if the states obtain a settlement or judgment establishing debtor's liability for a released claim. Therefore, the states are not losing the use of the money as would an ordinary unsecured creditor.

However, the prime rate also compensates for the risk of inflation, which is still present when the claim is not paid in full on confirmation. Further, Till says that the interest rate is to be determined under an objective standard rather than a subjective one. 541 U.S. at 477. That would entail treating the states' claims the same as claims of other unsecured creditors.

Thus, we start with the prime rate as of the date of the last confirmation hearing, and adjust for risk. 541 U.S. at 479. The testimony at the confirmation hearing was that debtor was unable to obtain a loan in the commercial market, which indicates that the market considers debtor a high risk. The risk of nonpayment by debtor is also evidenced by its difficulties with the various states with regard to its TPM status and the possibility that it will be precluded from selling its product in some states.

While ordinarily this risk would result in an addition to the prime rate, I conclude that adding a risk factor to the prime rate is not appropriate in this case, because the interest is being paid into the escrow accounts, to be returned to debtor if the states do not pursue any claims against debtor. Because the escrow deposits are not paid directly to the states, payment of the prime rate will adequately compensate for the risk of default.

The states also argue that the plan is not fair and equitable, because it proposes to pay interest on Class 3 claims only from the date such claims are allowed, rather than from the date of confirmation. See Debtor’s Third Amended Chapter 11 Plan § 4.03. I agree with the states that § 1129(b)(2) requires that interest commence from the date of confirmation (the plan must provide for payment of the value of the claim as of the effective date); Ambanc La Mesa Ltd. P’ship, 115 F.3d at 654 (senior creditors must be paid interest on claims for post-confirmation time-value of amount of claim). Thus, I will not confirm the plan unless it is modified to provide for interest from the date of confirmation.

Finally, the states complain that the plan is not fair and equitable, because under its view of debtor’s financial projections, debtor will have adequate funds to pay the conceded escrow deposit claims much earlier than the plan proposes to do, and there is excess money going to debtor’s principal, while making the states wait for debtor to come into compliance with the law by curing the default in the escrow deposits. Debtor has convinced me that it will pay the escrow deposits as soon as it can while retaining an adequate cash reserve. To be confirmed, the plan must provide for accelerated payments if debtor has the ability to make payments sooner than provided in the plan. If the plan is so modified, it will meet the test for being fair and equitable.

7. States’ proposed changes to plan language

Finally, the states proposed numerous changes to the language of the

Third Amended Plan. Debtor has agreed to make some but not all of the changes. I have reviewed the parties' arguments with regard to those areas of dispute. I view the plan as debtor's to propose, and will not require changes unless there is some compelling reason to do so.

The states listed 22 proposed changes in their Exhibit 1 to their Final Statement of Objections With Respect to Debtor's Third Amended Plan, filed on January 19, 2006. I have reviewed those proposals and debtor's responses to them. My ruling on the proposed changes is as follows:

A. Debtor need not make the changes proposed in # 2, 5, 6, 7, 10, 11, 12, 15, and 17.

B. Per debtor's agreement, debtor shall make the changes proposed in # 8, 9, 13, and 16.

C. With regard to # 1, debtor must revise the plan language to define "States' Allowed Claims" to mean only the states' claims for prepetition escrow deposits, not their assertions that debtor was not a TPM.

D. With regard to # 3, debtor shall revise the plan language to set an outside deadline for payment in full of the prepetition escrow deposits. The current plan language is ambiguous. Compare ¶ 2.05 with ¶ 4.04. Debtor need not make the other changes proposed in # 3.

E. With regard to # 4, debtor must change the interest rate to the prime rate as of the date of the last confirmation hearing.

F. With regard to # 14 and # 21, debtor must revise ¶ 6.09(d) to provide that no payments will be made to Tideline for royalties until the states’ prepetition escrow deposits have been paid in full. Debtor must revise the language in the executory contract with Tideline to reflect this change. The plan and contract may provide that Tideline’s right to royalties will accrue during the escrow deposit repayment period, but must preclude payment of those royalties until the states’ prepetition escrow deposit claims are paid in full.

G. With regard to # 18, debtor shall revise ¶ 6.02(c) to provide as follows:

> Within one week after debtor receives calculations from the Financial Consultant used to calculate the amount of payment to be made to the States or other parties under this Plan, the Debtor shall provide the Financial Consultant’s calculations to the States and any other party with an unpaid claim, payment of which is affected by the calculation, who makes a written request for such calculations, showing how it calculated the payment made for the applicable period. The States or other parties whose claim payments are affected by the calculations may request that the Court review the calculations and explanations, determine whether the Debtor has complied with the requirements of paragraph 6.09 and, if not, what remedy is appropriate.

Debtor need not make the additional changes requested by the states.

H. With regard to # 19, debtor must revise the second sentence of ¶ 6.09(a) to provide: “Notwithstanding the above, the Debtor may exercise reasonable business judgment to incur expenses that are likely to lead to increased profitability within the Plan time period and allow the company to repay its creditors on a more expedited basis.”

I. With regard to # 20, debtor must revise paragraphs 6.09(b) and (c) as follows:

> (b) The wages or salaries for David H. Redmond, any of his Affiliates paid by the Debtor through D.H. Redmond & Associates, and anyone who would be an insider of David H. Redmond shall only be increased from those paid as of the Effective Date by amounts not to exceed increases in the cost of living.
>
> (c) No new, different or additional forms of compensation or benefits (including but not limited to bonuses, dividends, health or pension benefits or contributions, payments in kind, payments of living expenses or tax reimbursements) shall be paid or awarded after the Effective Date by CTC to David Redmond, any of his Affiliates, or anyone who would be an insider of David H. Redmond, beyond those currently received, other than benefits provided to all employees in the ordinary course of business.

J. With regard to # 22, debtor must insert the following bracketed clause in the first sentence of paragraph 6.09(g): "The debtor shall not make any capital expenditures outside the budget [singly or in combination during the time ¶ 6.09 is in effect] in excess of $500,000 . . . ."

Finally, the plan must provide that the effective date is 11 days after confirmation of the plan, not May 10, 2006, as proposed by debtor.

CONCLUSION

Debtor's Third Amended Plan can be confirmed, provided that, in the Order Confirming Plan, debtor makes the modifications set out in part 7, above, as well as the following modifications:

1. Provide that prepetition escrow deposits will be accelerated if debtor can do so while maintaining its $1 million cash reserve.
2. Provide for payment of interest on unsecured claims commencing on the date of confirmation, rather than the date of allowance of the claims.
3. Provide that amounts sufficient to fund the postpetition escrow

deposits will be set aside monthly through the life of the plan.

Debtor shall submit a revised confirmation order that is consistent with this opinion, or advise the court that it does not wish to proceed to confirmation.

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cc: Tara Schleicher
Karen Cordry
Tony Summers