Driving the Wedge Deeper: Fifth and Ninth Circuits Unite in Refusing to Condemn "Artificial Impairment" in Cramdown Chapter 11 Plans

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One of the prerequisites to confirmation of a cramdown (nonconsensual) chapter 11 plan is that at least one "impaired" class of creditors must vote in favor of the plan. This requirement reflects the basic principle that a plan may not be imposed on a dissident body of stakeholders of which no class has given approval. However, it is sometimes an invitation to creative machinations designed to muster the requisite votes for confirmation of the plan.

"Strategic" classification can entail, among other things, separately classifying similar, but arguably distinct, kinds of claims in an effort to create an accepting impaired class or to prevent a dissenting creditor from dominating a class because its claim is so substantial that the creditor can "block" the class's approval of a plan. This controversial practice, which most commonly arises in a single-asset real estate case involving an undersecured creditor holding a substantial deficiency claim, is sometimes referred to as class "gerrymandering" and has been held to be invalid by many courts, including the Fifth Circuit in *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1991), and the Fourth Circuit in *Travellers Ins. Co. v. Bryson Props., XVIII (In re Bryson Props., XVIII)*, 961 F.2d 496 (4th Cir. 1992).

Strategic classification can also take the form of "manufacturing" an impaired class even though impairment is unnecessary. For example, the plan could pay creditor claims nearly, but not

entirely, in full or modify the rights of the creditors in the class in some incidental way—in either case, with such minimal effect that creditors are still willing to vote to accept the plan despite slight impairment of their claims. Sometimes referred to as “artificial impairment,” this practice is also controversial. *See In re Swartville, LLC*, 2012 BL 211034, *2 (Bankr. E.D.N.C. Aug. 17, 2012) (“artificial impairment” refers to a scenario where a debtor “deliberately impairs a de minimis claim solely for the purpose of achieving a forced confirmation over the objection of a creditor”). So much so, in fact, that there is a split in the federal circuit courts of appeal concerning its legitimacy.

That rift recently widened when the U.S. Court of Appeals for the Fifth Circuit handed down its ruling in *Western Real Estate Equities, LLC v. Village at Camp Bowie I, LP (In re Village at Camp Bowie I, LP)*, 2013 BL 50530 (5th Cir. Feb. 26, 2013). In *Camp Bowie*, the Fifth Circuit joined the Ninth Circuit in holding that section 1129(a)(10) of the Bankruptcy Code, which contains the impaired-class acceptance requirement, “does not distinguish between discretionary and economically driven impairment.” However, the court held that artificial impairment may be relevant in assessing whether a chapter 11 plan has been proposed in bad faith.

Voting and Plan Confirmation in Chapter 11

Confirmation of a chapter 11 plan is possible under two circumstances: (i) the requisite majorities of creditors and equity interest holders in every “class” (explained below) vote in favor of the plan (or are deemed to have done so by reason of being “unimpaired”); or (ii) despite the absence of acceptance by all classes, the plan meets certain minimum standards spelled out in the nonconsensual confirmation, or “cramdown,” provisions of the Bankruptcy Code.

Voting in chapter 11 is tabulated by classes rather than individual creditors or shareholders. This means that a dissenting individual creditor or shareholder can be outvoted if the remaining class members hold enough of the claims or interests in the class to achieve the voting majorities specified in the Bankruptcy Code for class acceptance. As such, how a claim or interest is classified can have a significant impact on the debtor's prospects for confirming a chapter 11 plan. For example, as noted, a creditor whose claim is substantial enough to give it voting control of a class may be able to block confirmation.

Confirmation is possible only if at least one "impaired" class of creditors or shareholders under the plan votes to accept it (without counting insider votes). This requirement, which appears in section 1129(a)(10) of the Bankruptcy Code, operates as one of several statutory gatekeepers to cramdown. Cramdown is a powerful remedy—it imposes a binding reorganization (or liquidation) scheme upon a body of dissenting creditors and other stakeholders predicated upon sometimes complicated judicial determinations concerning asset and claim valuation, feasibility, and other important issues. Section 1129(a)(10) is premised on the policy that, before compelling stakeholders to bear the consequences associated with cramdown, at least one class whose members are not being paid in full (or whose claims or interests are otherwise "impaired") is willing to go along with the chapter 11 plan.

Cramdown Requirements

Section 1129(b) of the Bankruptcy Code sets forth the requirements that must be met before a bankruptcy court can confirm a chapter 11 plan over the objections of a dissenting class of

creditors whose rights are impaired by the plan. Among these cramdown requirements is the dictate in section 1129(b)(1) that a plan "not discriminate unfairly" and that it be "fair and equitable" with respect to a dissenting class of creditors.

A plan discriminates unfairly if it treats a dissenting class of creditors less favorably than other classes of creditors that are similarly situated in terms of their legal rights to payment.

Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured claimants' retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan's effective date, of their secured claims; (ii) the sale, subject to a secured creditor's right to credit-bid its claim, of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims.

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor of lesser priority, or no equity holder, receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

Impairment

Section 1123(b)(1) of the Bankruptcy Code provides that a chapter 11 plan may "impair or leave unimpaired any class of claims, secured or unsecured, or of interests." Section 1124 defines "impairment" as follows:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) *leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest* [emphasis added]; or
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
>
> (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;
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> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;
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> (D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and
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> (E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

Section 1123(a)(4) states that a plan must provide the same treatment for creditors or interest holders in the same class "unless the holder of a particular claim or interest agrees to a less favorable treatment" of its claim or interest.

Section 1124 is derived from section 107 of chapter X of the former Bankruptcy Act of 1898 (11 U.S.C. § 507; repealed in 1978), which provided that "creditors" or "any class thereof" would be "affected" for purposes of a plan—and therefore entitled to vote—"only if their or its interest shall be materially and adversely affected thereby." When section 1124 (and the remainder of the Bankruptcy Code) was enacted in 1978, the legislative history indicates that floor leaders for the final version of the bill stated that the provision "defines the new concept of 'impairment' of claims or interests; the concept differs significantly from the concept of 'materially and adversely affected' under the Bankruptcy Act." 124 Cong. Rec. H11,103 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,419–17,420 (daily ed. Oct. 6, 1978).

Section 1124 originally included a third option for rendering a claim unimpaired: by providing the claimant with cash equal to the allowed amount of its claim. This option was removed by the Bankruptcy Reform Act of 1994. The amendment overruled a bankruptcy court's decision in *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1984). In *New Valley*, the court ruled that unsecured creditors of a solvent debtor who are to be paid in full in cash under a chapter 11 plan are unimpaired even though the plan does not provide for the payment of postpetition interest on their claims.

The 1994 amendment permits creditors slated not to receive postpetition interest under a plan involving a solvent debtor to vote against the plan. (Pursuant to sections 1126(a), (f), and (g) of the Bankruptcy Code, only the holders of impaired claims or interests are permitted to vote.) Assuming that the class of creditors rejects the plan, it can be confirmed only if the plan satisfies the cramdown standards in section 1129(b). Also, because their claims are impaired, these

creditors are entitled to the protection of the "best interests of creditors" test in section 1129(a)(7), which requires that they receive or retain at least as much under a chapter 11 plan as they would receive in a chapter 7 liquidation. Since 1994, most courts considering the issue have held that payment in full in cash with postpetition interest at an appropriate rate constitutes unimpairment under section 1124(1).

Artificial Impairment

Courts disagree over the question of whether section 1129(a)(10) draws a distinction between "artificial" and "economically driven" impairment. For example, in *Matter of Windsor on the River Associates, Ltd.*, 7 F.3d 127 (8th Cir. 1993), the Eighth Circuit ruled that "a claim is not impaired [for purposes of section 1129(b)] if the alteration of the rights in question arises solely from the debtor's exercise of discretion." According to this approach, section 1129(a)(10) recognizes impairment only to the extent that it is caused by economic "need."

Many courts have applied *Windsor* to deny confirmation of a chapter 11 plan impairing the *de minimis* claims of some creditors for the purpose of contriving a class to accept the plan. *See*, *e.g.*, *In re Combustion Engineering*, *Inc.*, 391 F.3d 190, 243−44 (3d Cir. 2003); *In re All Land Investments, LLC*, 468 B.R. 676, 690 (Bankr. D. Del. 2012); *In re Daly*, 167 B.R. 734, 737 (Bankr. D. Mass. 1994); *see also In re Deming Hospitality, LLC*, 2013 BL 93045, *6 (Bankr. D.N.M. Apr. 5, 2013) (stating that "[i]f there is no economic justification for failing to pay Class 6 in full after confirmation rather than the proposed 75%, then the impairment of the class likely would be 'artificial' and impermissible"). These courts reason that allowing manipulation of this kind undermines the policy of consensual reorganization expressed in section 1129(a)(10).

Other courts have concluded that artificial impairment does not violate section 1129(a)(10). In *L & J Anaheim Assocs. v. Kawasaki Leasing Intl., Inc. (In re L & J Anaheim Assocs.)*, 995 F.2d 940 (9th Cir. 1993), for example, the Ninth Circuit ruled that section 1129(a)(10) does not distinguish between discretionary and economically driven impairment. According to the court, "the plain language of section 1124 says that a creditor's claim is 'impaired' unless its rights are left 'unaltered' by the plan," and "[t]here is no suggestion here that only alterations of a particular kind or degree can constitute impairment." *Accord In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213 (Bankr. D.N.J. 2000); *In re Duval Manor Assocs*., 191 B.R. 622 (Bankr. E.D. Pa. 1996).

Many of these courts have reasoned, however, that artificial impairment is relevant to the issue of the debtor's good faith in proposing a chapter 11 plan. Section 1129(a)(3) of the Bankruptcy Code provides that a plan may be confirmed only if "proposed in good faith and not by any means forbidden by law." Even if artificial impairment is not impermissible per se, these courts have held, contriving an impaired class may constitute bad faith. *See*, *e.g.*, *FNMA v. Village Green I, GP*, 483 B.R. 807 (W.D. Tenn. 2012) (refusing to reject artificial impairment outright but holding that, under either section 1129(a)(3) or 1129(a)(10), the debtor must demonstrate some economic justification for delaying payment to *de minimis* creditors); *In re The Beare Co.*, 177 B.R. 886 (Bankr. W.D. Tenn. 1994).

The Fifth Circuit weighed in on the issue of artificial impairment in *Camp Bowie*.

Camp Bowie

Village at Camp Bowie I, LLC ("VCB") owns real property in Fort Worth, Texas, that includes several buildings leased out by VCB for retail and office space. In 2010, VCB defaulted on loans secured by the real estate. The day before a scheduled foreclosure sale of the property, VCB filed for chapter 11 protection in Texas.

At the time of the filing, VCB owed approximately $32 million to the mortgagee, Western Real Estate Equities, L.L.C. ("Western"), which acquired the debt with the intention of displacing VCB as the owner of the property. VCB's other debts consisted of approximately $60,000 in miscellaneous claims held by 38 trade creditors.

Western sought relief from the automatic stay, arguing that VCB lacked both equity in the property and any prospect of proposing a confirmable chapter 11 plan. The bankruptcy court ultimately found that the real property was worth $34 million, such that Western was oversecured and VCB had equity in the property.

VCB filed a series of proposed chapter 11 plans, the latest of which designated two impaired-creditor classes. The first class consisted of Western's secured claim, as to which VCB proposed to give Western a new five-year balloon note accruing interest at 6.4 percent secured by the real estate. The other class included all unsecured claims, which VCB proposed to pay in full within three months of the effective date of the plan, without interest. Finally, the plan provided that VCB's prebankruptcy owners and certain related parties would receive 100 percent of the equity in the reorganized VCB in exchange for a cash infusion of $1.5 million.

The unsecured class unanimously voted to accept the plan. Western voted against the plan and argued at the confirmation hearing that the plan violated section 1129(a)(10) because it impaired the trade claims solely to create an accepting impaired class. According to Western, VCB had the cash flow to pay off the trade claims in full at confirmation. Western also claimed that VCB's tactics constituted an abuse of the bankruptcy process in violation of the good-faith requirement of section 1129(a)(3).

The bankruptcy court confirmed VCB's plan. It rejected Western's theory that section 1129(a)(10) distinguishes between artificial and economically driven impairment. It also concluded that, although artificial impairment is a factor to consider in determining whether a plan proponent has complied with section 1129(a)(3), "in the usual case, artificial impairment does not amount per se to a failure of good faith." The court certified an appeal of its ruling directly to the Fifth Circuit, on the basis that the opinion addressed questions of law as to which there was no controlling Fifth Circuit or U.S. Supreme Court precedent and that an immediate appeal might materially advance progress of the case.

The Fifth Circuit's Ruling

A three-judge panel of the Fifth Circuit affirmed. At the outset of its analysis, the court noted that "this Circuit has yet to stake out a clear position in the debate over artificial impairment." The panel discussed prior Fifth Circuit case law on the issue. In *Brite v. Sun Country Development, Inc. (In re Sun Country Development, Inc.)*, 764 F.2d 406 (5th Cir. 1985), the debtor, to satisfy section 1129(a)(10), modified its treatment of unsecured creditors under a chapter 11 plan from payment in full to a distribution of nonnegotiable 90-day notes. The court ruled that the plan did not violate section 1129(a)(3) because, among other things, the bankruptcy

court found that the change was "necessary," as the debtor's cash flow was insufficient to pay creditors in full on confirmation.

In *Sandy Ridge Development Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Development Corp.)*, 881 F.2d 1346 (5th Cir. 1989), the Fifth Circuit remanded a case to the bankruptcy court for, among other things, a determination as to whether artificial impairment under a chapter 11 plan to create an accepting impaired class satisfies the good-faith requirement of section 1129(a)(3).

With this preamble, the Fifth Circuit in *Camp Bowie* staked out its position on the issue—this time unequivocally:

> Today, we expressly reject *Windsor* and join the Ninth Circuit in holding that § 1129(a)(10) does not distinguish between discretionary and economically driven impairment. As the *Windsor* court itself acknowledged, § 1124 provides that "any alteration of a creditor's rights, no matter how minor, constitutes 'impairment.' " . . . By shoehorning a motive inquiry and materiality requirement into § 1129(a)(10), *Windsor* warps the text of the Code, requiring a court to "deem" a claim unimpaired for purposes of § 1129(a)(10) even though it plainly qualifies as impaired under § 1124. . . . *Windsor*'s motive inquiry is also inconsistent with § 1123(b)(1), which provides that a plan proponent "*may* impair or leave unimpaired any class of claims," and does not contain any indication that impairment must be driven by economic motives. . . .

According to the Fifth Circuit, the *Windsor* court based its "strained reading" of sections 1129(a)(10) and 1124 on the premise that lawmakers enacted section 1129(a)(10) "to provide some indicia of support [for a cramdown plan] by affected creditors," and it reasoned that literal application of section 1124 would "vitiate this congressional purpose." That approach, the Fifth Circuit emphasized, is flawed because "the Bankruptcy Code *must* be read literally, and congressional intent is relevant only when the statutory language is ambiguous." Moreover, the

court explained, the scant legislative history of section 1129(a)(10) “provides no insight as to the provision’s intended use,” and Congress, when it enacted section 1124, “considered and rejected precisely the sort of materiality requirement that *Windsor* has imposed by judicial fiat.”

The Fifth Circuit also faulted *Windsor*’s reasoning that condoning artificial impairment would “reduce [section 1129(a)(10)] to a nullity.” The Eighth Circuit’s logic in *Windsor*, the Fifth Circuit explained, is premised on “the unsupported assumption that Congress intended § 1129(a)(10) to implicitly mandate a materiality requirement and a motive inquiry.” According to the court, such an approach ignores the determinative role the provision plays in the typical single-asset bankruptcy, where the debtor has negative equity and the secured creditor has an unsecured-deficiency claim that allows it to control the unsecured class. “In such circumstances,” the Fifth Circuit wrote, “secured creditors routinely invoke § 1129(a)(10) to block confirmation, . . . aided rather than impeded by the Code’s broad definition of impairment.”

The Fifth Circuit rejected Western’s argument that the Fifth Circuit’s 1991 condemnation of gerrymandering in *Greystone* “enunciate[s] a broad, extraordinary, extrastatutory policy against ‘voting manipulation’ ” and that “prohibiting artificial impairment is merely the next logical extension of this policy.” This contention, the court wrote, “brushes over the fact that *Greystone*’s anti-gerrymandering principle resolves an ambiguity left open by the classification rules set forth in § 1122.” *Greystone*, the Fifth Circuit observed, “does not stand for the proposition that a court can ride roughshod over affirmative language in the Bankruptcy Code to enforce some Platonic ideal of a fair voting process.”

Having concluded that a plan proponent's motives and methods for satisfying section 1129(a)(10) must be scrutinized, "if at all, under the rubric of § 1129(a)(3)," the Fifth Circuit examined the bankruptcy court's finding that VCB had proposed its chapter 11 plan in good faith. The court of appeals found no clear error in this determination. VCB, the Fifth Circuit wrote, "proposed a feasible cramdown plan for the legitimate purposes of reorganizing its debts, continuing its real estate venture, and preserving its non-trivial equity in its properties." According to the court, "A single-asset debtor's desire to protect its equity can be a legitimate Chapter 11 objective."

However, the Fifth Circuit cautioned that, "though we reject the concept of artificial impairment as developed in *Windsor*, we do not suggest that a debtor's methods for achieving literal compliance with § 1129(a)(10) enjoy a free pass from scrutiny under § 1129(a)(3)." According to the court, had the case involved the creation of "an impaired accepting class out of whole cloth" in a "sham" lending transaction with related parties, rather than independent trade creditors who extended prepetition credit to VCB in the ordinary course of business, "[a]n inference of bad faith might be stronger."

Outlook

Camp Bowie can be viewed as a positive development for single-asset debtors with an oversecured creditor. By refusing to invalidate artificial impairment outright, the Fifth Circuit made it easier for a debtor to obtain confirmation of a nonconsensual chapter 11 plan that impairs the claim of an oversecured creditor by modifying its credit terms. Whether the possibility of such adverse treatment may make it more difficult for single-asset entities to obtain financing (at least in the Fifth Circuit) remains to be seen.

An oversecured creditor in a single-asset bankruptcy case is far from the norm. The more common scenario involves an undersecured creditor and strategic classification—gerrymandering—to isolate the unsecured-deficiency claim in a separate class and thereby prevent the creditor from blocking confirmation. The Fifth Circuit was careful to distinguish between artificial impairment and gerrymandering.

Finding an accepting impaired class of creditors can also be challenging in non-single-asset chapter 11 cases, where a debtor typically wants to preserve its trade creditor and employee relationships, while restructuring long-term debt and other obligations. *Camp Bowie* will provide debtors in the Fifth Circuit greater flexibility to technically impair “friendly” classes of creditors to create an accepting impaired class under a nonconsensual plan.