

By RICHARD A. ROBINSON

## All Good-Faith Impairments of Classes Are Created Equal

All chapter 11 debtors need to have an impaired accepted class under § 1129(a)(10) of the Bankruptcy Code. The limits on a debtor's ability to "artificially" impair a class to satisfy § 1129(a)(10) may determine whether a debtor can reorganize. In *Western Real Estate Equities LLC v. Village at Camp Bowie I LP* (*In re Village at Camp Bowie I LP*),<sup>1</sup> the U.S. Court of Appeals for the Fifth Circuit addressed "artificial" impairment. Under the plan proposed by the debtor, Village at Camp Bowie I LP, there were two impaired classes of creditors. One class included the oversecured claim of Western Real Estate Equities LLC,<sup>2</sup> and a second class included unsecured claims.<sup>3</sup>

With respect to Western's fully secured claim, the plan provided for payments, including interest, on a five-year note with a balloon payment due at the end of the term on all unpaid principal and interest.<sup>4</sup> With respect to the class of unsecured creditors, the plan provided for payment in full, without interest, within three months of the effective date.<sup>5</sup> The holders of all 38 unsecured claims in the case, with claims aggregating approximately \$59,000, voted to accept the plan.<sup>6</sup> Western, on account of its secured claims in excess of \$30 million, voted to reject the plan.<sup>7</sup>

Not surprisingly, Western argued that the Village at Camp Bowie had the financial wherewithal to pay the unsecured claims in full on the effective date and that it impaired such unsecured claims "solely" to create an accepting impaired class to satisfy § 1129(a)(10).<sup>8</sup> Western further argued that such "artificial" impairment constituted an "abuse of the bankruptcy process" and, accordingly, that the plan was not proposed in good faith as required by § 1129(a)(3).<sup>9</sup>

Noting that the definition of impairment in § 1124 of the Bankruptcy Code does not "require any particular degree of impairment," the bankruptcy court refused to distinguish "between artificial and economically driven impairment."<sup>10</sup> The bankruptcy court declared that "in the usual case, arti-

cial impairment does not amount *per se* to a failure of good faith."<sup>11</sup> Thus, the bankruptcy court held that the plan was proposed in good faith because it was proposed for "legitimate bankruptcy purposes of reorganizing its debts, continuing its real estate venture and preserving its nontrivial equity in its real estate."<sup>12</sup>

On appeal, the Fifth Circuit recognized the split of authority on whether a plan may be confirmed notwithstanding "artificial" impairment of a class of claims. The Eighth Circuit and certain lower courts have held that a class of claims should not be considered impaired for purposes of § 1129(a)(10) if the impairment is the result of the plan proponents' exercise of "discretion" and not "driven by economic 'need.'"<sup>13</sup> Conversely, the Ninth Circuit and certain other lower courts adopted a plain-language interpretation of § 1129(a)(10) consistent with the holding of the bankruptcy court in *Village at Camp Bowie*.<sup>14</sup>

Aligning itself with the Ninth Circuit, the Fifth Circuit declined to recognize any distinction between "artificial" and "economically driven" impairment.<sup>15</sup> The Fifth Circuit reasoned:

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at page 3.

<sup>13</sup> *Matter of Windsor on the River Associates Ltd.*, 7 F.3d 127, 132 (8th Cir. 1993) ("If this impairment has been manufactured, then the plan must be regarded as having circumvented the purpose of the statute, namely, consensual reorganization."); *In re All Land Investments LLC*, 468 B.R. 676, 690 (Bankr. D. Del. 2012) (citations omitted) ("I conclude that it is appropriate to consider whether Classes 1 and 3 are artificially impaired; that is, are Classes 1 and 3 impaired for a proper business purposes solely to satisfy § 1129(a)(10)?"); *In re Daly*, 167 B.R. 734, 737-37 (Bankr. D. Mass. 1994) (citations omitted) ("This contrived and artificial impairment can be viewed as a violation of the requirement of an accepting impaired class, § 1129(a)(10), or as a violation of the requirement that the plan be proposed in good faith, § 1129(a)(3), or as both. Whichever way it is viewed, it prevents confirmation of the plan."); *In re N. Washington Ctr. Ltd. P'ship*, 165 B.R. 805, 810 (Bankr. D. Md. 1994) (citations omitted); *In re Miami Ctr. Assocs. Ltd.*, 144 B.R. 937, 943 (Bankr. S.D. Fla. 1992) (citations omitted) ("A debtor cannot artificially impair a class to satisfy the requirements of § 1129(a)(10)."); *Willows Convalescent Ctrs. Ltd. P'ship v. Unum Life Ins. Co.* (*In re Willows Convalescent Ctrs. Ltd. P'ship*), 151 B.R. 220, 222-23 (D. Minn. 1991) (citations omitted) ("The law is clear that a debtor may not manufacture impaired classes merely for the purpose of gathering votes in favor of its Plan."); *In re Lettich Typographic Inc.*, 103 B.R. 32, 39 (Bankr. D. Conn. 1989) (citations omitted) ("While the debtor may have achieved literal compliance with § 1129(a)(10), this engineered impairment so distorts the meaning and purpose of that subsection that to permit it would reduce (a)(10) to a nullity."); *In re Club Assocs.*, 107 B.R. 385, 401 (Bankr. N.D. Ga. 1989) (citations omitted) ("An alteration [that] is clearly intended only to create an impaired class to vote in favor or a plan so that a debtor can effectuate a cramdown, however, will not be allowed.");

<sup>14</sup> *Matter of L&J Anaheim Assocs.*, 995 F.2d 940,943 (9th Cir. 1993); *Conn. Gen. Life Ins. Co. v. Hotel Assocs. of Tucson* (*In re Hotel Assocs. of Tucson*), 165 B.R. 470, 475 (B.A.P. 9th Cir. 1994) (citations omitted) ("[N]owhere does the Code require a plan proponent to use all efforts to create unimpaired classes. Such a requirement should not be imposed by judicial fiat."); *In re Grete Bay Hotel & Casino Inc.*, 251 B.R. 213, 240 (Bankr. D.N.J. 2000) (citations omitted); *In re Duval Manor Assocs.*, 191 B.R. 622, 628 (Bankr. E.D. Pa. 1996) (citations omitted) ("This Court agrees that restricting 'artificial' impairment could itself give rise to a veritable Pandora's box of related problems, as Courts perforce grapple with disputes over the particular degree of class impairment needed to pass muster."); *In re The Beare Co.*, 177 B.R. 886, 889 (Bankr. W.D. Tenn. 1994) (citations omitted).

<sup>15</sup> *Camp Bowie* at page 4.



**Richard A. Robinson**  
Reed Smith LLP,  
Wilmington, Del.,  
and New York

Richard Robinson is a partner in Reed Smith LLP's Creditors' Rights and Bankruptcy Group, practicing in the firm's Wilmington, Del., and New York offices.

<sup>1</sup> *Western Real Estate Equities LLC v. Village at Camp Bowie I LP* (*In re Village at Camp Bowie I LP*), No. 12-10271, 2013 WL 690497 (5th Cir. Feb. 26, 2013).

<sup>2</sup> *Id.* at page 2.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

By shoehorning a motive inquiry and materiality requirement into § 1129(a)(10), *Windsor* [the decision of the Eighth Circuit] 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.<sup>16</sup>

The Fifth Circuit rejected the Eighth Circuit’s determination that allowing “artificial” impairment would render § 1129(a)(10) a “nullity.”<sup>17</sup> Specifically, the court declared:

The *Windsor* court also reasoned that condoning artificial impairment would “reduce [§ 1129(a)(10)] to a nullity.” But this logic sets the cart before the horse, resting on the unsupported assumption that Congress intended [for] § 1129(a)(10) to implicitly mandate a materiality requirement and motive inquiry. Moreover, it ignores the determinative role [that] § 1129(a)(10) plays in the typical single-asset bankruptcy, in which the debtor has negative equity and the secured creditor receives a deficiency claim that allows it to control the vote of the unsecured class. In such circumstances, secured creditors routinely invoke § 1129(a)(10) to block a cramdown, aided rather than impeded by the Code’s broad definition of impairment.<sup>18</sup>

In *Village at Camp Bowie*, Western was oversecured, and accordingly, § 1129(a)(10) did not aid Western’s attempt to thwart confirmation. Turning its attention to the good-faith requirement of § 1129(a)(3), the Fifth Circuit could not conclude that the lower court “erred in its § 1129(a)(3) analysis, particularly as we have recognized that a single-asset debtor’s desire to protect its equity can be a legitimate Chapter 11 objective.”<sup>19</sup> The court noted that although artificial impairment alone does not evidence a lack of good faith where a single-asset debtor seeks to protect its equity through a chapter 11 plan, “the [§ 1129(a)(3) inquiry is fact-specific, fully empowering the bankruptcy courts to deal with chicanery.”<sup>20</sup> The Fifth Circuit’s holding in *Village at Camp Bowie* will significantly alter the balance of power in plan negotiations and intensify the debate regarding the propriety of “artificial” impairment.

The importance of the Fifth Circuit’s holding in *Village at Camp Bowie* is well illustrated by a recent decision of the U.S. District Court for the Western District of Tennessee.<sup>21</sup> In *In re Village Green*, the plan proponent was relying on the vote of a *de minimis* class of unsecured claims of approximately \$2,400 that was being paid in full in two equal installments payable on the 30th and 60th day after the effective date.<sup>22</sup> Not surprisingly, the undersecured creditor (which held an unsecured deficiency claim of in excess of \$2 million) objected to confirmation.<sup>23</sup> The plan proponent argued that the *de minimis* class, which had accepted the plan, was

an impaired class for purposes satisfying § 1129(a)(10). In reversing and remanding the bankruptcy court on the issue of “artificial” impairment, the district court noted that the plan proponent “must demonstrate some economic justification for delaying payment [and thereby creating impairment] to the *de minimis* creditors.”<sup>24</sup> In contrast, the Fifth Circuit’s holding in *Village at Camp Bowie*—depending on the applicable, controlling precedent, if any, or separate classification of the unsecured deficiency claim—would appear, on its face, to leave the door open for a plan proponent to attempt to use a *de minimis* class as an impaired accepting class for purposes of § 1129(a)(10).

**[T]he ability to gerrymander or manipulate classes of creditors and to “artificially” impair classes of creditors is likely to affect venue choices as federal courts line up with the Eighth Circuit or the Ninth and Fifth Circuits.**

Notably, bankruptcy courts in the most popular venues for filing business bankruptcy cases, the Southern District of New York and the District of Delaware, have addressed the propriety of utilizing the vote of an “artificially” impaired class to satisfy the requirement of § 1129(a)(10).<sup>25</sup> The majority of these cases, following the Eighth Circuit, have denied confirmation under § 1129(a)(10) due to a lack of a legitimate business purpose (other than seeking to confirm a plan) for the impairment of the class of claims.<sup>26</sup> There is, nevertheless, one case in the Southern District of New York in which the bankruptcy court does not address whether “artificial” impairment precludes a finding that § 1129(a)(10) has been satisfied because the court determined that the same underlying conduct constitutes bad faith under § 1129(a)(3).<sup>27</sup>

## Conclusion

Absent guidance from the U.S. Supreme Court, the ability to gerrymander or manipulate classes of creditors and to “artificially” impair classes of creditors is likely to affect venue choices as federal courts line up with the Eighth Circuit or the Ninth and Fifth Circuits. “Artificial” impairment to satisfy § 1129(a)(10) is likely to be more successful in cases where (1) secured creditors are oversecured and (2) secured creditors are undersecured, in jurisdictions where there is no controlling precedent prohibiting the separate classification of unsecured deficiency claims. **abi**

<sup>24</sup> *Id.* at page 7.

<sup>25</sup> See *In re All Land Investments LLC*, 468 B.R. 676, 692 (Bankr. D. Del. 2012); *In re Fur Creations by Varriale Ltd.*, 188 B.R. 754, 760 (Bankr. S.D.N.Y. 1995); *cf.*, *In re Global Ocean Carriers*, 251 B.R. 31, 42 (Bankr. D. Del. 2000); *In re Quigley Co. Inc.*, 437 B.R. 102, 126, fn.31 (Bankr. S.D.N.Y. 2010); *cf.*, *In re Combustion Engineering Inc.*, 391 F.3d 190, 244 (3d Cir. 2004) (citations omitted) (“On the facts here, the monitoring function of § 1129(a)(10) may have been significantly weakened. This type of manipulation is especially problematic in the asbestos context where a voting majority can be made to consist of nonmalignant claimants whose interests may be adverse to those of claimants with more severe injuries.”).

<sup>26</sup> *Id.*

<sup>27</sup> *Quigley* at page 126, fn.31 (citations omitted) (“There is a split of authorities as to whether the creation of an artificially impaired accepting class violates § 1129(a)(10) or, instead, is a species of lack of good faith under § 1129(a)(3)... Because the Court concludes that the voting manipulation in this case constituted bad faith under § 1129(a)(3), it does not address whether the same conduct is also prohibited under § 1129(a)(10).”).

<sup>16</sup> *Id.* at page 4 (citations omitted).

<sup>17</sup> *Id.* at page 5.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at page 7 (citations omitted).

<sup>20</sup> *Id.* at pages 7-8.

<sup>21</sup> *Federal National Mortgage Ass’n v. Village Green I GP (In re Village Green I GP)*, No. 12-2163, 2012 WL 6045896 (W.D. Tenn. Dec. 5, 2012).

<sup>22</sup> *Id.* at page 2.

<sup>23</sup> *Id.*