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Client Alert

Financial Restructuring Practice Group

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Fifth Circuit Rejects "Artificial Impairment" Standard in Confirmation of Single Asset Real Estate Plan

In a pro-debtor opinion released on February 26, 2013, the Fifth Circuit Court of Appeals held that a debtor may "artificial impair" claims in a class to obtain an impaired and accepting class of claims as required by section 1129(a)(10) of the Bankruptcy Code. *Western Real Estate Equities, L.L.C. v. Village at Camp Bowie I, L.P. (In re Village at Camp Bowie I, L.P.)*, No. 12-10271, 2013 WL 690497 (5th Cir. Feb. 26, 2013).

Statutory Background to the Artificial Impairment Issue

As a condition of confirmation of a Chapter 11 plan, Bankruptcy Code section 1129(a)(10) requires that at least one class of claims that is impaired under the plan has accepted the plan. This is referred to as the "impaired and accepting class" requirement. A class of claims is considered impaired unless the plan leaves unaltered the legal, equitable, and contractual rights of the claim holder. 11 U.S.C. § 1124(1).

The combined effect of Bankruptcy Code sections 1129(a)(10) and 1124(1) is that a plan must either leave the rights of creditors unaltered (rendering their claims unimpaired), or there must be at least one impaired class of creditors voting in favor of the plan (excluding the votes of insiders). This requirement creates an issue in single asset real estate cases where the secured lender expresses its dissatisfaction with the payment terms proposed by the plan and the debtor is left scrambling to find an impaired class that will accept the plan.

A common solution to this quandary is to "impair" a class of unsecured claims not controlled by the secured creditor's deficiency claim (if any) by proposing to pay such claims in full, but without interest over the course of a few months. Such minimal altering of the rights of these creditors, "impairs" their claims for purposes of Section 1124. This practice, particularly when the debtor has the economic ability to pay unsecured claims in full with interest, has been the subject of significant debate and conflicting court decisions, both under the statutory provisions quoted above and Bankruptcy Code section 1129(a)(3), which requires that "[t]he plan has been proposed in good faith and not by any means forbidden by law."

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The *In re Village at Camp Bowie I, L.P.* Bankruptcy Case

In *In re Village at Camp Bowie I, L.P.*, the debtor owned commercial real estate that secured payment of promissory notes in the principal amount of approximately $32,000,000. The collateral was determined to be worth $34,000,000. Western Real Estate Equities I, LLC ("Western") acquired the notes at a discount after they matured and promptly commenced foreclosure proceedings. The debtor filed a Chapter 11 petition the day before the scheduled foreclosure sale.

Several months after the bankruptcy filing, and after having defeated a motion to lift the automatic stay brought by Western, the debtor filed its Chapter 11 plan of reorganization. The plan created two impaired creditor classes, one consisting of Western's $32,000,000 secured claim and the other consisting of $58,000 in unsecured trade debt owed to vendors who provided the property with maintenance, landscaping, repairs, and the like. The plan provided for payment of Western's claim with a five-year balloon note with interest accruing at a 6.4% annual rate. The plan provided for payment of the trade claims in full, without interest, over three months. In addition, the plan provided for a capital infusion of $1,500,000 by the pre-petition equity holders and related parties, in exchange for newly issued preferred equity.

Western objected to the plan and voted against it, while all thirty-eight unsecured trade creditors voted in favor. Among other things, Western argued that the debtor had only "minimally impaired" the unsecured trade creditor class by delaying payment for three months and refusing to pay interest during that time and therefore the class of unsecured trade creditors should not be viewed as an impaired class for purposes of section 1129(a)(10). According to Western, the aggregate economic impairment suffered by the unsecured trade creditors by deprivation of three months interest at the prevailing judgment rate was only about $900. Western argued that such impairment was not material and, moreover, it was artificial because there was no dispute that the debtor had the cash to pay those claims in full at the time of confirmation. In addition, Western posited that the debtor's artificial impairment of unsecured trade claims violated the good faith requirement of Bankruptcy Code section 1129(a)(3).

The Bankruptcy Court rejected Western's arguments and, following a three-day confirmation hearing, confirmed the debtor's plan of reorganization. The Court observed that neither section 1124 nor section 1129(a)(10) impose a materiality requirement to the definition of impairment or to the requirement for an impaired accepting class.

With respect to good faith, the Bankruptcy Court suggested that artificial impairment is a factor to consider under section 1129(a)(3), but found that no bad faith existed because the Debtor's bankruptcy plan furthered the legitimate bankruptcy purposes of preserving existing equity, reorganizing debts, and continuing the Debtor's business.

The Fifth Circuit's Decision

The Fifth Circuit observed the existence of a circuit split on the issue of whether artificial, as opposed to economically driven, impairment is allowed. The Eighth Circuit Court of Appeals in *In re Windsor on the River Associates, Ltd.*, 7 F.3d 127 (8th Cir. 1993), held that a claim is not truly impaired if the alteration in rights arises solely form the debtor's exercise of its discretion. In contrast, in *In re L&J Anaheim Associates*, 995 F.2d 940 (9th Cir. 1993), the Ninth Circuit Court of appeals relied on the "plain language" of the statutes to leave open the possibility that discretionary impairment could be permitted.

Siding with the Ninth Circuit, the Fifth Circuit concluded that artificial impairment is not disqualifying for purposes of determining whether section 1129(a)(10) has been satisfied. The Court unambiguously rejected the Eighth Circuit's position as requiring "a motive inquiry and materiality requirement" that is not present in the statutes and observed that its decision in 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."

The Court also rejected the argument that its prior opinion in *In re Greystone III Joint Venture*, 995 F.2d 1274 (5th Cir. 1991) created a "broad, extrastatutory policy against 'voting manipulation.'" In that case the Fifth Circuit had held that a plan proponent cannot gerrymander creditor claims in order to create an impaired accepting class—but it did not decide the artificial impairment issue or provide a basis to "ride roughshod over affirmative language in the Bankruptcy Code to enforce some Platonic ideal of a fair voting process."

Finally, the Court held that discretionary or artificial impairment of a class of claims does not constitute bad faith for purposes of section 1129(a)(3) which required the plan proponent to have proposed the plan in good faith. The Court observed that section 1129(a)(3) generally is satisfied where "a plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success . . . .". Based on the findings by the Bankruptcy Court that the Debtor's plan had been proposed for the legitimate purpose to preserve its significant equity in the property, to reorganize its debts, and to continue its real estate venture, the Court had little trouble finding an absence of clear error. This is particularly true given the Court's previous holdings recognizing that a single asset real estate debtor's "desire to protect its equity can be a legitimate Chapter 11 objective." By holding that "artificial" impairment is not per se bad faith, the Court provided clear guidance that a proper factual evaluation of good faith is required, and a creditor cannot shortcut this analysis by demonstrating that artificial impairment has occurred.

Outlook

The Fifth Circuit articulated two bright-line principles in *In re Village at Camp Bowie I, L.P*. that will impact single asset real estate practice. First, Bankruptcy Code section 1129(a)(10) does not prohibit a debtor from using its discretion to "artificially" impair a class of claims. Second, such artificial impairment does not *per se* constitute bad faith under Bankruptcy Code section 1129(a)(3). The Court decision makes reorganization more feasible for single asset real estate debtors who often have minimal claims other than those held by the secured lender. It also creates an interesting juxtaposition with the Court's decision more than twenty years ago in *Greystone* strictly prohibiting the "gerrymandering" of claims within classes to obtain an impaired accepting class. Thus, in the Fifth Circuit, the good faith impairment of claims is permitted, but separate classification of similar claims is not.