Real Estate Committee

ABI Committee News

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Artificial Impairment of Classes in a Cramdown Plan Permitted in Fifth Circuit

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Fifth Circuit's Decision in *In re Village at Camp Bowie I L.P.*

In a recent decision, the Fifth Circuit provided its answer to the question of whether § 1129(a)(10) of the Bankruptcy Code draws a distinction between artificial and economically driven impairment and held that the plain language of that section does not distinguish between the two. In *In re Village at Camp Bowie I L.P.,*[1] the Fifth Circuit upheld the bankruptcy court's order confirming the debtor's chapter 11 cramdown plan based on the plan's acceptance by a small class of unsecured creditors ($59,000 as compared to secured debt of $32 million). The evidence showed that the unsecured creditors could have been immediately paid in full by the debtor and thus be considered "unimpaired," but instead were paid over three months without interest, which created the impairment. The secured creditor, Western Real Estate Equities L.L.C. (Western), argued that the debtor's cramdown plan offended § 1129(a)(10) by "artificially" impairing the unsecured trade creditors solely to create an accepting impaired class in violation of § 1129(a)(10) and the good-faith requirement of § 1129(a)(3). In support of this argument, Western cited to the Eighth Circuit's decision in *Matter of Windsor on the River Associate Ltd.,*[2] which held that "a claim is not impaired [for the purposes of § 1129(a)(10)] if the alteration of the rights in question arises solely from the debtor's exercise of discretion." Accordingly, the Eighth Circuit recognized impairment only to the extent driven by economic "need."[3] In *Village Camp*, the Fifth Circuit expressly rejected *Windsor* and joined the Ninth Circuit's decision in *Matter of L&J Anaheim Associates*[4] in holding that § 1129(a)(10) does not distinguish between discretionary and economically driven impairment.

Fifth Circuit's Analysis of § 1129(a)(10)

The Fifth Circuit criticized the *Windsor* court's interpretation of § 1129(a)(10) as warping the plain language of the Bankruptcy Code to require a court to engage in a motive inquiry when deciding whether a claim was impaired for the purposes of § 1129(a)(10). The Fifth Circuit

reasoned that such an inquiry would lead a court to deem a claim unimpaired for the purposes of § 1129(a)(10), even though it would clearly qualify as impaired under § 1124, which provides that "any alteration of a creditor's rights, no matter how minor, constitutes impairment."[5] The court further articulated that *Windsor's* motive inquiry conflicts with § 1123(b)(1), which states that a plan proponent "may impair or leave unimpaired any class of claims" and does not indicate that impairment must be based on economic motives.[6]

In reaching this conclusion, the Fifth Circuit remarked that the Bankruptcy Code must be read literally. Accordingly, after reading the plain text of §§ 1129(a)(10) and 1124, the Fifth Circuit found no support for the *Windsor* court's interpretation that §§ 1129(a)(10) and 1124 afford protection to affected creditors by preventing the debtor from artificially impairing classes in a cramdown plan. The Fifth Circuit commented further that such an interpretation would diminish the role of § 1129(a)(10) in the more typical single-asset bankruptcies where the debtor has negative equity and the secured creditor obtains a deficiency claim that enables it to control the vote of the unsecured class. The Fifth Circuit further noted that under those circumstances, secured creditors often take advantage of the Bankruptcy Code's broad definition of impairment and often invoke § 1129(a)(10) to block a cramdown.

The Fifth Circuit recognized, however, that a plan proponent's motives and methods for achieving compliance with the voting requirement of § 1129(a)(1) must continue to be scrutinized under § 1129(a)(3), which requires that the plan proponent propose its plan "in good faith and not by any means forbidden by law."[7] Reviewing the bankruptcy court's decision for clear error only, the Fifth Circuit found that the bankruptcy court correctly determined that the debtor had not violated § 1129(a)(3), as it proposed a "feasible cramdown plan [that paid the secured lender in full] for the legitimate purposes of reorganizing its debts, continuing its real estate venture, and preserving its non-trivial equity in its properties."[8] The Fifth Circuit concluded by acknowledging that a single-asset debtor's goal of protecting its equity can be a legitimate chapter 11 objective. Plainly, the circumstances of the *Village* case were very different than the typical single-asset case, where the debtor is substantially underwater and provided little or no equity, new or old.

The Impact of the Fifth Circuit's Decision on Single-Asset and other Bankruptcies

The Fifth Circuit's decision in *Village* may have a significant impact on single-asset cases specifically, and chapter 11 cases generally, as it arguably permits "artificial impairment" of a class of creditors under § 1129(a)(10), even if the debtor has the ability to treat them as unimpaired, regardless of whether the case involves a single-asset real estate debtor or, for example, a large manufacturing concern. Moreover, the Fifth Circuit held that artificial impairment does not amount to *per se* bad faith under § 1129(a)(3). As such, the Fifth Circuit's decision opens the doors to single-asset real estate and other debtors to put forth feasible plans over the objection of secured creditors whose claims may dwarf those of the artificially impaired class. The Fifth Circuit did not, however, give carte blanche approval to artificial impairment, as it recognized that the debtor must still satisfy the Code's good-faith requirement and articulated a circumstance where the impairment in favor of a related party could fail to pass "good faith" muster. It remains to be seen whether the unusual circumstances of the *Village* case—payment in full of the secured creditor's entire claim and

substantial equity investment by the debtor—will be utilized as a distinguishing factor in future cases addressing this issue.

1. 710 F.3d 239, 242 (5th Cir. 2013).

2. 7 F.3d 127 (8th Cir. 1993).

3. *Id.* at 132.

4. 995 F.2d 940 (9th Cir. 1993).

5. *Windsor*, 7 F.3d at 130.

6. 11 U.S.C. § 1123(b)(1).

7. 11 U.S.C. § 1129(a)(3).

8. *In re Village*, 710 F.3d at 247.