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A Lesson On Good Faith Artificial Impairment

Law360, New York (December 12, 2011, 10:12 AM ET) -- One of the most frequent questions asked by a secured creditor or potential buyer of a secured note is whether a debtor, through a Chapter 11 plan, can modify the terms of the note. The answer always includes recitation of the plan confirmation requirements of section 1129, such as the best interest test, the absolute priority rule, etc. One of the plan confirmation requirements, having an impaired class which votes, not counting insiders, for the plan (1129(a)(10)) just may have gotten easier to satisfy.

To satisfy the impaired consenting class requirement of 1129(a)(10), debtors often attempt to create a class (frequently pejoratively referred to as “gerrymandering”) that will vote for the plan. Debtors employ numerous techniques to obtain a consenting class, including separate classification of similar claims, the use of strategic convenience classes and by “artificially impairing” a class of creditors.

Artificial impairment is “the technique of minimally impairing a class of creditors solely to satisfy the prerequisite to cramdown of an accepting class.” In re Village at Camp Bowie I LP, 454 B.R. 702, 707 (Bankr. N.D. Tex. 2011).

In the typical case, a debtor will artificially impair a class of creditors by deferring payments over several months despite the ability to make the required payments on the effective date of the plan. Courts are split on whether a debtor can use artificial impairment to satisfy 1129(a)(10), with many courts unwilling to allow debtors to use artificial impairment to cramdown a plan on a nonconsenting secured creditor. See, e.g., Windsor on the River Assocs. Ltd. v. Balcor Real Estate Fin. Inc. (In re Windsor on the River Assocs. Ltd.), 7 F.3d 127, 130 (8th Cir. 1993).

In Camp Bowie, the Bankruptcy Court for the Northern District of Texas held that a debtor could artificially impair its unsecured creditor class in order to satisfy the cramdown requirements of the Bankruptcy Code without violating the good faith requirement of 1129(a)(3) of the Bankruptcy Code. In this case, the debtor’s plan proposed to pay its unsecured creditor class, who were owed approximately $60,000, in three equal monthly installments commencing on the effective date of the plan. Camp Bowie, 454 B.R. at 706-07.

The debtor proposed this payment plan notwithstanding its ability to pay the entire $60,000 on the effective date of the plan. Id. at 708. The debtor's secured creditor, Western Real Estate Equities LLC, asserted (and the debtor did not dispute) that the sole purpose of the payment plan for the unsecured creditors was to have an impaired consenting class under 1129(a)(10) and allow the debtor to cramdown its plan on Western.

The court, in Camp Bowie, recognized that sections 1124 and 1129(a)(10) do not impose a meaningfulness or materiality requirement on the degree of impairment required to satisfy the impairment requirement of 1129(a)(10). Id. at 708-09. Due to the lack of a materiality requirement under 1129(a)(10), the court held that the debtor satisfied 1129(a)(10) and next looked to 1129(a)(3) to determine if the debtor's plan was proposed in good faith. Id.

Section 1129(a)(3) requires that the plan be proposed in good faith and "with the legitimate and honest purpose to reorganize and has a reasonable hope of success." Britte v. Sun Country Dev. Inc. (In re Sun Country Dev. Inc.), 764 F.2d 406, 408 (5th Cir. 1985).

Further, in assessing good faith under 1129(a)(3), courts must look to "the totality of the circumstances surrounding establishment of a Chapter 11 plan, keeping in mind the purpose of the Bankruptcy Code to give debtors a reasonable opportunity to make a fresh start." Id.

In Camp Bowie, the court held that the debtor could only accomplish its reorganization, which provided for the preservation of equity in accordance with the Bankruptcy Code, by artificially impairing the unsecured creditor class. Camp Bowie, 454 B.R. at 710. However, the fact that the debtor used artificial impairment for the legitimate and honest purpose of pursuing its reorganization did not taint the debtor's motive such that it would not satisfy the good faith requirement of 1129(a)(3). Id.

Ultimately, the court held that "[w]here a fair and equitable restructuring may be accomplished only through artificial payment, it should not be prohibited. In the case at bar, where the court has found value available to equity, it would be contrary to the requirements of section 1129(b)(2)(C) to decline approval of the only plan that will achieve a fair result for both equity owners and creditors." Id. at 710.

Therefore, any impairment of the creditors' rights under a plan is sufficient to satisfy the "impaired consenting class" requirement of 1129(a)(10). Thus, the court held that the acceptance of the plan by the debtor's artificially impaired class of unsecured creditors complied with 1129(a)(10).

In contrast, in Windsor, the Eighth Circuit Court of Appeals strongly disapproved of the debtor's attempt to artificially impair a class of creditors, explaining that "[t]o allow manipulation of claims in a reorganization proceeding under Chapter 11 would be contrary to the purpose of the provisions of the bankruptcy code." 7 F.3d at 130.

Ultimately, the court held, notwithstanding the lack of any materiality requirement, that "[c]onfirmation of a plan where the debtor engineers the impairment of the only approving impaired class 'so distorts the meaning and purpose of [section 1129(a)(10)] that to permit it would reduce (a)(10) to a nullity.'" Id. at 131 (citing In re Lettick Typografic Inc., 103 B.R. 32, 38 (Bankr. D. Conn. 1989)).

Unlike Windsor, most courts considering artificial impairment look beyond 1129(a)(10) and instead focus on whether the artificial impairment violates the good faith requirement of 1129(a)(3). See, e.g., Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1352-53 (5th Cir. 1989), 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). The courts which consider the artificial impairment under the good faith test look to the facts and circumstances of the particular case.

As there is a split in authority regarding whether a debtor can artificially impair an unsecured creditor class solely to satisfy 1129(a)(10), secured lenders and note buyers alike should carefully consider the potential for artificial impairment to facilitate a cramdown. In particular, secured lenders should be cognizant of the "totality of the circumstances" test for determining good faith under 1129(a)(3).

Notably, in Camp Bowie, the court found that Western, the secured creditor, had questionable motives because it had purchased its secured position at a discount with the goal of acquiring the collateral for less than its fair value. Camp Bowie, 454 B.R. at 710.

The court noting the prior testimony of Western's principals that Western "wished to own and operate the Property" found that "where Western's goal is the elimination of Debtor, it is but a small step in assessing Debtor's good faith to weigh Western's motives against its allegations that the Debtor is guilty of bad faith by reason of artificial impairment." Id.

Secured creditors typically have a considerable amount of control over the resolution of a bankruptcy case. However, the debtor's ability to cramdown its secured creditors has long been the primary tool in a debtor's arsenal against secured creditors and the holding of Camp Bowie will likely be used by debtors to take a measure of control back from the secured creditors. Thus, secured creditors and those looking to acquire secured positions postpetition must be mindful of artificial impairment and how their actions may be perceived in the "totality of the circumstances" test for good faith under 1129(a)(3).

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