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Artificial Impairment: Recent Case Law a Warning for Secured Creditors

In bankruptcy, cramdown is one of the biggest risks that a secured creditor faces. Through the power of cramdown, a debtor (or other plan proponent) can effectively restructure the claim of a secured creditor including to extend the maturity date, reduce the interest rate or alter the timing of repayment. Balancing creditors' rights, the Bankruptcy Code imposes a number of constraints that protect the crammed down creditor, including requiring that the reorganization plan be feasible, be fair and equitable to the affected creditor and not unfairly discriminate against the affected creditor. In this article, we are focused on the requirement that at least one consenting impaired class of creditors' claims vote to approve the reorganization plan, and whether the debtor can satisfy that requirement by "artificial impairment."

As we discuss below, most courts, including lower courts in the Second and Third Circuits, have resisted debtors' efforts to artificially impair a consenting creditor class absent economic necessity. However, the Fifth Circuit Court of Appeals in *Western Real Estate Equities L.L.C. v. Village at Camp Bowie I L.P. (In re Village at Camp Bowie I, L.P.)*, 710 F.3d 239 (5th Cir. Feb. 26, 2013) recently joined the Ninth Circuit Court of Appeals in holding that the Bankruptcy Code does not prohibit artificial impairment. It is critical that secured creditors understand the resulting risks.

A. Impairment

Cramdown cannot be invoked unless at least one class of "impaired" claims (excluding insiders) votes to accept the plan. A class of claims is "impaired" if the plan alters any of the creditors' rights, such as partial payment (e.g., payment of 50% of a claim) or payment over time. Artificial impairment refers to a *de minimis* modification that impairs the claim in an immaterial manner (e.g., delaying payment for 30 days, paying 99% of the claim), where the purpose of the impairment is solely to obtain a consenting impaired class and satisfy Section 1129(a)(10) of the Bankruptcy Code.

B. *Village at Camp Bowie*: The Fifth Circuit Permits Artificial Impairment

In *Village at Camp Bowie*, the debtor had one oversecured secured creditor owed approximately \$32.1 million and 38 unsecured trade creditors owed \$59,398. After filing for bankruptcy on the eve of a foreclosure sale, the debtor proposed a plan designating two impaired classes: one class contained the oversecured creditor's claim, while the other class contained the unsecured trade claims, which would be paid in full within three months from the effective date, without interest. The secured creditor argued that the debtor had impermissibly artificially impaired the trade creditors solely to obtain an impaired accepting class and cramdown the secured creditor's claim.

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The Fifth Circuit followed the Ninth Circuit's reasoning in *L & J Anaheim Associates v. Kawasaki Leasing International, Inc. (In re L & J Anaheim Associates)*, 995 F.2d 940, 942 n.2 (9th Cir. 1993) and, affirming the bankruptcy court's confirmation of the plan, concluded that artificial impairment is not prohibited by the Bankruptcy Code because Section 1129(a)(10) does not distinguish between discretionary and economically driven impairment and, as such, the bankruptcy court's finding that the debtor had sufficient cash flow to pay the trade creditors on the effective date was of no moment. In the court's view, the debtor's motives are only scrutinized when determining whether the debtor proposed its plan overall in good faith.

C. Other Courts Bar Artificial Impairment

Secured creditors can take some comfort that the majority view has rejected artificial impairment, holding that a debtor cannot satisfy Section 1129(a)(10) when the impairment is structured solely for the purpose of obtaining a consenting impaired class, as opposed to a proper business role. The leading case adopting this view is the Eighth Circuit's decision in *Windsor on the River Associates, Ltd. v. Balcor Real Estate Finance, Inc. (In re Windsor on the River Associates, Ltd.)*, 7 F.3d 127, 132 (8th Cir. 1993). The court acknowledged that any alteration of a creditor's rights could make a claim impaired; in *Windsor*, the challenged class of claims would be paid in full in 60 days. *See id.* at 130. However, the court reasoned that allowing a debtor to engineer an impaired class solely for purposes of securing plan confirmation would nullify the protection that truly impaired creditors otherwise receive through Section 1129(a)(10). *See id.* at 131. The Third Circuit Court of Appeals has followed the *Windsor* approach, at least in the context of asbestos-related bankruptcies, calling artificial impairment “troubling” and observing that “[t]he chief concern with such conduct is that it potentially allows a debtor to manipulate the Chapter 11 confirmation process by engineering literal compliance with the Code while avoiding opposition to reorganization by truly impaired creditors.” *See In re Combustion Engineering, Inc.*, 391 F.3d 190, 243 (3d Cir. 2004).

A majority of courts have followed *Windsor's* approach in barring debtors from unfairly manipulating impairment of a class to satisfy Section 1129(a)(10). See *In re RYYZ, LLC*, 490 B.R. 29, 43 (Bankr. E.D.N.Y. Apr. 4, 2013) (observing that majority view is that artificial impairment is not permitted). Recently, the Bankruptcy Court for the District of Delaware disqualified the votes of creditors in two impaired classes because the debtor did not provide any evidence of a valid business purpose for "impairing" the two classes of claims that the court found were or could be deemed unimpaired. See *In re All Land Invs., LLC*, 468 B.R. 676, 691 (Bankr. D. Del. 2012) (explaining that with respect to first class, debtor had ability to pay \$3,000 claim in full on the effective date; with respect to second class, debtor's transfer of the collateral to oversecured creditor did not make creditor impaired). Lower courts in the Second Circuit have similarly held that the artificial impairment of claims runs afoul of the requirements to confirm a plan; however, the Second Circuit Court of Appeals has not ruled on the issue. See e.g., *In re Fur Creations by Varriale, Ltd.*, 188 B.R. 754, 760-61 (Bankr. S.D.N.Y. 1995); *RYYZ*, 490 B.R. at 43 (artificial impairment premised on debtor's failure to separately escrow tenant security deposits).

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D. Implications for Secured Creditors

The result in *Village at Camp Bowie* is a cautionary tale for secured creditors -- by artificially impairing a small class of trade creditors (\$59,000) the debtor was able to preserve its own equity position (in exchange for a new investment of \$1.5 million) and involuntarily restructure the secured creditor's \$32.1 million claim. Under the plan, the secured creditor would receive a new five year note, with interest-only payments for three years, followed by two years of payments of interest and principal amortized over 30 years and with a balloon payment of the loan balance to be paid at maturity. This is a sobering result for a secured creditor that was one day away from a foreclosure sale when the bankruptcy case was commenced.

In the restructuring war between a debtor and its secured creditor, artificial impairment can be a major weapon for a debtor, even where that secured creditor holds virtually all of the outstanding debt. As a practical matter, courts that allow artificial impairment effectively nullify the protective requirement of Section 1129(a)(10). Although *Village at Camp Bowie* does not represent the majority view on artificial impairment, it cannot be characterized as an outlier decision and secured creditors certainly need to be mindful of that risk in making their credit decisions particularly in jurisdictions that permit artificial impairment. To be clear, the Bankruptcy Code does afford other provisions that limit and constrain a debtor's ability to effect a cramdown and the terms of cramdown treatment and a secured creditor will be able to rely on those protections, even in jurisdictions that permit artificial impairment.

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