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BUSINESS BRIEF

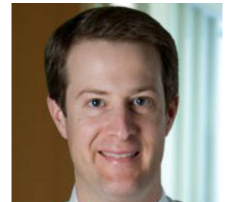
"ARTIFICIALLY IMPAIRED" CREDITORS CAN VOTE ON CHAPTER 11 PLANS IN THE FIFTH CIRCUIT

The U.S. Fifth Circuit Court of Appeals dealt a blow to secured creditors in a recent opinion affirming a successful "cramdown" reorganization plan in a commercial real estate ("CRE") case. See *In re Village at Camp Bowie I, L.P.,* --- F.3d --- (5th Cir. Feb. 26), 2013 WL 690497. The panel opinion in *Bowie* allowed a debtor in CRE bankruptcy case to intentionally delay paying trade debt that it had cash available to pay and to classify those trade creditors as "impaired" under Chapter 11 – thus giving a class of friendly creditors the ability to vote for the debtor's plan of reorganization. The court expressly rejected the argument that "artificially impaired" creditors that a debtor could pay in full, like the trade creditors in *Bowie*, should not be allowed to vote on a Chapter 11 plan. The result in *Bowie* was a confirmed plan based on the vote of unsecured creditors owed $60,000 over the objection of the fully secured creditor owed $32 million.

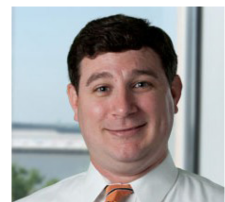
In *Bowie*, the debtor financed the acquisition and development of land in Fort Worth (the "Property") with equity capital and short-term promissory notes (the "Notes"). The Notes were secured by a first mortgage on the Property. The debtor's development of offices and retail did not do as well as planned. After a series of modification agreements and forbearance agreements to extend the due dates for the Notes, the then-current holder of the Notes initiated foreclosure proceedings on the Property. The debtor filed its petition for relief under Chapter 11 of the Bankruptcy Code one day before the scheduled foreclosure sale, which stayed the foreclosure proceedings.

The debtor filed a reorganization plan that divided its creditors into only two classes – one for the fully secured creditor, i.e. the owner and holder to the Notes, owed approximately $32,000,000, and one for the debtor's unsecured trade creditors owed approximately $60,000. Although the debtor had enough cash on hand at confirmation to pay its trade creditors, the plan provided that the trade creditors would be paid over ninety (90) days. The trade creditors voted to accept the plan while the secured creditor voted against it. The secured creditor argued that the trade creditors should not be allowed to vote because they were "artificially impaired" for the purpose of creating an accepting class of creditors. The creation of an artificially impaired class – here, the trade creditors that could have been paid from cash on hand – violates the "good faith" required of Chapter 11 plans found in 11 U.S.C. §1129(a)(3), according to the secured creditor. The bankruptcy court overruled the secured creditor's objection and confirmed the plan under the "cramdown" provision in 11 U.S.C. §1129.

The secured creditor urged its "artificial impairment" and "good faith" arguments on appeal to the Fifth Circuit, which had not squarely addressed the issue before. The Fifth Circuit noted that other circuits are divided over the question of "whether §1129(a)(10) draws a distinction between artificial and economically driven impairment." For example, the Eight Circuit recognizes impairment only to the extent that it is driven by economic need. See *In re Windsor on the Rivers Associates, Ltd.*, 7 F.3d 127 (8th Cir. 1993). Stated differently, a claim is not really "impaired," and thus not eligible to vote on the plan, if the impairment is a result of



ERIC LOCKRIDGE
Partner
225.389.3756
eric.lockridge@keanmiller.com



BEN ANDERSON
Associate
225.389.3734
ben.anderson@keanmiller.com

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the debtor's discretion rather than economic necessity. On the other hand, the Ninth Circuit does not distinguish between discretionary and economically driven impairment. See *Matter of L & J Associates*, 995 F.2d 940 (9th Cir. 1993).

In *Bowie*, the Fifth Circuit held that the "impairment" requirement in 11 U.S.C. §1129(a)(10) does not distinguish between an impairment created at the debtor's discretion and impairment dictated by economic necessity. The Fifth Circuit expressly rejected the secured creditor's argument and the Eighth Circuit's view of what qualifies as an "impaired claim." As a result, a debtor, in the Fifth Circuit, may purposefully delay paying unsecured creditors for the purpose of creating an accepting "impaired" class, despite having enough cash on hand to pay them at confirmation.

The *Bowie* opinion does have something positive for secured creditors dealing with undersecured single asset real estate ("SARE") cases. Footnote 30 to the *Bowie* opinion states that in a SARE where the creditor is undersecured, the creditor's deficiency claim should be placed in the same class as the debtor's unsecured debt. Debtors often argue that a lender's deficiency claim is different than other unsecured debt and should be place in its own class, thus improving their chances of having at least one class of creditors vote in favor of a proposed plan. Footnote 30 in *Bowie*, however, gives an undersecured creditor good support for the argument that its deficiency claim should be classified with the other unsecured claims, which may give that creditor the opportunity to control the unsecured class's vote on the plan and prevent the debtor from cramming down an unwanted plan under 11 U.S.C. §1129(a)(10)