Client Alert

March 2013

Fifth Circuit Affirms Confirmation of Cramdown Plan With Artificial Impairment

On February 26, 2013, the Fifth Circuit Court of Appeals issued an opinion in *Western Real Estate Equities, L.L.C. v. Village at Camp Bowie I, L.P.*[1] ("*Camp Bowie*"). The bankruptcy court confirmed a debtor's plan of reorganization over the objection of the secured creditor that argued the impaired accepting class of the cramdown plan was "artificially" impaired and that the plan was not proposed in good faith. In *Camp Bowie*, the Fifth Circuit joined the Ninth Circuit in concluding that any impairment, including artificial impairment, could meet the statutory requirements of 11 U.S.C. §§ 1124 and 1129(a)(10).

Case Background

The Village at Camp Bowie I, L.P. (the "Village" or the "Debtor") owns a low-rise, mixed use development in Fort Worth, Texas known as the Village at Camp Bowie (the "Property"). In 2004, the Debtor acquired the Property using (a) $10,000,000 in equity; (b) the proceeds from a short term senior secured promissory note payable to SouthTrust Bank ("SouthTrust") in the original principal amount of $26,535,000 (the "SouthTrust Note") and (c) the proceeds from a short term, subordinate secured promissory note payable to Texas Capital Bank ("TCB") in the original principal amount of $10,000,000 (the "TCB Note").[2] The Property was leased for office, retail, restaurant, and entertainment purposes.

The original maturity date of the Notes was January 2008, but Wells Fargo[3] entered into a series of modifications with the Debtor and then a series of forbearance agreements. The final forbearance period expired on July 9, 2010, after which, Wells Fargo sold the Notes, at a discount, to Western Real Estate Equities, LLC ("Western"). After acquiring the Notes, Western instituted collection efforts and scheduled the Property for foreclosure in August 2010.

To prevent Western from conducting a foreclosure sale, the Debtor filed for bankruptcy on August 2, 2010 (the "Petition Date"). As of the Petition Date, the Debtor calculated the outstanding balance on the Notes to be $32,264,938. At the time the Debtor sought to confirm its First Modification to the Debtor's Second Amended Plan of Reorganization,[4] the Property was approximately 80% occupied and the bankruptcy court concluded that the value of the Property was approximately $34,000,000, an amount in excess of the total amount of debt owing by the Debtor to all its creditors. At the confirmation hearing, a representative for Western testified that Western is not in the lending business and wished to own and

[1] *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).

[2] Collectively, the SouthTrust Note and the TCB Note are referred to as the "Notes".

[3] Wachovia Bank, N.A. ("Wachovia") became successor by merger with SouthTrust to the SouthTrust Note and successor by assignment to the TCB Note. Wells Fargo Bank, N.A. ("Wells Fargo") became successor in interest to the Notes by merger with Wachovia.

[4] Collectively all the Debtor's Plans of Reorganization, amendments and modifications to the same, are referred to herein as the "Plan".

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operate the Property. Consequently, Western had no interest in negotiating a consensual plan with the Debtor.

Bankruptcy Court Decision

On August 4, 2011, the motion for confirmation of the Second Amended Plan of Reorganization of the Village at Camp Bowie, I L.P. and the Objection to the Confirmation and Renewed Motion for Relief from the Automatic Stay came before the court for hearing (the "Confirmation Hearing").[5]

In its Plan, the Debtor proposed to pay Western interest only payments at the rate of 5.83% for three years followed by two years of interest and principal amortized over thirty years. At the end of five years, the Debtor's remaining obligations to Western was to be paid in full. In addition to Western, the Debtor owed general unsecured creditors approximately $60,000.[6] The Plan proposed to pay the general unsecured creditors in full with three monthly installment payments commencing on the effective date of the Plan. Finally, the Debtor's Plan provided that the Debtor's pre-petition owners and related parties would infuse equity into the Debtor in the amount of $1,500,000 in exchange for newly issued preferred equity.[7]

The Plan designated only two voting, impaired classes – one consisting of Western and the second consisting of general unsecured creditors. Western voted to reject the Plan and all of the general unsecured creditors voted to accept the Plan.

Western objected to confirmation of the Plan based on 11 U.S.C. § 1129(a)(1), (3), (9), (10), (11) and (b)(2)(A)(i). Of the objections raised by Western, the bankruptcy court primarily focused on Western's assertion that confirmation of the Plan should be denied because the Debtor artificially impaired the general unsecured creditors, that the Plan did not provide present value for Western on its claim as required by section 1129(b)(2)(A)(i),[8] and that the Plan was not proposed in good faith as required by section 1129(a)(3).

Confirmation of a Plan over the objection of a secured creditor under section 1129(b)(1) requires that all tests of section 1129(a), except 1129(a)(8), be satisfied and section 1129(a)(10) requires acceptance of a plan by at least one class of impaired creditors. Artificial impairment is a technique whereby a Debtor slightly impairs a class of creditors solely to create a class of creditors who will accept the Plan to meet the requirements of section 1129(a)(10). The bankruptcy court observed that the Fifth Circuit had not squarely addressed the issue of whether artificial impairment was permissible.[9] The bankruptcy court

[5] On August 10, 2010, a week after the Petition Date, Western filed a motion for relief from the automatic stay. After hearing testimony from expert appraisers presented by the Debtor and Western, the court denied the motion to lift the automatic stay and determined that the Debtor had a small amount of equity in the Property in excess of Western's secured interest. *In re Villages at Camp Bowie, I, L.P.*, 454 B.R. 702 (Bankr. N.D. Tex 2011).

[6] These creditors consisted of thirty-eight miscellaneous, independent trade creditors.

[7] Earlier iterations of the Debtor's Plan provided for an equity investment of $600,000; however, the equity infusion was subsequently increased to $1,500,000 after the Court advised the Debtor that it would not consider confirming the Plan unless the equity infusion exceeded $1,000,000.

[8] The bankruptcy court determined that the Debtor's compliance with section 1129(b)(2)(A)(i) rested on whether the present value of the payments made to Western equaled or exceeded the allowed amount of Western's secured claim. The bankruptcy court concluded that the interest rate proposed by the Debtor – 5.83% - was too low, but indicated that a rate of at least 6.4% would meet with its approval. The Debtor revised the proposed interest rate to 6.4% prior to the entry of the order confirming the Plan and this issue was not part of the appeal to the Fifth Circuit.

[9] Prior to its decision in *Camp Bowie*, the bankruptcy court noted that the closest the Fifth Circuit had come to addressing artificial impairment was in *B.M. Brite v. Sun Country Dev., Inc.* (*In re Sun Country Dev. Inc.)*, 764 F.2d 406 (5th Cir. 1985), where the Court was untroubled by the debtor taking advantage of the plain meaning of the Bankruptcy Code in modifying its plan from an earlier version that provided full payment to a group of creditors who were owed less than $4,000 to impair this class of creditors in order to create an accepting class of creditors to achieve confirmation of a cramdown plan.

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also recognized that there was a split between the Eighth Circuit Court of Appeals and the Ninth Circuit Court of Appeals on this issue.[10]

Western asserted, and it was undisputed by the Debtor, that the Debtor would have sufficient cash on hand to pay the class of general unsecured creditors in full on the effective date of the Plan.[11] Western argued that the Debtor's proposal to pay these creditors their entire claim amounts without interest over the course of three months was an artificial impairment, which should prevent the court from confirming the Plan. The bankruptcy court did not accept Western's position that the definition of impairment in section 1124 of the Bankruptcy Code should be read to require a certain level of impairment. The bankruptcy court determined that the definition of impairment in section 1124 of the Bankruptcy Code was clear and broad. Moreover, the bankruptcy court noted that if Congress had wished to qualify that type of impairment necessary to comply with section 1129(a)(10) it clearly could have done so and, in the absence of such limiting language, the bankruptcy court held that *any* impairment was sufficient to meet the requirements to section 1129(a)(10).

After concluding that the extent of the impairment of the class of accepting creditors was not a determinative issue for confirmation, the bankruptcy court examined whether the Plan, including the artificial impairment, was proposed in good faith as required by section 1129(a)(3).[12] The bankruptcy court held that an artificial impairment is not a *per se* failure of the good faith test and in examining the facts before it – including, a creditor, Western, that would only be satisfied by payment in full or the demise of the Debtor - the bankruptcy court refused to find that the Debtor was not acting in good faith when it exercised its only option to protect equity by artificially impairing a small group of creditors and seeking to confirm a plan over the objection of the secured creditor.

The Fifth Circuit Affirms Confirmation

On appeal, Western reasserted its position that a plan proponent cannot "artificially" impair a class of creditors solely to create the impaired accepting class necessary to satisfy section 1129(a)(10) and that such strategy also runs afoul of the good faith requirements of 1129(a)(3).[13] The Fifth Circuit noted the split between the Ninth Circuit and Eight Circuit on the issue of "artificial" impairments and commented that in *Matter of Sun Country Development, Inc.*, 764 F.2d 406 (5th Cir. 1986) it rejected the concept of artificial impairment being improper as a matter of good faith pursuant to section 1129(a)(3) and, implicitly, in connection with the voting requirements under section 1129(a)(10); however, the Court determined that the impairment in *Sun Country* was economically motivated. To muddy the waters a bit, subsequent to *Sun Country*, in *Matter of Sandy Ridge Development Corp.*, 881 F.2d 1346 (5th Cir. 1989) the Court expressed its concern with an artificial impairment in a single asset real-estate case not dissimilar from *Camp Bowie* and remanded the issue to the bankruptcy court to consider the impairment in the context of the good faith requirement.

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[10]The Eighth Circuit, 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 (8th Cir. 1993), looked to Congress' intent in drafting section 1129(a)(10) and concluded that a claim is not impaired if the alteration of the creditors' rights is solely at the debtor's discretion and impairment under section 1129(a)(10) is only recognized when it is a function of economic necessity. The Ninth Circuit in *In re: L&J Anaheim Assoc.,* 995 F.2d 940 (9th Cir. 1993) rejected a narrow reading of the definition of the impairment in examining section 1129(a)(10) and considered any alteration of a creditors' legal, equitable, or contractual rights to be sufficient to qualify as an impairment.

[11] The bankruptcy court considered payment in full with interest on the effective date of a plan to leave such creditors unimpaired.

[12] The test for good faith pursuant to section 1129(a)(3) is whether the plan has been proposed with a legitimate and honest purpose to reorganize and has a reasonable hope of success. In making this assessment, the court should consider the totality of the circumstances surrounding the Chapter 11 case.

[13] *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).

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In *Camp Bowie*, the Fifth Circuit expressly rejected *Windsor* and cast its lot with the Ninth Circuit in holding that section 1129(a)(10) does not discriminate between an impairment as an economic necessity and a discretionary, artificial impairment. In reaching this holding, the Court relied on the plain language of sections 1124 and 1129(a)(10). The Fifth Circuit criticized the Eighth Circuit's attempt to divine, or more accurately shoehorn, congressional intent into the unambiguous statutory language of sections 1124 and 1129(a)(10), and asserted, that even if the Court were to consider the congressional intent of the statute, the Congress that passed section 1124 "considered and rejected precisely the sort of materiality requirement *Windsor* imposed by judicial fiat".[14]

Additionally, the Fifth Circuit remarked that the Eighth Circuit's concern that allowing an artificial impairment would essentially vitiate section 1129(a)(10) was inconsistent with the role section 1129(a)(10) plays in the typical single asset real estate bankruptcy case. In the majority of single asset real estate cases, the debtor has negative equity, not positive equity as the Village did in this case. Consequently, in those cases, the secured creditor often has a deficiency claim that allows it to control the vote of the unsecured class regardless of a debtor's attempt to artificially impair that class and the secured creditor can rely on section 1129(a)(10) to block a cramdown plan. Rather than a hurdle to overcome, in practical application, section 1129(a)(10) is a tool for a secured creditor to defeat a cramdown plan.

In turning to the good faith analysis, the Court held a "plan proponent's motives and methods for achieving compliance with the voting requirements of § 1129(a)(10) must be scrutinized, if at all, under the rubric of §1129(a)(3), which imposes on plan proponents a duty to propose a plan 'in good faith and not for any means forbidden by law'".[15] The Court concluded that based on the bankruptcy court's record before it - the Debtor had proposed a feasible cramdown plan to reorganize its debts, was continuing its operations, was preserving the interests of equity and that Western did not dispute the Debtor's ability to stay current on the reorganized obligations - it could not conclude the bankruptcy court had clearly erred in its section 1129(a)(3) good faith analysis.

It is worth noting that the Debtor's success in complying with the good faith section was likely aided by the make up of the artificially impaired general unsecured creditors. The Fifth Circuit mentioned that the impaired creditors were independent, third party creditors who extend credit to the Debtor in the ordinary court of business prior to the Petition Date. The Fifth Circuit cautioned that an inference of bad faith may be stronger if a debtor were to conjure an impaired class of out thin air by incurring a debt to a related party or engaging in sham lending transactions, but it commented that because section 1129(a)(3) provided the bankruptcy court with the ability to conduct a fact specific inquiry into the *bona fides* of the impaired creditors, it would continue to accord deference to the bankruptcy court's determinations on this issue.

Conclusion

The Fifth Circuit's decision in *Camp Bowie* is instructive for debtors and potential purchasers of distressed debt that intend to leverage such a purchase to obtain control of a debtor and operate its business. With the Fifth Circuit joining the Ninth Circuit in determining that artificial impairment can be used to satisfy 11 U.S.C. § 1129(a)(10) to create an impaired accepting class of creditors in connection with a cramdown plan, the trend appears to be moving away from the Eighth Circuit's holding that impairment is only recognized to the extent it is driven by economic need. Unless, and until, the Supreme Court settles this split in the Circuits, debtors should be cognizant that if they have the resources to artificially impair a class of creditors, who will vote to accept the plan, they will likely be able to confirm their cramdown plan, provided the good faith requirements of 11 U.S.C. §1129(a)(3) are not an issue. Conversely, purchasers of distressed debt who hope to acquire a senior secured position in the Debtor's obligations may find

[14] *Id.*

[15] *Id.*

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themselves in the situation that befell Western in *Camp Bowie* – unable to foreclose its interest in the assets secured by the debtor's obligations and forced to accept a plan whereby they became lenders to a reorganized debtor rather than owners and operators of the debtor in a turnaround situation.

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