Finding Acceptance: Using Strategic Impairment to Satisfy § 1129(a)(10)

Section 1129(a)(10) of the Bankruptcy Code — requiring acceptance of a proposed plan from at least one impaired voting class — can often pose a unique challenge for single asset real estate debtors. [1] Indeed, finding an impaired accepting class may be the lynchpin for success in run of the mill single-asset bankruptcies, where debtors have a single large secured creditor and only a few small unsecured trade creditors. In such cases, if consensual restructuring of the secured creditor’s claim is not possible, one option available for a debtor may be to seek cramdown over the secured creditor’s objection by strategically, or “artificially,” impairing minor creditors. Whether such artificial impairment is permissible remains an open question, but the majority view is that § 1129(a)(10) does not distinguish between artificial and economically driven impairment. [2] Nevertheless, while technically satisfying the requirement of § 1129(a)(10), plans that rely upon strategic impairment may face heightened scrutiny under § 1129(a)(3)’s good faith requirements. [3] This article examines the challenges of utilizing strategic impairment to create an accepting class of impaired creditors.

Avoiding an Inference of Bad Faith

*Western Real Estate Equities, L.L.C. v. Village at Camp Bowie I, L.P.* explains the majority view on artificial impairment. [4] There, the Fifth Circuit rejected the argument that a plan proponent cannot artificially impair a friendly class of creditors solely to create the impaired accepting class necessary to satisfy § 1129(a)(10). [5] In doing so, the Fifth Circuit joined the Ninth Circuit by holding that § 1129(a)(10) does not distinguish between discretionary and economically driven impairment. [6] As explained in *Western*, impairment is determined solely pursuant to § 1124, which provides that a plan impairs a class of claims unless it “leaves unaltered the legal, equitable, and contractual rights” of the claimants. [7] In other words, any alteration of the creditor’s rights, no matter how minor, constitutes impairment. [8] A plan proponent’s motives and methods for achieving compliance with § 1129(a)(10) may be examined, if at all, under the requirements of § 1129(a)(3), which requires the plan to be proposed in good faith and not by and means forbidden by law. [9]

Turning to the Bankruptcy Code’s good faith requirement, the *Western* Court upheld the bankruptcy and district courts’ determination that the debtor satisfied § 1129(a)(3). Ultimately, the *Western* Court found that the debtor had not run afoul of § 1129(a)(3) because it proposed a feasible cramdown plan for legitimate purposes, including reorganizing its debts, continuing its real estate venture, and preserving its non-trivial equity. [10] The *Western* Court further noted that there was no evidence of an improper relationship between the debtor and the impaired creditors. [11] Although the Fifth Circuit did not enumerate specific factors to consider when evaluating good faith, the court indicated that an inference of bad faith is strong where the debtor creates the impaired accepting class through the use of related parties. [12]

In *Village Green I, L.P. v. Fannie Mae*, the Sixth Circuit joined the Fifth and Ninth Circuits in holding that impairment need not be economically driven to satisfy § 1129(a)(10). Nevertheless, the *Village Green* Court upheld the district court’s decision to reverse confirmation of the debtor’s plan because the debtor failed to propose the plan in good faith. [13] In *Village Green*, the debtor’s former lawyer and accountant were owed approximately 2,400 for prepetition services. [14] Despite the minimal size of the the claims and robust cash-flow projections, the debtor proposed to “impair” these *de minimis* claims by making two installment payments over 60 days. [15] The Sixth Circuit first — joining the majority view — noted that the plan undisputedly impaired the class of claims. [16]
The Sixth Circuit then analyzed § 1129(a)(3)’s good faith factors. In affirming the district court’s finding of bad faith, the court of appeals focused its analysis on (1) the debtor’s cash flow projections, which showed that the minor claims could have easily been paid in full at the time of plan confirmation, and (2) the fact that the secured creditor offered full payment to the minor creditors prior to confirmation, yet the minor claimants refused to accept the offer. [17] Further, the Village Green Court gave substantial weight to evidence of a close relationship between the debtor and the impaired creditors. [18] Similar to the Fifth Circuit’s observation in Western, [19] the Village Green Court found that this evidence of an alliance between the debtor and the impaired creditors gave the appearance of bad faith. [20] As such, the Sixth Circuit found that the bankruptcy court’s confirmation order was properly overturned by the district court because the debtor’s plan failed to satisfy § 1129(a)(3)’s good faith requirement.

Conclusion

Following the decisions of Western and Village Green, a clear majority now exists supporting the proposition that a debtor’s strategic or artificial impairment of a class of claims does not preclude such class of creditors from serving as § 1129(a)(10)’s required impaired accepting class. Despite this majority view, a debtor’s decision to artificially impair a class of claims is not immune from scrutiny and may run afoul of § 1129(a)(3)’s good faith requirement. The juxtaposition of results in Western and Village Green provide helpful insight to single asset real estate debtors structuring a cramdown plan over the objection of secured lenders. On the one hand, while these opinions clearly accept strategic impairment as a useful means to preserve significant equity in a continuing real estate venture and a legitimate use of the bankruptcy process, the selection of impaired creditors is key. Debtors must be aware that strategically impairing closely related parties will likely give rise to an inference of bad faith that, if not otherwise overcome, may preclude confirmation pursuant to § 1129(a)(3). However, the ability to strategically impair unrelated, minor creditors may serve as an invaluable tool for single asset real estate debtors.


[4] Western Real Estate Equities, L.L.C., 710 F.3d at 244.

[5] Id.

[6] Id. at 245.


[9] Id. at 247.

[10] Id.


[12] Id.


[14] Id. at 817.

[15] Id.

[16] Id. at 818.

[17] Id. at 819.

[18] Id.
