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Artificial vs. Economic Impairment of Claims – The Sixth Circuit Rules

United States Bankruptcy Code[1] section 1129(a)(10) requires that, unless all claims are unimpaired, at least one impaired class of noninsider claimholders must accept a plan of reorganization before the plan can be confirmed. Where there are only a few separate classes of claims, in real estate cases for example, even though a plan proponent may have the economic ability to pay a small class of claimants in full, the proponent will often defer full payment of a small class for a short period of time to create this requisite accepting impaired class. This has been styled "artificial," as opposed to "economic," impairment. In *In re Village Green I, GP**[i][2]**,* the Sixth Circuit Court of Appeals becomes the fourth circuit court to address the issue of artificial impairment, and its decision sets a standard distinct from its fellow circuits.

The Ninth Circuit was the first circuit to address the issue in *In re L&J Anaheim Associates.*[3] In that case, Kawasaki, which was owed $13.2 million secured by a hotel, proposed a creditor plan which actually resulted in an improvement of its prepetition position. The debtor argued that an improvement in position did not constitute "impairment" under Code section 1124. The bankruptcy court disagreed and confirmed the plan. On appeal, the Ninth Circuit ruled that "impairment" means that a creditor's legal, equitable or contractual rights are altered under the plan, and that the plan changed Kawasaki's state law rights. No particular alteration was required, said the court, whether the alteration resulted in an improvement.[4] However, the plan proponent must still comply with the requirement that the plan be proposed in good faith pursuant to Code section 1129(a)(3).

That same year, the Eighth Circuit reached the opposite conclusion in *In re Windsor on the River Associates Ltd.*[5] In that case, a secured creditor which was owed $9.8 million (constituting approximately 99% of the claims in the case) appealed confirmation of a plan that provided that the claims in an accepting unsecured class, totaling approximately $13,000, would be paid in 60 days and therefore the class was impaired. The Eighth Circuit found that the claims could have been paid in full on the effective date and therefore were "arbitrarily and artificially impaired."[6] The court held that "a claim is not impaired [for the purposes of § 1129(a)(10)] if the alteration of [the] rights in question arises solely from the debtor's exercise of discretion."[7] Section 1129(a)(10), said the court,

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recognizes impairment only to the extent it is driven by economic need.[8]

Twenty years later, the Fifth Circuit considered the question of artificial versus economic impairment in *In re Village at Camp Bowie I L.P.*[9] There, an unsecured class comprised of claimants owed a total $38,000 accepted a plan which paid them in full over three months even though it was undisputed that the plan could have paid them in full on the effective date. The secured creditor, which voted its deficiency claim to reject the plan, asserted that the artificial impairment contravened Code section 1129(a)(10) and also violated the requirement that the plan be proposed in good faith under Code section 1129(a)(3). The bankruptcy court rejected both arguments, concluding that Code section 1129(a)(10) did not distinguish between artificial and economic impairment, and that artificial impairment did not amount to *per se* bad faith, and the secured creditor appealed.

After considering both *L&J Anaheim Associates* and *Windsor,* the Fifth Circuit affirmed the bankruptcy court adopting the Ninth Circuit's view that Code section 1129(a)(10) does not distinguish between discretionary and artificial impairment.[10] The court reasoned:

By shoehorning a motive inquiry and materiality requirement into § 1129(a)(10), *Windsor* warps the text of the Code, requiring a court to "deem" a claim unimpaired for the purposes of § 1129(a)(10) even though it plainly qualifies as impaired under § 1124. *Windsor's* motive inquiry is also inconsistent with § 1123(b)(1), which provides that a plan proponent "*may* impair or leave unimpaired any class of claims," and does not contain any indication that impairment must be driven by economic motives.[11]

However, the court also concluded that Code section 1129(a)(10) must be scrutinized in light of the good faith requirements of Code section 1129(a)(3), and that plan proponents do not enjoy a "free pass" under that section.[12] Where the accepting creditor class was not comprised of independent third parties who extended ordinary course pre petition trade debt, or the class was created out of whole cloth, particularly if the class members were related to the proponent, or there is evidence of a sham, an inference of bad faith may arise.[13]

In October 2015, the Sixth Circuit again took up the issue of discretionary impairment under Code sections 1124 and 1129(a)(10) in *In re Village Green I, GP.*[14] In that case, the debtor proposed a plan which impaired an unsecured class comprised of the debtor's lawyer and accountant, owed a total of less than

$2,400, by paying them over 60 days after the effective date. The secured creditor holding both a secured and an unsecured deficiency claim objected to confirmation and the bankruptcy court overruled the objection and confirmed the plan. The secured creditor appealed.[15]

The Sixth Circuit found that whether the impairment of a class is contrived is irrelevant for the purposes of Code section 1124. That section provides that altering the legal rights of the claimants is impairment without any inquiry into the motives of the plan proponent. Citing *Camp Bowie*, the court concluded that the unsecured class was clearly impaired, while acknowledging that *Windsor* held to the contrary.[16]

However, said the court, the proponent's motives are expressly the business of Code section 1129(a)(3), which requires the plan to be proposed in good faith.[17] The court found that Village Green's unsecured claims could be paid in full on the effective date, contrary to the debtor's assertion that it needed to ration every dollar. Moreover, the close relationship of the claimholders to the debtor, and the fact that the claimholders refused to accept payment in full from the secured creditor, convinced the court that the claimant's impairment was "transparently an artifice to circumvent the purposes of § 1129(a)(10)."[18]

It is hard to say where *Village Green* leaves practitioners. The Sixth Circuit joins with the Fifth and Ninth in holding that any impairment, whether discretionary or economic, is sufficient to meet the requirements of Code sections 1124 and 1129(a)(10). This clearly seems correct. However, where a debtor with only a few classes of creditors necessarily pushes the envelope by minimally impairing a small class of creditors, the good faith requirements of Code section 1129(a)(3) also clearly authorize an inquiry into the proponent's motives for the impairment. Where secured and deficiency claims total millions of dollars, the difference between $2,400 in *Village Green* and $38,000 in *Camp Bowie* seems insignificant. The upshot may be that while a proponent's employment of minor discretionary (rather than economic) impairment is sufficient to jump the Code section 1129(a)(10) hurdle of having an impaired class accept the plan, the debtor's motive in meeting that requirement is fair game for the bankruptcy court to find an absence of good faith and doom confirmation. This will likely make it harder to predict how any given bankruptcy court will rule on confirmation on any particular day. Perhaps the only alternative in many real estate and similar cases is to make sure the class of impaired unsecured claims is comprised of bona fide creditors . . . and cross your fingers.

[1] 11 U.S.C. §§ 101 1532 (the "Code").

[2] *Vill. Green I GP v. Fed. Nat'l Mort.Ass'n (In re Vill. Green I, GP),* 811 F.3d 816 (6th Cir. 2015).

[3] *L&J Anaheim Associates v. Kawasaki Leasing International Inc. (In re L&J Anaheim Associates),* 995 F.2d 940 (9th Cir. 1993).

[4] *Id.* at 943.

[5] *Windsor on the River Assocs. Ltd. v. Balcor Real Estate Fin. Inc. (In re Windsor on the River Assocs. Ltd.),* 7 F.3d 127 (8th Cir. 1993).

[6] *Id.* at 132.

[7] *Id.*

[8] *Id.* at 132 33.

[9] *W. Real Estate Equities L.L.C. v. Vill. of Camp Bowie I L.P. (In re Vill. of Camp Bowie I L.P.),* 710 F.3d 239 (5th Cir. 2013).

[10] *Id.* at 245.

[11] *Id.*at 245 46 (citations omitted).

[12] *Id.* at 248.

[13] *Id.*

[14] *(In re Vill. Green I, GP),* 811 F.3d 816 (6th Cir. 2015).

[15] On appeal, the district court remanded to the bankruptcy court to determine whether the plan had been proposed in good faith. The bankruptcy court found that the plan was proposed in good faith and confirmed the plan again. The district court vacated and remanded, which caused the bankruptcy court to dismiss the case and lift the automatic stay, which resulted in the appeal to the Circuit Court. *Id.* at 818.

[16] *Id.* at 818 19.

[17] *Id.* at 819.

[18] *Id*.