BuchalterNemer
A Professional Law Corporation

Confirmation Of A Chapter 11 Plan: Good Faith In The Context Of "Artificial Impairment"

Daniel H. Slate

In order to confirm a chapter 11 plan, at least one class of creditors whose claims are "impaired" must accept the plan. The concept of "impairment" is very broad. Under the Bankruptcy Code, a class of claims is impaired unless the plan "leaves unaltered the legal, equitable, and contractual rights" to which the holder of the claim is entitled. That alteration can be very modest: payment in full but paid half at confirmation and the other half in 30 days, reduction of the applicable interest rate by one basis point, etc. With such wide latitude in impairment, courts have struggled with whether such "artificial" impairment bumps up against another requirement of confirmation: that the plan is proposed in good faith. The question boils down to whether the Bankruptcy Code draws a distinction between artificial impairment and economically driven impairment.

The 8th Circuit directly addressed the tension between concepts of good faith and artificial impairment in *In re Windsor on the River Associates*, 7 F. 3d 127 (8th Cir. 1993) ("*Windsor*"). The *Windsor* court held that "a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion." In *Windsor*, the debtor had no reason to impair several classes of creditors, calling the delay in payment to those classes of creditors "manufactured," and effectively circumventing the purpose of bankruptcy, consensual reorganization. In other words, the *Windsor* court determined that artificial impairment is not "impairment" for confirmation purposes.

The Ninth Circuit, in *Matter of L&J Anaheim Associates*, 995 F. 2d 940 (9th Cir. 1993) held that the Bankruptcy Code did not distinguish between discretionary and economically driven impairment, relying on the "plain language" of the statute. The reasoning undertaken by the *Windsor* court has been criticized by a number of courts. The Fifth Circuit, in the *Matter of Village at Camp Bowie I, LP,* 710 F. 3d 239 (5th Cir. 2013) ("*Camp Bowie*") expressly rejected *Windsor*, and joined the Ninth Circuit in holding that the Bankruptcy Code does not distinguish between discretionary and economically driven impairment. *Camp Bowie* went on, however, to consider the issue under good faith. Over the objection of the secured creditor, the Court determined that the plan was in good faith, even though the only class to vote in favor of the plan was the class of general unsecured creditors, and they were to be paid in full three months after confirmation.

While finding good faith in that instance, the *Camp Bowie* court expressly rejected the concept that artificial impairment should get a "free pass" under the good faith analysis. The facts mentioned in the *Camp Bowie* opinion included the following: (i) the debtor's property was worth several million dollars over and above the debt owed the secured creditor; (ii) the debtor's principals were investing $1.5 million in new money into the property; and (iii) the debtor's unsecured creditors were "independent third parties."

The Sixth Circuit recently followed the lead of *Camp Bowie*, and found that even though the plan artificially impaired several creditors, the debtor's motives are addressed through the lens of good faith issues. The facts in I*n re: Village Green I, GP*, 811 F. 3d 816 (6th Cir. 2016) ("*Village Green*")[1] were different from those mentioned in *Camp Bowie*. For example, in *Village Green*, (i) the real property was worth substantially less than the secured debt; (ii) the debtor's principals were not contributing any new money into the property; and (iii) the only unsecured creditors were the debtor's former lawyer and accountant.

Under those facts, the Court, in affirming the District Court's reversal of a determination of good faith by the Bankruptcy Court, relied upon a number of factors to conclude that the Bankruptcy Court's determination was clearly erroneous. The appellate court determined that the debtor did not have an economic justification for "rationing" every dollar when the total of impaired claims was less than $2,400, and the debtor's projections indicated net operating income of $857,000 during the first year after confirmation. The appellate court also cited the fact that the two impaired creditors were the debtor's former lawyer and accountant compounded the appearance that impairment was undertaken in order to circumvent the purpose of the Bankruptcy Code. The *Village Green* court referenced the District Court's reasoning that in the context of good faith it is useful to consider whether there is an "economic justification" for the artificial impairment. The Sixth Circuit determined that there was no such justification in *Village Green*.

Daniel Slate is a Shareholder in the Firm's Insolvency & Financial Law Practice Group in Los Angeles. He can be reached at 213.891.5444 or dslate@buchalter.com.

[1] Buchalter Nemer successfully represented the secured creditor in *Village Green*.