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6th Circ. Rejects Transparently Artificial Chapter 11 Plan

Law360, New York (February 16, 2016, 5:30 PM ET) -- A Chapter 11 debtor's impairment in its reorganization plan of two unsecured claims filed by its former lawyer and accountant "was transparently an artifice to circumvent the purposes of" the Bankruptcy Code, held the U.S. Court of Appeals for the Sixth Circuit on Jan. 27, 2016. In re Village Green I GP, 2016 U.S. App. LEXIS 1243, at *2 (6th Cir. Jan. 27, 2016). Affirming the reversal of the bankruptcy court's finding that the debtor had "proposed its plan in good faith," the Sixth Circuit rejected the debtor's "assertion that it could not safely pay off the [two] minor claims (total value: less than $2,400) up front rather than over 60 days." It stressed the debtor's projected "net income of $71,400 per month" to support the "feasibility" of its plan, which undermined its purported need to "ration ... every dollar." Id. at *5.

Relevant Statutory Requirements

The two relevant statutory requirements in Village Green are contained in Bankruptcy Code Section 1129(a)(10) ("at least one class of claims that is impaired under the plan has accepted the plan") (the so-called "gatekeeper" requirement), and Section 1129(a)(3) (plan must be "proposed in good faith and not by any means forbidden by law").

Relevance

A desperate Chapter 11 debtor will, because of the requirement of an impaired accepting class, engineer the impairment of a friendly creditor class by slightly altering the rights of the creditors in that class in order to cram down a dissenting creditor class (e.g., the mortgagee in Village Green). Thus, rather than provide full payment with post-bankruptcy interest on the plan's effective date, as was possible in Village Green, the plan may provide for payment shortly after the effective date. Unless the plan proponent (e.g., debtor) can offer a business justification for this manipulation, courts have found that the slightly impaired claims are not truly impaired for voting purposes. In re Combustion Engineering Inc., 391 F.3d 190, 243-44 (3d Cir. 2004) (pre-bankruptcy arrangement granting stub claims to claimants and creating voting majority "may constitute 'artificial impairment' under [Bankruptcy Code] § 1129(a)(1)"); In re Country Squire Associates of Carle Place LP, 1997 Bankr. LEXIS 1163, at *25 (B.A.P. 2d Cir. 1997) ("Artificial impairment is not allowed where the sole purpose of such impairment is to achieve a cram down of a debtor's major creditor under Section 1129(b)."); In re Windsor River Associates Ltd., 7 F.3d 127, 132-33 (8th Cir. 1993) (plan should not have been confirmed when only accepting classes were artificially impaired; the debtor had ability to pay those classes on the effective date; 60-day delay in payment unnecessary, and the debtor offered no plausible alternative explanation for manipulation of plan terms).

Not all courts, though, distinguish between artificial impairment and actual impairment of a creditor

class. Some will find the class impaired, regardless of the plan proponent's motive for impairing that class. In re Village at Camp Bowie I LP, 710 F.3d 239, 248 (5th Cir. 2013) (rejecting "theory that artificial impairment constitutes bad faith as a matter of law — a theory that has no basis in the Code or our precedents"; debtor may artificially impair claims to obtain an impaired and accepting class); In re L&J Anaheim Associates, 995 F.2d 940, 943 n.2 (9th Cir. 1993) ("[A]buses on the part of a plan proponent ought not affect the application of Congress' definition of impairment."); In re Hotel Associates of Tucson, 165 B.R. 470, 475 (B.A.P. 9th Cir. 1994) (class receiving full payment with interest 30 days after confirmation impaired although the debtor had ability to pay on effective date; "[w]e do not believe that [it is a] bankruptcy court's role to ask whether alternative payment structures could produce a different scenario in regard to impairment of classes"); In re Greate Bay Hotel & Casino Inc., 251 B.R. 213, 240 (Bankr. D.N.J. 2000) ("a claim need not and cannot be artificially impaired"; the Bankruptcy Code's statutory scheme for classification and treatment of claims allows plan proponent to impair class of claims and if impaired class accepts plan, then Section 1129(a)(10) is satisfied). As did the Sixth Circuit in Village Green, these courts instead analyze the plan proponent's motives for impairing classes in the context of the Bankruptcy Code's good-faith requirement, Section 1129(a)(3).

Facts

The debtor owned an apartment building subject to an $8.6 million mortgage. After it missed its monthly mortgage payment, it filed a Chapter 11 petition, staying the mortgagee from foreclosing on the building, which was "worth $5.4 million and is [the debtor's] only asset in the bankruptcy." 2016 U.S. App. LEXIS 1243. Apart from the mortgagee, the debtor's only other "creditors ... were its own former lawyer and accountant," with total claims "less than $2,400." Id. at *1.

The debtor's proposed reorganization plan would pay the lender "relatively slowly, leaving a balance of $6.6 million after ten years." Id. at *3. The plan also stripped the lender of protections in the parties' loan agreements (e.g., requirements for proper maintenance and adequate insurance). As for the only two unsecured claims, the debtor proposed to pay them in "two payments (of roughly $1,200 each) over 60 days."

The Lower Courts

The bankruptcy court found that at least one impaired class of creditors had accepted the plan and that the plan had been proposed in good faith. The district court, however, reversed, finding that the debtor had proposed the plan in bad faith, and directing the bankruptcy court to dismiss the case and lift the stay of foreclosure.

The Sixth Circuit

The debtor's Chapter 11 plan impaired the unsecured claims, explained the Sixth Circuit: "[T]hese claimants are legally entitled to payment immediately rather than in two installments over 60 days. That this impairment seems contrived to create a class to vote in favor of the plan is immaterial." The terms of Bankruptcy Code Section 1124(1) precluded any inquiry as to "whether the debtor had bad motives in seeking to alter" the creditors' rights. Id. at *5.

But the debtor had proposed its plan in bad faith, held the court. First, the debtor could easily have paid the two creditors. Second, their "close ... alli[ance]" with the debtor only showed the debtor's attempt to "circumvent" the Bankruptcy Code's requirement of an impaired accepting class. In fact, the two creditors had rejected the lender's attempt to "tender[ ] ... each of them checks for full payment of their

claims." Id. at *6.

Comment

The court's literal reading of Bankruptcy Code Section 1124(i) in Village Green has support in the case law, as noted. Instead of relying on the "artificial impairment" line of cases, though, it found another fact-specific way to correct the debtor's manipulation: an attack on the debtor's good faith in proposing its plan. The Sixth Circuit's approach made sense on the clear "record" of the Village Green case but may generate further expensive litigation in other cases. If the two unsecured creditors had no prior connection to the debtor in Village Green, and if the debtor had less available working capital, the result might have been different. See, e.g., Beal Bank SSB v. Waters Edge LP, 248 B.R. 668, 690-91 (D. Mass. 2000) ("A class … is legitimately impaired if the creditors' rights are altered for a proper business purpose."); In re Village at Camp Bowie I LP, 710 F.3d at 248.

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