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Absolute Priority Rule Prevents Cram Down in In re RAMZ Real Estate Co., LLC

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September 18, 2014 - In a May 9, 2014 decision, Chief Judge Morris of the United States Bankruptcy Court for the Southern District of New York held that a Chapter 11 bankruptcy plan proposed by an LLC that owned two parcels of land could not be confirmed over the objection of a creditor with both secured and unsecured claims. The decision turned on whether an unsecured, junior, impaired claim relating to an ownership interest in the debtor triggered the absolute priority rule to prevent cram down. *In re RAMZ Real Estate Co., LLC*, 510 B.R. 712 (Bankr. S.D.N.Y 2014)

The debtor, RAMZ Real Estate Co., LLC filed a Chapter 11 bankruptcy plan with seven classes of claims, five of which were secured by liens against property owned by RAMZ and two of which were unsecured. The dispute arose from the objections of one creditor, the Community Preservation Corporation ("CPC"), which held a secured, but impaired, interest in Class 3 and an unsecured, impaired interest in Class 6.

Under Section 1129 of the Bankruptcy Code, a debtor must satisfy two conditions to confirm a Chapter 11 plan. First, section 1129(a)(8) requires that each impaired class of claim must accept the plan. Section 1124 assumes that a class is impaired unless the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." In other words, a claim is impaired when the plan alters a legal, equitable, or contractual right held by the creditor (*e.g.*, when the plan calls for the repayment of 50%, but not all, of an outstanding loan). Second, in the event that the first condition is not met (*e.g.*, when another class of creditors with impaired interests objects), section 1129(a)(10) provides for the possibility of "cram down," in which, as long as at least one class of impaired claims held by non-insider creditors votes to approve the plan, the plan can still be confirmed.

In the present case, CPC filed an objection to the RAMZ Chapter 11 Plan. Thus, the court evaluated whether the RAMZ Plan could be confirmed under the cram down provisions of section 1129(a)(10).

CPC represented the controlling interest in two of the three impaired classes under the RAMZ Plan. The sole remaining impaired class, Class 4, contained the secured property tax claim of the County of Ulster. Although some authority (*e.g., In re Bryson Properties, XVIII*, 961 F.2d 496, 501 (4th Cir. 1992)), held that priority tax claimants were not an impaired class for the purposes of cram down, Chief Judge Morris found that the County of Ulster *was* impaired because the Plan called for a reduction from 12% to 9% of the statutory interest rate for the repayment of the tax burden.

Next, the court considered whether the Plan artificially created the County of Ulster's impairment. Artificial impairment occurs when the debtor alters the treatment of a class solely to obtain the approval of at least one impaired class. Here, the impairment was not artificial because the 3% reduction in the interest rate would result in lower monthly costs for the debtor while still providing income for the County.

Finally, the court evaluated whether the Plan violated the absolute priority rule. Generally, any cram down to override an objection must not discriminate unfairly and must be fair and equitable with respect to the claims and interests of impaired classes. In *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999), the United States Supreme Court held that if a class of impaired, unsecured creditors objected to a Chapter 11 plan, and that creditor's interests will not be paid in full under the plan, then the plan would be fair and equitable only if the claims and interests of any classes junior to that objecting class will not receive or retain any interests in real property. Chief Judge Morris concluded that while the plan did not entail the full payment of the CPC's impaired, unsecured claim in Class 6, a member of a junior class, Class 7, nevertheless retained an equity interest by maintaining 100% ownership of RAMZ and its properties.

After finding that the RAMZ Plan *did* violate the absolute priority rule, the court evaluated whether the Plan could be exempted under the "new value" exception. Under the "new value" exception, a debtor must show that the junior class equity holder provides a capital contribution that is: 1) new; 2) substantial; 3) money or money's worth; 4) "necessary" for a successful reorganization; and 5) reasonably equivalent to the property that the equity holder is retaining or receiving. The CPC only disputed prongs 2, 4, and 5. Starting with prong 4, the court defined "necessary" to mean that, unless a debtor can show that others in the market had the opportunity to bid on the junior equity interest or to provide a competing reorganization plan, the debtor's reorganization plan must fail. Therefore, the court found that the RAMZ Plan was not exempted under the new value exception and denied confirmation. The court then chose not to reach the issues presented by the other prongs.

Finally, although confirmation of the RAMZ Plan was already denied, the court addressed CPC's objection that the Plan was not feasible. The court noted that in any future Chapter 11 plan, RAMZ must demonstrate that the plan is workable by showing: 1) the adequacy of the debtor's capital structure; 2) the earning power of its business; 3) economic conditions; 4) the ability of the debtor's management; 5) the probability of continuing the same management; and 6) anything else determinative of the future success of the business.

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