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Fifth Circuit: Impairment Can Be "Artificial"

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May 24, 2013 - "Cram-down," "indubitable equivalent," "hypothetical lien creditor": these are quintessentially arcane expressions that only a bankruptcy lawyer could love. To this distinguished list can now be added "artificial impairment," a nice example, in that a layperson could ponder the expression for a long time and still have no idea what it means. Even better, there is a split among the Circuits regarding the phenomenon, and its effect on confirmation of plans of reorganization under chapter 11 of the Bankruptcy Code.

In Chapter 11 reorganizations, the "plan of reorganization" is a Bankruptcy Court judgment that comprehensively fixes the rights of all creditors and other stakeholders as against the reorganizing debtor. If the plan terms are acceptable to all parties, confirmation poses few legal issues. Where plan acceptance is not unanimous, however, the Bankruptcy Code provides a mechanism to impose the plan terms on all parties, including creditor classes who object to the treatment of their claims. The statutory conditions to confirmation of such a "cram-down" plan include that "at least one class of claims that is impaired under the plan" has voted in favor. 11 U.S.C. § 1129(a)(10) (2010) (emphasis added). *Impairment* of a class means that the plan affords claims treatment that is less than the full legal entitlement of the claim holders; under section 1124(1) of the Code, impairment exists unless the plan "leaves unaltered" all "legal, equitable and contractual rights." 11 U.S.C. § 1124(1) (2010).

Creativity (like arcane expressions) being a notable characteristic of the bankruptcy bar, this situation led to the phenomenon of "artificial impairment." Assume, for illustrative purposes, that the plan contemplates unsecured and secured classes, and the debtor wishes to cram down the secured class, anticipating a dispute over whether the plan treatment provides the "indubitable equivalent" of existing security interests, which will be an issue in any event under section 1129(a)(7)(B).

To avoid the additional problem that would be presented by non-fulfillment of the acceptance condition in section 1129(a)(10), however, at least one impaired class needs to accept the plan. The plan might accordingly define a class of creditors who will receive *almost* (but not quite) what they would have received if the claims had been paid in full, and with interest, outside of bankruptcy. If the debtor actually has enough cash to satisfy the claims in

full, but chooses instead to create an impaired class that is likely to accept the plan, this is termed "artificial" impairment, as distinguished from "economic" impairment, where the debtor really cannot pay.

Courts are split on whether acceptance by an "artificially" impaired class satisfies section 1129(a)(10). The 8th Circuit has found it just too clever, and holds that "material" impairment is required to satisfy the condition. *See In re Windsor on the River Assocs., Ltd.*, 7 F.3d 127, 131-2 (8th Cir. 1993). The 9th Circuit, taking literally the "unaltered" definition of impairment in section 1124, concluded that impairment should have the same meaning in section 1129(a)(10), and rejected the contention that alteration of rights must be "of a particular kind or degree." *In re L&J Anaheim Assocs.*, 995 F.2d 940, 943 (9th Cir. 1993)).

On February 26, 2013 the United States Court of Appeals for the Fifth Circuit came down on the "no problem" side of the debate. *See In re Village at Camp Bowie I, LP*, 710 F.3d 239 (5th Cir. 2013). After reviewing the competing authorities and inconclusive Fifth Circuit precedents, the court stated:

Today, we expressly reject *Windsor*, and join with the Ninth Circuit in holding that §1129(a)(10) does not distinguish between discretionary and economically driven impairment. . . . 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 purposes of §1129(a)(10) even though it plainly qualifies under § 1124.

Id. at 245.

Especially pointed was the court's rejection of contentions that the plain meaning of sections 1124 and 1129 of the Code could be overridden by the court's understanding of "congressional intent" in enacting these provisions: the Bankruptcy Code must be read literally, and congressional intent is relevant only when the statutory language is ambiguous. Nor did claimed "manipulation of the bankruptcy process" justify departure from the terms of the statute. Rejecting an analogy to an earlier Fifth Circuit case where "gerrymandering" of creditor classes justified reference to "manipulation," the court found that this precedent really was based on an ambiguity in the Code, and did not "stand for the proposition that a court can ride roughshod over affirmative language in the Bankruptcy Code to enforce some Platonic ideal of a fair voting process. *Id.* at 247.

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