ALERT
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Bankruptcy Court for the District of Delaware Denies Cramdown of Liquidating Plan Because Approving Classes Were "Artificially Impaired"

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When a debtor is unable to obtain acceptance of its chapter 11 plan of reorganization or liquidation by all impaired creditor classes, it may attempt to "cramdown" the plan upon certain rejecting classes.[1] One of the requirements in order to obtain confirmation of a plan through a cramdown is that at least one class of *impaired* claims must approve the plan, determined without including the votes of insider creditors.[2] In certain instances, creditors have challenged confirmation of a plan which relies on the acceptance of a so called "artificially impaired" class.

Artificial impairment is an insignificant or de minimis impairment of claims for the purpose of utilizing the class into which those claims fall as the impaired accepting class to satisfy section 1129(a)(10) of the Bankruptcy Code.[3] While there is nothing in the Bankruptcy Code that expressly prohibits artificial impairment, the concern is that such conduct permits a debtor to manipulate the confirmation process by "engineering literal compliance with the Code while avoiding opposition to reorganization by truly impaired creditors."[4]

The 3rd Circuit Court of Appeals has only addressed artificial impairment once.[5] In *Combustion Engineering*,[6] the court stated that artificial impairment was troubling in the context of an asbestos-related bankruptcy. However, the court fell short of announcing a per se rule prohibiting artificial impairment and remanded the case for further consideration.[7] Since *Combustion Engineering*, courts in the 3rd Circuit have struggled to determine its reach, particularly outside the context of an asbestos-related bankruptcy.[8] Nevertheless, in the recent Delaware Bankruptcy Court opinion, *In re All Land Investments, LLC*,[9] the court held that it was appropriate to deny a plan's confirmation in a non-asbestos commercial bankruptcy where the only impaired classes that accepted the plan were artificially impaired.

FACTUAL BACKGROUND

All Land Investments, LLC (the debtor) was formed in 2004 to purchase and develop real property for residential use in Kent County, Delaware (the farm subdivision). In 2006, RBS Citizens, N.A. (Citizens) extended a first land acquisition loan and a second loan for land acquisition and site improvements (collectively, the mortgage notes) to the debtor. Each of the mortgage notes was secured by a mortgage on the farm subdivision, the debtor's primary asset.

Prior to the petition date, the slowing housing industry caused the debtor to experience a significant shortage in working capital which resulted in contractors ceasing to work and delayed closings. In 2009, the debtor defaulted on the mortgage notes and a final judgment was entered in favor of Citizens in the amount due under the mortgage notes and related expenses. On October 29, 2009, the debtor filed its chapter 11 bankruptcy petition.

The debtor's amended plan of liquidation (the amended plan) classified claims and interests into six classes. Classes 1, 2, 3, and 5 were listed as impaired. After the voting deadline had passed, the debtors determined that Classes 1 and 3 voted to accept the amended plan and all Class 5 claimants except Citizens voted in favor of the plan. Subsequently, Citizens objected to the amended plan because, among other things, the amended plan failed to obtain the approval of a *truly* impaired class of claims. The debtor responded by arguing that Classes 1, 3, and 5 were impaired classes that accepted the amended plan. With respect to Class 5, the debtor argued that Citizens was over-secured, so it had no general unsecured Class 5 claim. Therefore, Citizens' rejection of the amended plan did not control Class 5 and, as such, Class 5 should be counted as an additional impaired class accepting the amended plan.

APPROVAL BY AN ARTIFICIALLY IMPAIRED CLASS IS INSUFFICIENT TO MEET THE REQUIREMENTS OF § 1129(a)(10)

In order to determine whether the approval by Classes 1 and 3 should be excluded because they were artificially impaired, the *All Land Investments* court examined and applied *Combustion Engineering*. At the outset, Judge Carey pointed out that *Combustion Engineering* recognized a split over the issue of artificial impairment:

> One line of cases concludes that the plain language of § 1129(a)(10) does not prevent a debtor from artificially impairing claims. The other line of cases has determined that allowing debtors to manipulate impairment of a class to satisfy § 1129(a)(10) so distorts the meaning and purpose of [§ 1129(a)(10)] that to permit it would reduce (a)(10) to a nullity.[10]

Nonetheless, in *Combustion Engineering*, the 3rd Circuit showed its skepticism toward the use of artificially impaired classes to satisfy Section 1129(a)(10).

Turning to the facts of the case, Judge Carey concluded that "it is appropriate to consider whether, in the present case, Classes 1 and 3 were artificially impaired; that is, are Class 1 and 3 impaired for a proper business purpose or solely to satisfy § 1129(a)(10)?"[11] Here, the debtor offered no evidence of a valid business purpose for impairing Classes 1 and 3. "Together, the circumstances indicate that Classes 1 and 3 are impaired solely to obtain the requisite vote to permit confirmation by cramdown."[12] As such, Classes 1 and 3 were artificially impaired and "must be disqualified for purposes of determining whether the debtor has obtained the affirmative vote of an impaired class as required by § 1129(a)(10)."[13] Since there were no other impaired classes that voted in favor of the amended plan, the amended plan could not be confirmed.[14]

VIEWPOINT

All Land Investments should serve as support for creditors who want to seek denial of confirmation where it appears that the debtor has manipulated the class structure or creditors' treatment solely to confirm a non-consensual plan.

From a debtor's perspective, this case serves as a warning that the court may deny confirmation if it finds that a marginally impaired class is impaired for the sole purpose of meeting the technical requirements for a cramdown. The court's analysis will likely turn on whether the purported impairment serves a valid business purpose or is supported by any economic justification as opposed to a de minimis impairment choreographed to gain a friendly "impaired class."

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1 11 U.S.C. § 1129(b).

2 11 U.S.C. § 1129(a)(10).

3 *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 243 (3d Cir. 2004).

4 Id.

5 See Id. at 243-45.

6 Id.

7 Id. at 245.

8 See *In re S. Canaan Cellular Inv., Inc.*, 2009 WL 2922959, at *14 (Bankr. E.D. Pa. May 19, 2009) ("The Third Circuit has not addressed the issue other than in the context of a mass tort chapter 11 case [citing *Combustion Engineering*]"); see also *In re La Guardia Assocs., L.P.*, 2006 WL 6601650, at *20 – 22 (Bankr. E.D. Pa. Sept. 13, 2006) (stating that *Combustion Engineering* stopped short of enunciating a per se rule that artificial impairment is prohibited and to interpret the opinion to hold that artificial impairment is prohibited in all circumstances, would require "a particularly expansive interpretation of [*Combustible Engineering*]").

9 *In re All Land Investments, LLC*, --- B.R. ----, 2012 WL 812341 (Bankr. D. Del. Mar. 9, 2012).

10 Id. at *11 (quoting *Windsor on the River Assoc. v. Balcor Real Estate Fin. (In re Windsor on the River Assoc.)*, 7 F.3d 127, 131 (8th Cir. 1993)) (internal citations omitted).

11 *All Land Investments*, 2012 WL 812341, at *12.

12 Id.

13 Id. at *13 (internal citations omitted).

14 Class 5 was found to be controlled by Citizens' deficiency claim, and since Citizens voted against the amended plan, Class 5 was determined to have rejected the amended plan.