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Successful Collateral Valuation Perhaps Key to Plan Objections

It is no surprise to anyone in the business of secured lending that valuation matters. It is worth noting, however, that collateral valuation may be outcome-determinative in litigation over a plan of reorganization in bankruptcy. Although valuation was not the central focus of the Fifth Circuit's recent decision in *Western Real Estate Equities, L.L.C. v. Village at Camp Bowie I, L.P. (Matter of Village at Camp Bowie I, L.P.)*, No. 12-10271, 2013 U.S. App. LEXIS 3949 (5th Cir. Feb. 26, 2013), imbedded in that decision is an important practical point for a secured lender seeking to prevent the "cramdown" of a reorganization plan over its objection: the valuation of collateral may be a critical lynchpin to any secured lender's plan objections.

Background

In *Camp Bowie*, the debtor owed Western Real Estate Equities, LLC ("Western"), the purchaser of certain notes secured by the debtor's real estate, $32,112,711. The debtor also owed its thirty-eight trade creditors, who performed maintenance and other miscellaneous services, a relatively minuscule $59,398. Under its Chapter 11 plan, the debtor, over Western's objection, sought to extend the term over which payments would be made to Western, relying on its trade creditors—despite the relatively small value of their claims compared to Western's secured claim—to act as an "accepting impaired class." Both the bankruptcy court and the district court on appeal overruled Western's objection and confirmed the debtor's cramdown plan

Decision

On appeal, Western focused its objections on (a) the alleged "artificial impairment" of the trade creditors' claims and (b) the lack of "good faith" by the debtor in proposing its cramdown plan. To confirm a plan, Bankruptcy Code section 1129(a)(10) requires that a class of "impaired" creditors vote in favor of the plan. Consequently, whether the "accepting" class is truly impaired is a frequent issue, especially in cramdown situations. In *Camp Bowie*, Western argued that the debtor had artificially impaired its trade creditors to manipulate the plan confirmation process. In particular, Western asserted that the debtor's plan minimally and unnecessarily impaired trade vendor claims by proposing to pay them in full, without interest, over just a three-month period. Western calculated the trade creditors' foregone interest to be approximately $900. Moreover, no one disputed that the debtor had sufficient cash flow to pay the trade creditors' claims in full.

The Fifth Circuit, in affirming the bankruptcy court's rejection of Western's argument, concluded that "§ 1129(a)(10) does not distinguish between discretionary and economically driven impairment." 2013 U.S. App. LEXIS 3949, at *11. This conclusion is interesting, if for no other reason than because it deepens a split amongst the Courts of Appeals, with the Eighth Circuit (and, somewhat indirectly, the Third Circuit) reaching a conclusion contrary to that adopted by the Fifth and Ninth Circuits. Compare Matter of Windsor on the River Associates, Ltd., 7 F.3d 127 (8th Cir. 1993), and Matter of Combustion Engineering, 391 F.3d 190 (3d Cir. 2004), with Camp Bowie, 2013 U.S. App. LEXIS 3949, and Matter of L&J Anaheim Associates, 995 F.2d 940 (9th Cir. 1993).

Western also argued, in the alternative, that the debtor's artificial impairment of the trade creditors' claims constituted an abuse of the bankruptcy process in violation of the "good faith" requirement set forth in Bankruptcy Code section 1129(a)(3). Again, the Fifth Circuit agreed with the lower courts' determinations, noting that the debtor "had proposed a feasible cramdown plan for the legitimate purposes of reorganizing its debts, continuing its real estate venture, and preserving its non-trivial equity in its properties." 2013 U.S. App. LEXIS 3949, at *18-19. In other words, the Fifth Circuit rejected the notion that artificial impairment constitutes bad faith as a matter of law.

Although the Fifth Circuit's decision certainly presents another example of the risks to secured lenders in cramdown cases, *Camp Bowie* also provides a significant reminder regarding the importance of collateral valuation. In the bankruptcy case, Western moved for relief from the automatic stay and asserted that the debtor had no equity in its real estate. The bankruptcy court, after hearing testimony from appraisers for both Western and the debtor, determined the value of the debtor's real estate to be $34,000,000, greater than the approximately $32,000,000 owed to Western. *See* 2013 U.S. App. LEXIS 3949, at *3. The consequence of Western's oversecured status is significant. Had Western been undersecured, it would have held an unsecured deficiency claim. In many jurisdictions, that deficiency claim must be placed in the same class as other unsecured claims and often allows the holder of the deficiency claim to control the vote of the unsecured class.[1] As the Fifth Circuit explained, "While debtors have attempted to prevent this outcome by placing the trade claims and deficiency claims into separate unsecured classes, many circuits -- including this Circuit -- have held that such gerrymandering is prohibited by the classification rules of § 1122." *Id.* at *15 n.30 (collecting cases). In other words, in *Camp Bowie*, the debtor's artificial impairment of the trade creditors may never have mattered if Western had been undersecured and thus held a deficiency claim that dwarfed the relatively small claims of trade creditors.

Conclusion

The *Camp Bowie* case presents another example of the power the Bankruptcy Code bestows upon corporate debtors, particularly in single-asset real estate cases, to cramdown secured creditors by leveraging a handful of unsecured creditors to create an accepting, "impaired" class. In addition, the decision underscores the importance to secured lenders of focusing on valuation as a potential lynchpin to their objections to plan confirmation. Implicit in the Fifth Circuit's comments is the very real possibility that Western could have blocked plan confirmation had it succeeded in controverting the debtor's proposed valuation of the collateral. This observation is not to suggest that Western failed to put up a valiant fight with respect to valuation, but rather is intended to highlight the significance of collateral valuation strategies in avoiding the problems of cramdown and artificial impairment in the first instance. With a more favorable outcome on valuation, Western could have bolstered its position with objections based not only on artificial impairment and good faith, but also on (1) the classification and potential gerrymandering of claims, (2) the proposed treatment of its claims (including the cramdown interest rate or the possibly disparate treatment of its unsecured deficiency claim vis-à-vis the trade creditors' unsecured claims), and (3) the absolute priority rule if equity owners failed to contribute sufficient "new value" to the reorganized debtor.

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[1] Bankruptcy Code section 1126(c) provides that "[a] class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors . . . that have accepted or rejected such plan." In many cases, the deficiency claims held by secured lenders far exceed trade creditors' claims, particularly in instances of artificial impairment. Thus, holders of such deficiency claims have the ability to prevent their class from accepting the plan, because other claim holders in that class do not hold "at least two-thirds in amount" of the allowed claims.