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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

WINDSOR ON THE RIVER: THE EIGHTH CIRCUIT MAKES IT HARDER TO FIND AN ACCEPTING IMPAIRED CLASS NEEDED FOR CRAMDOWN

Although most confirmed chapter 11 plans have been accepted by all classes of creditors and equity interest holders, the Bankruptcy Code provides that if a plan is fair and equitable and does not unfairly discriminate with respect to nonaccepting classes, and certain other requirements are met, it may be crammed down classes that do not accept the plan.¹ One such requirement, set forth in Section 1129(a)(10) of the Bankruptcy Code (the Code), is that if any class is impaired under the plan, at least one impaired class must accept the plan without counting the votes of insiders.² The purpose of this require-

ment is to prohibit the debtor from cramming down a plan against all impaired classes. In essence, the debtor must be able to persuade at least one class of creditors—dealing at arm's length—to accept a plan that alters their legal or equitable rights.

A recent case that has far-reaching effects on the ability of a debtor to cram down a chapter 11 plan is *Windsor on the River Associates, Ltd. v. Balcor Real Estate Finance, Inc.*³ Windsor on the River Associates, Ltd. is a limited partnership that owns only one asset, a 298-unit apartment complex situated on twenty-three acres in Cedar Rapids, Iowa. The apartment complex was purchased in 1982. In 1987, Windsor refinanced its existing mortgage loan by borrowing \$9.35 million from Balcor Real Estate Finance, Inc. Balcor was given a first mortgage on the apartment complex, as well as an assignment of rents, to secure Windsor's obligations under a four-year note that provided for a balloon payment of all unpaid principal and deferred interest in May 1991.

Windsor made all required payments on the note until March 1991, when it tried unsuccessfully to nego-

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¹ 11 U.S.C. § 1129(b). See 11 U.S.C. § 1126 on voting requirements necessary for a class to have accepted the plan.

² See 11 U.S.C. § 1124 on impairment of claims, and 11 U.S.C. § 101 for the definition of "insider."

³ 7 F.3d 127 (8th Cir. 1993).

tiate a loan extension and to obtain refinancing from other sources. Only five days after the maturity date of the loan, while in default, Windsor filed a chapter 11 petition. The bankruptcy court determined that the value of the apartment complex was \$10.5 million, while the outstanding amount owed to Balcor was approximately \$9.9 million. Therefore, Balcor was an oversecured creditor and did not have any unsecured deficiency claim.

The Plan

Windsor's third amended plan, which provided for a new \$1 million capital contribution by the partners, divided the creditors' claims and the partners' interests into six classes with the following treatment:

Class 1, consisting of Balcor's \$9.9 million secured claim, was to be reduced by a payment of \$500,000 on the effective date of the plan (funded in part by \$435,000 of the partners' capital contribution). The balance was to be paid in monthly payments over ten years, in amounts based on a thirty-year amortization schedule with interest at 8.5 percent, with a balloon payment due in ten years consisting of the outstanding principal and accrued unpaid interest.

Class 2, consisting of a disputed unsecured claim held by an individual in the amount of \$59,249, was to be paid in full sixty days after the effective date. However, the district court disallowed this claim, so that Class 2 had no members.

Class 3 consisted of unsecured trade claims originally owed to thirty-four creditors, aggregating to only \$13,000. The plan provided that these claims were to be paid in full sixty days after the effective date.

Class 4 consisted of the claims of tenants for return of their security deposits. The plan provided for payment of these deposits in accordance with the leases.

Class 5 consisted of the interests of the limited partners.

Class 6 consisted of the interests of the general partners.

Only Classes 1, 2, and 3 were impaired under the plan; Class 1 (Balcor) voted to reject the plan, and the only claim in Class 2 was disallowed. Class 3, the unsecured trade claims, accepted the plan and, therefore, was the only impaired class that accepted the plan.

Balcor feared that the plan could be crammed down under Section 1129(b) of the Code despite its rejection of the plan. As previously indicated, a plan may be confirmed without the acceptance by all classes if, among other requirements, at least one impaired class—not counting the votes of insiders—accepts the plan. To avoid this situation, Balcor successfully challenged the validity of the Class 2 claim and, to secure an unfavorable vote by the Class 3 trade creditors, purchased a majority of the Class 3 claims.

The district court denied Balcor the right to vote the Class 3 unsecured trade claims, in part because

thirteen of the votes had been cast before Balcor had purchased them. Class 3 was deemed to have accepted the plan, providing the impaired class required for cramdown. Balcor appealed to the Court of Appeals for the Eighth Circuit, arguing that Section 1129(a)(10) was not satisfied because Class 3 was not really impaired.

Application of the Bankruptcy Code

The court of appeals began its analysis by setting forth its approach to statutory construction.

Bankruptcy is a creature of statute. Applications of the bankruptcy code must, therefore, be consistent with long established canons of statutory construction. One such established maxim is that “the starting point for interpreting a statute is the language of the statute itself.” [Citations omitted.] While the language is the starting point, it is equally true that it is the task of federal courts when engaging in statutory construction “to interpret the words of the statute in light of the purposes Congress sought to serve.” [Citations omitted.] Accordingly, “we must avoid statutory interpretation that renders any section superfluous and does not give effect to all of the words used by Congress.” [Citations omitted.]⁴

The court then focused on the language of Section 1129(a) of the Code:

(a) The court shall confirm a plan only if all of the following requirements are met:

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.⁵

The term “impaired” is explained in Section 1124 of the Code. In general, pursuant to Section 1124(1), a claim is impaired under a plan if the plan alters the legal, equitable, or contractual rights to which such claim or interest entitles the holder. The court noted that, “[b]y this standard, any alteration of a creditor’s rights, no matter how minor, constitutes ‘impairment.’”⁶ The court of appeals saw the central issue in the case as being “whether such impairment may be manufactured at the will of the debtor,” in the words of Judge Posner, “just to stave off the evil day of liquidation.”⁷ The court answered this question with a clear and definite “no.”

The court stated that it would be contrary to the purpose of the Bankruptcy Code to allow manipulation of claims in a chapter 11 case. The court then commented that Section 1129(a)(10) was created to protect lenders from the potential inequities of the cram-down provisions of the Bankruptcy Act. Recalling that, under the former act, a reorganization plan for real property could have been confirmed so long as the mort-

⁵ *Id.* at 130.

⁶ *Id.* at 130.

⁷ *Id.* at 130. The court was quoting from Richard A. Posner, *Economic Analysis of Law* 378 (3d ed. 1986).

⁴ *Id.* at 130.

gagagee received the appraised value of the property, the court found that Section 1129(a)(10) was included in the Code "[t]o curb the inequities of such reorganization plans being 'crammed down' the throat of secured lenders. The purpose of the section 'is to provide some indicia of support by affected creditors and prevent confirmation where such support is lacking.'" [Citations omitted.]⁸

The court continued:

Since Chapter 11 is designed to promote consensual reorganization plans, a proposal that has no support from impaired creditors cannot serve its purpose. It would be odd if an amendment designed to give secured creditors more protection were used as the means to rewrite their credit agreements without their consent. Confirmation of a plan where the debtor engineers the impairment of the only approving impaired class "so distorts the meaning and purpose of [Section 1129(a)(10)] that to permit it would reduce (a)(10) to a nullity." [Citation omitted.]⁹

The Related Problem of Artificial Classification

The court of appeals found that the issue in this case was similar to the so-called artificial classification cases in which the debtor formulates a chapter 11 plan that puts an undersecured mortgagee's large unsecured deficiency claim in a class that is separate from the relatively small unsecured claims of trade

creditors. By separately classifying the trade claims, and obtaining their acceptance of the plan, Section 1129(a)(10) would be satisfied despite rejection of the plan by the mortgagee who holds the only secured and the largest unsecured claims. The court cited its own decision in *In re Lumber Exchange Building Ltd. Partnership*,¹⁰ where it held that separate classification of trade claims in that situation was improper and affirmed dismissal of the chapter 11 case.

The difference between the facts in *Lumber Exchange* and those in *Windsor* is that in *Windsor* the mortgagee is oversecured and, therefore, has no unsecured claim that could be placed in the same class as the unsecured trade creditors. However, although classification in *Windsor* is proper, the court focused on the issue of whether impairment of the small class of trade claims, where the debtor easily could have left the class unimpaired, is a manipulation of the Code. The court commented that in a single-asset real estate case involving an oversecured mortgagee, the debtor's equity in the property often is sufficient to satisfy in full the much smaller unsecured trade claims, so that impairment of such claims is not necessary.

The possible effects of confirmation under such circumstances are somewhat unsettling. Confirmation might encourage similarly situated debtors

⁸ *Id.* at 131.

⁹ *Id.* at 131.

¹⁰ 968 F2d 647 (8th Cir. 1992).

to view the bankruptcy code as an alternative to refinancing. First, debtors with projects lacking the fiscal promise necessary to gain refinancing on the open market might resort to section 1129(a)(10) as the mechanism by which they might draft their own loans from existing lenders. Second, the very threat of such an alternative might coerce lenders into extensions of credit terms that might otherwise not be called for by market conditions.¹¹

Discouraging "Side Dealing"

The court also warned that confirmation of reorganization plans under such circumstances would directly undermine one of the primary functions of bankruptcy law, which is to discourage side dealing between the shareholders of a corporation and some creditors to the detriment of other creditors. Debtors in these situations would be encouraged to make side deals with relatively small trade creditors—leaving them only marginally affected—in order to gain their acceptance of a plan. "It is exactly such 'side dealing' that prompted the adoption of a bankruptcy code."¹²

The court of appeals, based on this reasoning, articulated its broad holding as follows: "[W]e hold that, for purposes of 11 U.S.C. § 1129(a)(10), a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion."¹³

The only accepting class alleged to have been impaired under the plan was Class 3, consisting of only \$13,000 in trade claims. The alleged impairment was the delay in the full payment of these claims for a period of sixty days. Clearly, such a delay alters the legal rights of such creditors and, therefore, they are impaired under Section 1124(1) of the Code. However, the question of fact, according to the court of appeals, was whether this class was impaired for the purpose of satisfying Section 1129(a)(10): "If this impairment has been manufactured, then the plan must be regarded as having circumvented the purpose of the statute, namely, consensual reorganization."¹⁴

Although findings of fact made by the trial court should not be disturbed on appeal unless they are clearly erroneous, the court of appeals had no difficulty in finding that the district court clearly erred when it determined that the Class 3 trade claims were impaired for Section 1129(a)(10) purposes. The court of appeals found that the Class 3 trade claims, as well as the Class 2 claim that was eventually disallowed, were arbitrarily and artificially impaired, as may be shown by simple remanipulation of the plan: "Had Debtor's plan allowed for a smaller payment to Balcor, say, \$400,000 instead of \$500,000, Debtor could have paid both the Class 2 and Class 3 claimants on the effective date. Balcor would have

¹¹ *Windsor*, 7 F.3d at 132.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

been the only impaired claimant. . . . Oddly, Balcor was placed in the position of possibly having to argue that it should receive less under the plan in the hope that its interests might be protected."¹⁵

Since Windsor could have easily submitted a plan that would have left the trade claims unimpaired, Balcor became the only impaired creditor. Given Balcor's preference for immediate foreclosure of its mortgage, it was unlikely that it would accept any plan that the debtor might propose. Accordingly, the court of appeals found that remand of the case would be futile and it dismissed the chapter 11 case.

Conclusion

The court of appeals in *Windsor* could have reached the same result by dismissing the case based on a finding that the alleged impairment of the small class of trade claims was too de minimis to constitute true impairment for Section 1129(a)(10) purposes. It would be hard to disagree with a holding that slight impairment, such as delaying the full payment of \$13,000 in trade claims for only sixty days in a case involving almost \$10 million in total claims, should not satisfy Section 1129(a)(10). To take this point to the extreme, one could hardly imagine a court confirming a plan where the only impaired class accepting the plan is a very small class to be paid in full only twenty-four hours after the effective date, or who will

receive 99.9 percent payment on the effective date. If the court's holding in *Windsor* was limited to de minimis impairment situations, it would not have been significant enough to warrant an article in this journal.

It is especially interesting that the court's opinion starts by stating the issue as one involving only de minimis alteration of rights: "At issue is whether a debtor's voluntary Chapter 11 reorganization plan can be confirmed over the objections of a secured creditor holding a claim worth over 99 percent of the total value of the claims against the debtor's assets, when no other creditors are *materially* affected by the plan."¹⁶

However, the holding is much broader than that. The court of appeals did not limit its characterization of "artificial impairment" to situations in which the alteration of rights is de minimis. By holding that impairment is artificial and, therefore, does not count for satisfying Section 1129(a)(10) "if the alteration of rights in question arises solely from *the debtor's exercise of discretion*,"¹⁷ the court is effectively prohibiting confirmation of any plan where the debtor has in its financial power the ability to leave unimpaired all of those classes that have accepted the plan.

For example, suppose that Windsor's plan provided that the unsecured trade creditors were to receive payments over the next two

¹⁵ *Id.* at 133.

¹⁶ *Id.* at 129 (emphasis added).

¹⁷ *Id.* at 132 (emphasis added).

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¹⁵ *Id.* at 133.

¹⁶ *Id.* at 129 (emphasis added).

¹⁷ *Id.* at 132 (emphasis added).

years equaling only 10 percent of their allowed claims, and that every trade creditor, in good faith, accepted the plan because of the fear that foreclosure would result in the loss of a valued customer for its goods and services. Clearly, the alteration of their rights would be substantial, resulting in the discharge of 90 percent of their prepetition claims. Nonetheless, under its holding, the court of appeals would deny confirmation because the trade creditors

would not be impaired under Section 1129(a)(10) since the debtor had the discretion to pay them in full and immediately.

While the *Windsor* decision may slam the door on the debtor's ability to confirm a chapter 11 plan in a single-asset real estate case in the Eighth Circuit without the mortgagee's acceptance, it also may make it more difficult for debtors in other types of businesses to successfully cram down a chapter 11 plan under Section 1129(b).