Great Debates

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Resolved: Impairment is a good thing and should be encouraged.

Pro: **Hon. Kevin J. Carey**
U.S. Bankruptcy Court (D. Del.); Wilmington

Con: **Hon. John E. Hoffman, Jr.**
U.S. Bankruptcy Court (S.D. Ohio); Columbus

Resolved: If you get caught hiding assets from the piper, you should pay the piper — with exempt assets.

Pro: **Hon. Eugene R. Wedoff (ret.)**
U.S. Bankruptcy Court (N.D. Ill.); Chicago

Con: **Hon. James M. Carr**
U.S. Bankruptcy Court (S.D. Ind.); Indianapolis

Resolved: You should not be permitted to assert your claim against me. I'm new Jim. Go see Old Jim.

Pro: **Hon. Robert E. Gerber (ret.)**
U.S. Bankruptcy Court (S.D.N.Y.); New York

Con: **Bill Brandt**
Development Specialists, Inc.; New York

Debate 1: Impairment is a Good Thing and Should Be Encouraged

Pro - Honorable Kevin J. Carey, U.S. Bankruptcy Court, District of Delaware

Con - Honorable John E. Hoffman, U.S. Bankruptcy Court, Southern District of Ohio

Articles of Interest

Daniel J. Bussel and Kenneth N. Klee, *Recalibrating Consent in Bankruptcy,* 83 Am. Bankr. L.J. 663, 725 (Fall, 2009)

Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process,* 69 Am. Bankr. L.J. 551 (1995)

Richard Robinson, *All Good-Faith Impairments of Classes are Created Equal*, ABI Journal (May 2013)

Christopher Wick, *You Keep Using that Word – What Good-Faith Impairment Means in a Reorganization Plan*, ABI Journal (April 2016)

"The Battle for Camp Bowie: A Fifth-Circuit Story of Artificial Impairment, Cramdown, and the Risks of Secured Creditors, Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/chapter-11-plans/the-battle-for-camp-bowie-a-fifth-circuit-story-of-artificial-impairment-cramdown-and-the-risks-of-secured-creditors

"Recent Bankruptcy Court Decision Renews Debate over Artificial Impairment," Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/chapter-11-plans/recent-bankruptcy-court-decision-renews-debate-over-artificial-impairment/

"The Sixth Circuit's Take on Artificial Impairment," Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/chapter-11-plans/the-sixth-circuits-take-on-artificial-impairment/

Cases of Interest

Village Green I, GP v. Fannie Mae (*In re Village Green I, GP*), 811 F. 3d 816 (6th Cir. 2016) - The Sixth Circuit held that a single asset real estate debtor failed to propose its plan in good faith as required by Section 1129(a)(3) when it satisfied the impaired consenting class requirement of Section 1129(a)(10) by artificially impairing less than $2,400 of unsecured debt owing to the debtor's former lawyer and accountant.

Western Real Estate Equities LLC v. Village at Camp Bowie I LP (*In re Village at Camp Bowie I LP*), 710 F. 3d 239 (5th Cir. 2013) - The bankruptcy court rejected objections to confirmation based on artificial impairment and good faith arguments, concluding that

Section 1129(a)(10) did not distinguish between artificial and economic impairment and that artificial impairment did not amount to *per se* bad faith. The Fifth Circuit affirmed the bankruptcy court, stating:

> 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 the purposes of § 1129(a)(10) even though it plainly qualifies as impaired under § 1124. *Windsor's* motive inquiry is also inconsistent with § 1123(b)(1), which provides that a plan proponent "*may* impair or leave unimpaired any class of claims," and does not contain any indication that impairment must be driven by economic motives.
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> As we suggested in *Sandy Ridge*, a plan proponent's motives and methods for achieving compliance with the voting requirement of § 1129(a)(10) must be scrutinized, if at all, under the rubric of § 1129(a)(3), which imposes on a plan proponent a duty to propose its plan "in good faith and not by any means forbidden by law. "Good faith should be evaluated "in light of the totality of the circumstances surrounding establishment of [the] plan," mindful of the purposes underlying the Bankruptcy Code. Generally, "[w]here [a] plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the good faith requirement of § 1129(a)(3) is satisfied." We review a bankruptcy court's § 1129(a)(3) analysis only for clear error.
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> Here, the bankruptcy court determined that the Village had not run afoul of § 1129(a)(3), as it 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. Western does not dispute that the Village will be able to stay current on its restructured obligations or that it has significant equity in its properties, instead relying wholly on the theory that artificial impairment constitutes bad faith as a matter of law—a theory that has no basis in the Code or our precedents. On this record, we cannot conclude that the district court clearly erred in its § 1129(a)(3) analysis, particularly as we have recognized that a single-asset debtor's desire to protect its equity can be a legitimate Chapter 11 objective.
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> We emphasize, however, that our decision today does not circumscribe the factors bankruptcy courts may consider in evaluating a plan proponent's good faith. In particular, though we reject the concept of artificial impairment as developed in Windsor, we do not suggest that a debtor's methods for achieving literal compliance with § 1129(a)(10) enjoy a free pass from scrutiny under § 1129(a)(3). It bears mentioning that Western here concedes that the trade creditors are independent third parties who extended pre-petition credit to the Village in the ordinary course of business. An inference of bad faith might be stronger where a debtor creates an impaired accepting class out of whole cloth by incurring a debt with a related party, particularly if there is evidence that the

> lending transaction is a sham. Ultimately, the § 1129(a)(3) inquiry is fact-specific, fully empowering the bankruptcy courts to deal with chicanery. We will continue to accord deference to their determinations.

Matter of Windsor on the River Associates Ltd., 7 F.3d 127 (8th Cir. 1993) - The Eighth Circuit held that "for purposes of § 1129(a)(10), a claim is not impaired if alteration of rights in question arises solely from the debtor's exercise of discretion" and is not driven by economic need. In analyzing the facts of the case, the Eighth Circuit held that the trial court erred in holding that Class 3 claims were impaired because those claims could have been paid in full on the effective date and therefore were "arbitrarily and artificially impaired."

L&J Anaheim Assocs. v. Kawasaki Leasing Int'l Inc. (*In re L&J Anaheim Assocs*.), 995 F.2d 940 (9th Cir. 1993) - The Ninth Circuit held that a claim whose legal, equitable or contractual rights are improved is impaired and can be used to satisfy Code Section 1129(a)(10). However, the Court also held that the plan proponent must still comply with the requirement that the plan be proposed in good faith pursuant to Code Section 1129(a)(3) which is evaluated in light of the totality of circumstances.

In re Combustion Engineering, Inc., 391 F.3d 190, 244 (3d Cir. 2004), *as amended* (Feb. 23, 2005) – Although not directly addressing artificial impairment, the Third Circuit expressed concern over the debtor's pre-petition payments to a favored group of tort claimants stating that "[on] the facts here, the monitoring function of § 1129(a)(10) may have been significantly weakened."

Poncebank v. Mem'l Prods. Co., Inc. (In re Mem'l Prods. Co., Inc.), 212 B.R. 178, 184 (1st Cir. BAP 1997) – Artificial impairment will not satisfy Code Section 1129(a)(10). "Where the plan contemplates the debtor's continuation in business and the reasonable cash needs of that business—to meet accrued and foreseeable expenses and to make reasonable provision for contingencies—require some or all of the cash on hand that might otherwise be paid to plan creditors on confirmation, that need justifies the plan's deferment of payment to the plan creditors."

Beal Bank, S.S.B. v. Waters Edge L.P., 248 B.R. 668, 690–91 (D.Mass.2000) – Artificial Impairment will not satisfy Code Section 1129(a)(10). "A class is artificially impaired if a debtor intentionally alters the class members' rights in order to manipulate the voting process, but it is legitimately impaired if the creditors' rights are altered for a proper business purpose."

In re RAMZ Real Estate Co., LLC, 510 B.R. 712, 717 (Bankr. S.D.N.Y. 2014) – Artificial Impairment will not satisfy Code Section 1129(a)(10). "Where a debtor's motivation in altering the treatment of a class is solely to obtain approval by at least one impaired class, that class is considered to be 'artificially impaired' and its acceptance of the plan cannot be used to satisfy § 1129(a)(10). Where the debtor can show a legitimate business purpose for impairing a class, the class is not considered 'artificially impaired.' It should be noted that nothing in the Code prevents a debtor from negotiating a plan in order to gain acceptance and nothing requires a debtor to employ effort in creating unimpaired

classes. In fact, the Code contemplates that a debtor will indeed impair classes of claim in its plan of reorganization."

In re All Land Investments, LLC, 468 B.R. 676 (Bankr. D. Del. 2012) - Artificial Impairment will not satisfy Code Section 1129(a)(10). The court analyzed whether the classes were impaired for a proper business purpose or solely to satisfy Code Section 1129(a)(10). The court determined that impairment was artificial and denied confirmation because no impaired classes had accepted the plan.

In re Duval Manor Assocs., 191 B.R. 622 (Bankr.E.D.Pa.1996) - The court stated that artificial impairment is permitted under the plain meaning of the statute although "perhaps philosophically not the better view."

The court commented further:

> This Court agrees that restricting "artificial" impairment could itself give rise to a veritable Pandora's box of related problems, as courts perforce grapple with disputes over the particular degree of class impairment needed to pass muster. Consistent with the foregoing, even some courts which have determined to restrict the availability of artificial impairment have done so, not on the basis that the same is not permitted under a literal reading of the Bankruptcy Code, but on the basis that choosing this means to an end demonstrates a lack of the good faith required of the plan proponent under 11 U.S.C. § 1129(a)(3). See, e.g., In re Meadow Glen, Ltd., 87 B.R. 421 (Bankr.W.D.Tex.1988). This Court declines also to follow that lead, and agrees instead with the Fifth Circuit Court of Appeals which rejected that argument in In re Sun Country Development Inc., 764 F.2d 406 (5th Cir.1985). Indeed, it seems counterintuitive to assail the good faith of a Debtor who merely avails itself of a right afforded to it under the plain reading of a statute.

In re Daly, 167 B.R. 734, 737 (Bankr.D.Mass.1994) – The court stated that a debtor cannot satisfy § 1129(a)(10) by manufacturing an impaired class for the sole purpose of satisfying that provision, thereby forcing the plan upon a truly impaired class that has voted to reject the plan.

The court commented further:

> Even if the new evidence were admitted, it would be to no avail because the impairment of Rattey's claim in the most recent plan was plainly contrived and engineered solely to create an accepting impaired class . . .This contrived and artificial impairment can be viewed either as a violation of the requirement of an accepting impaired class, § 1129(a)(10), or as a violation of the requirement that the plan be proposed in good faith, § 1129(a)(3), or as both. Whichever way it is viewed, it prevents confirmation of the plan.

In re Lettick Typografic, Inc., 103 B.R. 32, 39 (Bankr.D.Conn.1989) - The court stated that, "[i]n a transparent attempt to stage compliance with (a)(10), the debtor created an

artificially impaired class by amending its Second Plan so that CNB is to be paid two weeks after the effective date of the Plan. While the debtor may have achieved literal compliance with § 1129(a)(10), this engineered impairment so distorts the meaning and purpose of that subsection that to permit it would reduce (a)(10) to a nullity."

Debate 2: If you get caught hiding assets from the piper, you should pay the piper -- with exempt assets.

Con – Honorable James M. Carr, U.S. District Court, Southern District of Indiana

Pro - Honorable Eugene R. Wedoff, U.S. Bankruptcy Court, Northern District of Illinois (retired)

Articles of Interest

Ashley M. McDow, Michael T. Delaney, *Law v. Siegel-the End of Equitable Authority of the Bankruptcy Court?*, 33 Cal. Bankr. J. 249 (2015)

Neil C. Gordon & Jonathan H. Azoff, *Law v. Siegel Dicta Leads Lower Courts Astray*, Am. Bankr. Inst. J., February 2015

"The Supreme Court Says, "No Need to Spare the Rod, but Don't Spoil the Fraudulent Debtor's Exemptions Either," Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/jurisdiction/the-supreme-court-says-no-need-to-spare-the-rod-but-dont-spoil-the-fraudulent-debtors-exemptions-either/

Cases of Interest

Law v. Siegel, 134 S.Ct. 1188, 188 L. Ed. 2d 146 (2014) – The Supreme Court held that by surcharging the debtor's exemption, the bankruptcy court exceeded its sanction powers and that federal law provides no authority to deny an exemption on a ground not specified by the Code.

Selected Post-SCOTUS *Law v. Siegel* Decisions

In re Baker, 791 F.3d 677 (6th Cir. 2015) – The debtors did not disclose their interest in a cause of action until years after their bankruptcy case was closed. The trustee learned of the cause of action and reopened the case to pursue it on behalf of the debtor's bankruptcy estate. The debtors amended their schedules to claim exemptions in the cause of action. Over the trustee's objection based on bad faith and fraudulent conduct, the bankruptcy court allowed the amended exemptions. Following *Law v. Siegel*, the Sixth Circuit affirmed, holding that the bankruptcy court does not have the authority to use its equitable powers to disallow exemptions based on debtor's bad faith or other misconduct.

In re Elliott, 544 B.R. 421 (B.A.P. 9th Cir. 2016) –The First Circuit B.A.P. distinguished *Law v. Siegel* and held that the debtor was not entitled to exempt property recovered by the trustee for the benefit of the estate. The court relied on Section 522(g)(1) which permits a debtor to exempt property recovered by the trustee but only if (i) the property was involuntarily transferred and (2) the debtor did not conceal the transfer or an interest in property. The debtor had concealed his interest in real property by

transferring title prepetition to a corporation that he controlled and not disclosing the interest in the real property or the corporation in his bankruptcy schedules.

In re Woolner, 2014 WL 7184042 (Bankr. E.D. Mich. Dec. 15, 2014) – The court granted a trustee's objection to the debtors' exemptions because the debtors intentionally undervalued the assets in bad faith. Distinguishing *Law v. Siegel*, the court stated "in this Court's view, there is a material and decisive difference between the Bankruptcy Court (a) not having the authority to surcharge a previously allowed and unobjected-to exemption and (b) not having the authority to disallow the exemption in the first place because it was initially claimed fraudulently or in bad faith."

Selected Pre-SCOTUS *Law v. Siegel* Decisions

Malley v. Agin, 693 F.3d 28, 30 (1st Cir. 2012) - Bankruptcy court was acting within its statutory authority when it imposed surcharge against value of otherwise exempt asset as remedy for Chapter 7 debtor's wrongful concealment of non-exempt and now unavailable property subject to creditors' claims.

In re Scrivner, 535 F.3d 1258 (10th Cir. 2008) –The debtors owned an interest in the television show "Cheaters" for which they received monthly income. The debtors failed to surrender any of this post-petition income to the Trustee. The Tenth Circuit held that the debtors' exempt assets could not be surcharged to satisfy amounts owing the Trustee from the Cheaters income that the debtors failed to surrender. The court reasoned that "a bankruptcy court may not exercise its 'broad equity powers' under § 105(a) 'in a manner that is inconsistent with the other, more specific, provisions of the Code.'

Latman v. Burdette (*In re Latman*), 366 F.3d 774, 786 (9th Cir. 2004) - The Ninth Circuit held that in "exceptional circumstances" surcharge is "reasonably necessary both to protect the integrity of the bankruptcy process and to ensure that a debtor exempts an amount no greater than what is permitted by the exemption scheme of the Bankruptcy Code."

In re Mazon, 395 B.R. 742 (M.D. Fla. 2008) – The court held that it lacks authority to impose a surcharge on exempt assets as a remedy for debtors' misconduct.

Debate 3: You Should Not be Permitted to Assert Your Claim Against Me. I'm New Jim. Go See Old Jim.

Pro - Robert E. Gerber, U.S. Bankruptcy Court, Southern District of New York (retired)

Con - William A. Brandt, Jr., Development Specialists, Inc.

Articles of Interest

Jo Ann J. Brighton, *How Free Is "Free and Clear"? (Redux) A Look at Al-Perry and Its Implications on S363 Sales (If Any)*, Am. Bankr. Inst. J., February 2008

Brad Warner, *Reconciling Bankruptcy Law and Corporate Law Principles: Imposing Successor Liability on GM and Similar "Sleight-of-Hand" 363 Sales*, 32 Emory Bankr. Dev. J. 537 (2016)

"Objecting to 363 Sale Orders Free and Clear of Interests: Speak Promptly or You'll Never Hold Your Piece." Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/363-sales/objecting-to-363-sale-orders-free-and-clear-of-interests-speak-promptly-or-youll-never-hold-your-piece/

"Free and Clear. Not So Fast. Bankruptcy Court Claws Back Ability to Sell Distressed Assets Free and Clear of Claims and Interests," Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/363-sales/free-and-clear-not-so-fast-bankruptcy-court-claws-back-ability-to-sell-distressed-assets-free-and-clear-of-claims-and-interests/

Does Silence Mean Consent? Some Courts Have Found That It Does Not (at Least for Purposes of Sales Under Section 363(f)), Weil Bankruptcy Blog, http://business-finance-restructuring.weil.com/363-sales/does-silence-mean-consent-some-courts-have-found-that-it-does-not-at-least-for-purposes-of-sales-under-section-363f/

Cases of Interest

C*ity of Concord, N.H. v. N. N.E. Tel. Operations LLC* (*In re N. N.E. Tel. Operations LLC*), 795 F. 3d 343 (2d Cir. 2015) – A secured creditor's lien can be extinguished pursuant to 1141(c) only if "(1) the text of the plan does not preserve the lien; (2) the plan is confirmed; (3) the property subject to the lien is 'dealt with' by the terms of the plan; and (4) the lienholder participated in the bankruptcy proceedings." The Second Circuit noted that, at a minimum, the participation requirement "requires more than passive receipt of effective notice" that a plan might deal with its lien.

In re Emoral, Inc., 740 F.3d 875 (3d Cir. 2014) –Prepetition buyer of debtor's assets from a debtor was the subject of toxic tort suits. Disputes arose between the trustee and the buyer of the assets which resulted in fraudulent transfer claims brought by the trustee. The trustee and buyer settled those disputes and the trustee agreed to release the buyer from any causes of action that were property of the estate. Plaintiffs then

asserted personal injury claims against the buyer based on successor liability. In a 2–1 decision, the majority held that the claims did in fact belong to the estate, and that the buyer was protected. As a legal matter, the majority found that the claim for successor liability was for the benefit of all of the estate's creditors.

Al Perry Enters., Inc. v. Appalachian Fuels, LLC, 503 F.3d 538 (6th Cir.2007) - The effect of a bankruptcy court's order approving the sale of a debtor's assets free and clear of any interest or claims that could be brought against the bankrupt estate is "to extinguish [the claimant's] claim unless it was expressly assumed by [the purchaser] as part of the purchase agreement.".

In re Trans World Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) – The bankruptcy court entered an order authorizing sale of assets of debtor-airline to successor free and clear of airline employees' successor liability claims. The district court affirmed. The Court of Appeals held that: (1) airline workers' employment discrimination claims, as well as flight attendants' rights under travel voucher program that debtor-airline had established in settlement of sex discrimination action, both qualified as "interests in property," under bankruptcy statute that provided for sale of assets of estate free and clear of interests in property; and (2) claims were reducible to monetary judgment, so as to permit sale of debtor's assets free and clear of such claims.

In re Polyurethane Foam Antitrust Litigation, 86 f. Supp. 3d 769 (N.D. Ohio 2015) - Buyer's purchase of corporation's assets at bankruptcy sale did not result in a "mere continuation" of corporation in a different form, so as to trigger exception to general New York rule that a corporate asset purchaser does not succeed to the seller's liabilities; corporation remained in existence after the sale and had $4 million in assets seven months after the sale closed, and involvement of unrelated bidders at sale indicated that the transaction between buyer and corporation was not arranged from the start to allow a "mere continuation" of corporation.

In re Grumman Olson Ind., Inc., 467 B.R. 694 (S.D.N.Y. 2012) – "Free and clear" sale order purporting to extinguish any claims for successor or vicarious liability asserted against purchaser of Chapter 11 debtor's assets could not be enforced to extinguish the New Jersey successor liability claims of claimants who were not injured by a product manufactured by debtor until after the bankruptcy closed when such claimants were not provided with notice of, or an opportunity to participate in, the bankruptcy proceedings that gave rise to the sale order. "[F]or due process reasons, a party that did not receive adequate notice of bankruptcy proceedings [can] not be bound by orders issued during those proceedings."

In re Motors Liquidation Co., 529 B.R. 510 (Bankr. S.D.N.Y. 2015) - General Motors LLC ("New GM"), the entity formed in 2009 to acquire the assets of General Motors Corporation ("Old GM"), is shielded from a substantial portion of the lawsuits based on ignition switch defects in cars manufactured prior to New GM's acquisition of the assets of Old GM in 2009. The court determined that the lawsuits are barred by the provisions of the Sale Order, which transferred the assets to New GM "free and clear" of claims against Old GM (other than a narrow range of expressly assumed liabilities) and

protected New GM from any claims based on theories of successor liability. The court held that:

- Holders of product liability claims have due process rights;
- Old GM's knowledge of the ignition switch defect that created a safety hazard, along with knowledge of names and addresses of owners of defective cars, served to make owners of these vehicle models "known creditors," to whom debtor-manufacturer had due process obligation to provide actual notice;
- Lack of notice did not prejudice creditors and did not result in due process violation, at least not insofar as it prevented them from arguing against "free and clear of" language in sales order where numerous other parties vigorously asserted "free and clear" objections to the sale order with no success;
- Lack of notice violated car buyers' due process rights, insofar as it resulted in entry of overbroad sales order because known creditors of Old GM, consisting of car buyers with economic loss claims arising from defective ignition switches in models of cars, were prejudiced by lack of anything but publication notice of sale of assets free and clear of all but very limited forms of liability for vehicles built by debtor, insofar as this lack of notice prevented them from asserting arguments that terms of sales order protected purchaser from any liability in connection with vehicles manufactured by debtor, even for liability arising from its own acts, that was not raised by other parties at hearing on sale, and that bankruptcy court had found persuasive in other cases;
- Known creditors of debtor had due process rights, not only to actual notice of proposed sale of debtor's assets free and clear, but to actual notice of debtor-manufacturer's bankruptcy filing and of deadline for filing proofs of claim; and
- As remedy for due process violation that occurred when debtor failed to provide actual notice of proposed sale free and clear, the court directed that overbroad language in sales order did not bind creditors without requisite notice.

In re Arch Hospitality, Inc., 530 B.R. 588 (Bankr. W.D.N.Y. 2015) – Holder of second mortgage and Worker's Compensation Board did not consent to 363 sale of a hotel by failing to respond to the sale motion. The court stated that the failure respond to the motion is fundamentally difference than "affirmation of acquiescence." The court acknowledged there are circumstances where silence indicates consent, but the sale of real property was a different situation. In this case, the creditors took steps to perfect their liens where they should be able to expect their liens to survive a transfer of title.

Burton, et al. v. Chrysler Group, LLC (*In re Old Carco LLC*), 492 B.R. 392 (Bankr. S.D.N.Y. 2013) - Purchasers of allegedly defective motor vehicles, that suffered from "fuel spit back" problem, brought class action against purchaser of bankrupt motor vehicle manufacturer's assets. The Court held that due process did not prevent "free and clear of" language in bankruptcy court's sales order, the "free and clear" language did not affect any claims held by individuals who purchased allegedly defective cars

manufactured or sold by successor entity after closing, the asset purchaser had no duty to extend lifetime warranties to owner of any vehicle manufactured by debtor; and "free and clear of" language prevented vehicle purchasers from asserting failure-to-warn claims against successor, for failing to advise them of "fuel spit back" problem with vehicles.