When "Loan to Own" Becomes "Own a Loan" – How a Recent Fifth Circuit Decision Rejecting the Artificial Impairment Doctrine Increases Risks for Distressed Real Estate Investors

Chapter 11 of the U.S. Bankruptcy Code provides debtors with a number of tools to restructure comprehensively their debts and other liabilities as well as immediate protection from secured and unsecured creditors. In single asset real estate ("SARE") cases, secured lenders (*i.e.,* mortgage holders) typically have greater protections against aggressive equity owners seeking to use chapter 11 to deprive lenders of their contractual and state law remedies, including foreclosure. However, 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 (5^{th} Cir. Feb. 26, 2013) may have turned the tables on these dynamics in favor of distressed property owners, and secured lenders may now have to consider alternative strategies to counter this changed dynamic. Otherwise, distressed investors could end up being forced by bankruptcy courts to continue lending substantial sums of money to SARE debtors on a long-term basis and on below-market terms.

Background

The debtor in *Camp Bowie* owned a mixed-use development in Fort Worth, Texas and filed for chapter 11 in the United States Bankruptcy Court for the Northern District of Texas the night before the foreclosure sale initiated by the debtor's secured mortgage lender, Western Real Estate Equities, L.L.C. ("Western"), who had acquired the loan from Wells Fargo at a significant discount. As of the filing, the debtor owed approximately $32 million to Western on the mortgage as well as a total of $60,000 to 38 different general unsecured creditors. Early in the case, Western sought relief from the automatic stay to foreclose on the property. The bankruptcy court denied Western's motion, finding that Western was oversecured (*i.e.*, the value of the property exceeded the outstanding mortgage debt).

The debtor proposed a non-consensual "cramdown" chapter 11 plan that sought to force Western to accept a new five-year note with a 5.83% interest rate and a balloon payment to be made upon the new note's maturity. Under the plan, the debtor's general unsecured creditors would be paid in full, but over a three month period, without interest, and the existing equity owners would retain the property. Western objected to confirmation on a number of grounds, arguing, among other things, that the plan's *de minimis* impairment of general unsecured creditors constituted "artificial impairment" and, therefore, precluded the debtor from satisfying the requirement in Bankruptcy Code section 1129(a)(10) that at least one impaired class of creditors vote to accept a "cramdown" plan. Western also argued that the debtor's contrived scheme to manufacture a minimally impaired class of creditors with comparatively little economic exposure to the debtor demonstrated that the plan was not proposed "in good faith" as required by Bankruptcy Code section 1129(a)(3).

The Bankruptcy Court and Fifth Circuit's Decisions

The Bankruptcy Court rejected Western's arguments and confirmed the plan. Specifically, the bankruptcy court rejected the doctrine of "artificial impairment," holding that the Bankruptcy Code's definition of impairment in Bankruptcy Code section 1124 is both clear and intentionally broad and makes no distinction between various degrees of impairment. In other words, impairment is impairment, whether or not material or driven by economic need. The bankruptcy court acknowledged, however, that it would be appropriate to consider whether the debtor's "artificial" impairment of unsecured creditors' claims under the plan means that the plan was not proposed in good faith. Ultimately, the bankruptcy court found that the plan was proposed in good faith because the debtor's equity owners were merely acting to reorganize the debtor's balance sheet in a manner that would also preserve their in-the-money equity interests in the property against an attempt by Western to appropriate that value for itself. Western appealed the bankruptcy court's decision to the Fifth Circuit Court of Appeals, which affirmed the bankruptcy court's decision and order confirming the debtor's plan. In so doing, the Fifth Circuit followed the Ninth Circuit's decision in *In re L&J Anaheim Associates*, which held that any impairment of a class of claims, no matter how economically insignificant, can be used by the debtor to meet the confirmation requirement of an impaired accepting class (subject to passing muster under the Code's good faith requirement). In its decision, the Fifth Circuit also rejected the Eighth Circuit's decision in *In re Windsor on the River Associates*, which, to date, is the only Circuit Court of Appeals to have held that the impaired accepting class requirement cannot be satisfied by nominally impairing a class of claims under a plan for the central purpose of satisfying that very requirement.

What Camp Bowie Means For Distressed Real Estate Investors Pursuing "Loan-to-Own" Strategies

In the wake of *Camp Bowie*, it is still possible for secured lenders facing the prospect of an unfavorable cramdown plan to defeat confirmation by asserting that the plan was not proposed in "good faith." After all, the Fifth Circuit did not independently decide that the debtor's plan in *Camp Bowie* was proposed in good faith, but rather held that the bankruptcy court did not clearly err in making its fact-specific finding of good faith. Nonetheless, the contours of the "good faith" requirement may vary from case to case and are insufficiently defined to provide distressed investors with the degree of clarity and predictability needed to make fully informed investment decisions. What is more, the limited guidance provided by the Fifth Circuit in *Camp Bowie* on the good faith issue suggests that artificial impairment, without more, could rarely, if ever, suffice to show that a plan was proposed in bad faith.

Previously, opportunistic real estate investors could purchase a SARE debtor's distressed mortgage debt at a deep discount and have a reasonable expectation that they would either end up owning the property through a bankruptcy (or through a state law foreclosure) or receive consideration for their debt that would substantially exceed the amount paid to acquire the debt. The *Camp Bowie* decision represents a significant shift in negotiating leverage that favors existing fee owners of distressed real estate and disfavors holders of secured mortgage debt. Accordingly, in light of *Camp Bowie*, real estate investors seeking to purchase mortgage debt as part of a "loan-to-own" strategy will undoubtedly want to exercise more caution before making a particular investment, particularly in mortgage debt issued by borrowers located in states in the Fifth and Ninth Circuits (*e.g.*, Texas and California).

For starters, investors will want to be even more vigilant in their pre-investment diligence and valuation analysis to ensure that the mortgage debt is comfortably "underwater," and continue analyzing the value of the collateral throughout the case. In cases where the market value of property is less than the amount of outstanding mortgage debt—secured lenders will often have a sizeable unsecured "deficiency" claim that will control the voting outcome of the unsecured class, thereby avoiding a situation where a SARE debtor can propose a plan that nominally (or even substantially) impairs an economically insignificant class of trade creditors to force the secured lenders to essentially refinance a debtor's mortgage on non-market terms.

Second, investors will want to develop a strategy to neutralize the debtor's ability to confirm a "cramdown" plan by nominally impairing a class of creditors if the debtor succeeds in demonstrating that there is equity value in the property over and above the mortgage debt. One possible strategy might involve purchasing a sufficient number of unsecured "trade" claims to allow the investor to vote claims comprising more than one-third of the total claims pool (*i.e.*, a blocking position) against the plan. For example, in *Camp Bowie*, if Western had acquired over $20,000 of the approximately $60,000 of unsecured trade claims against the debtor and voted those claims against the plan, it likely would have prevented the debtor from reaching the threshold needed to have an impaired accepting class. That amount would have been a very small price for Western to pay to avoid being forced to extend a $32 million loan for another five years on economic terms unavailable to most borrowers on the open market. Such a strategy is not foolproof, however. As an initial matter, there is no guarantee that a debtor's trade creditors will be willing to sell. In fact, these trade creditors may actively resist such overtures, preferring to have no recovery on account of their claims if it means preserving their business relationship with the SARE debtor (and perhaps other properties owned by the same entity as the debtor) post-bankruptcy. Even if a secured lender successfully purchases more than one-third of the unsecured claims pool, there is also a risk that the debtor may seek to "designate" (or have the bankruptcy court disregard) the secured lender's votes to reject the plan on account of the acquired claims pursuant to Bankruptcy Code section 1126(e). Although, case law suggests that the debtor would be unlikely to succeed in its effort to designate those votes, it is still a risk to consider before investing in the mortgage debt of a distressed borrower that could be oversecured.

Investors will also want to consider in advance what types of litigation tactics they might employ in a bankruptcy case to gain leverage vis-à-vis aggressive property owners, such as moving to dismiss the chapter 11 on the ground that it was filed in bad faith.

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