In re LaRosa, Case No. 03-4115,
2009 Bankr. LEXIS 517, 2009 WL 1172843,
51 Bankr. Ct. Dec. 140 (Bankr. N.D.W. Va.
March 25, 2009).

Order Entered.

Patrick M. Flatley
United States Bankruptcy Judge
Dated: Wednesday, March 25, 2009 3:00:41 PM

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF WEST VIRGINIA

IN RE:	)	
	)	
ESTATE OF VIRGIL B. LAROSA, and	)	Case No. 03-4115
JOAN LAROSA	)	
	)	
Debtors.	)	Chapter 11
	)	

MEMORANDUM OPINION

Joseph and Dominick LaRosa (collectively, "JDL"), brothers, seek to convert the Chapter 11 case of their deceased cousin, Virgil B. LaRosa, and his surviving spouse, Joan LaRosa, (the "Debtors") to a case under Chapter 7 of the Bankruptcy Code pursuant to 11 U.S.C. § 1112(b).[1] Although JDL asserts multiple grounds on which this court should convert the Debtors' case, JDL's contention that the Debtors have not proposed a plan that is capable of being confirmed under § 1129(a)(10) due to JDL's promised rejection convinces the court that JDL's motion to convert is meritorious.[2] The court will enter an order granting JDL's motion to convert unless the Debtors can file an amended plan within 20 days to cure this insuperable bar to confirmation.

I. BACKGROUND

When the Debtors filed their November 19, 2003 Chapter 11 bankruptcy case, they were the

[1] This case was filed before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became effective, and, therefore, is governed by the version of 11 U.S.C. § 1112(b) in existence before October 15, 2005.

[2] This is not to say that the other grounds raised by JDL are not meritorious; rather, the issue addressed by the court herein is so glaring that it overshadows the other grounds raised by JDL.

sole owners of Cheyenne Sales Company, Inc. Cheyenne operates a coal tipple and wash plant. Cheyenne is not in bankruptcy, but its operations are intertwined with the Debtors' reorganization efforts inasmuch as the Debtors seek to fund their proposed plan, in part, based on payments to them from Cheyenne. The Debtors value their Cheyenne stock at $1 and claim it as exempt.

This is a two creditor case. The first creditor is Huntington National Bank. On January 25, 2001, Cheyenne borrowed $950,000 from Huntington Bank. The Debtors guaranteed that obligation. The Debtors represent in their proposed disclosure statement and plan that the outstanding balance on the loan is about $700,000. Cheyenne is current in its loan payments to Huntington Bank, but, according to the Bank, the loan to Cheyenne matures on June 3, 2009, and no further loan extension will be granted. Huntington Bank is secured in all the assets of Cheyenne, which the Debtors estimate to be about $120,000, and in securities posted by the Debtors as collateral for their guarantee agreement. Those securities are valued at about $715,000; thus, Huntington National Bank's January 25, 2001 loan is fully secured. Cheyenne also owes the Debtors $915,000. No amount of this debt has been paid by Cheyenne since the Debtors filed their bankruptcy petition.

Huntington Bank has also issued three letters of credit to Cheyenne, aggregating $172,360, that are similarly guaranteed by the Debtors. The letters of credit relate to bonds associated with Cheyenne's environmental reclamation obligations. To date, no party has made a claim on the letters of credit, and while the exact amount of its future environmental liabilities are not ascertainable, the Debtors estimate that such costs could be in excess of $1 million. The letters of credit may never become due so long as Cheyenne is able to maintain compliance with environmental regulations. The letters of credit are reportedly secured by the Debtors' assets: two bank accounts with $33,463 in deposits; a bank CD worth $10,004, and Huntington Bank stock having an approximate value of $12,057.

JDL is the Debtors' only other creditor. JDL has a judgment lien against the Debtors' estate for about $4.1 million, which is reportedly junior to the liens of Huntington Bank, and which is allegedly secured by all real and personal property of the Debtors. In the Debtors' proposed Chapter 11 plan they value the secured portion of JDL's claim at $1,165,000, and the remainder ($2,935,000) is treated as unsecured. The Debtors propose to pay JDL's secured claim through the sale of real property; the unsecured portion of JDL's claim is to be paid in monthly installments of $7,000 over a period of five years. The source of the $7,000 monthly payment is Cheyenne, which will be reducing its $915,000 debt owed to the Debtors as the stream of payments occur. Payments from Cheyenne will not begin until the conclusion of an ancillary fraudulent transfer case that is pending in federal district court, but at the end of the five year plan, JDL will retain the right to collect the balance of the amount owed by Cheyenne to the Debtors.

II. DISCUSSION

JDL asserts that cause exists under 11 U.S.C. § 1112(b) to convert this case to one under Chapter 7 because an insuperable bar exists to confirmation of the Debtors' proposed plan. Namely, JDL asserts that Huntington Bank is not an impaired creditor within the meaning of §§ 1124(1) and 1129(a)(10), and as the only creditor impaired under the plan, JDL's promised rejection of the Debtors' proposed plan will mean that the plan cannot be confirmed.

Section 1112(b) of the Bankruptcy Code, before it was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provided that a bankruptcy case may be dismissed or converted for "cause," which includes, among other things, a debtor's "inability to effectuate a plan," or "unreasonable delay that is prejudicial to creditors." 11 U.S.C. § 1112(b)(2-3). The list of findings constituting "cause" in § 1112(b) is not exclusive:

> Subsection (b) gives wide discretion to the court to make an appropriate disposition of the case when a party in interest requests. The court is permitted to convert a reorganization case to a liquidation case or to dismiss the case, whichever is in the best interest of the creditors and the estate, only for cause . . . . The list [of conditions] is not exhaustive. The court will be able to consider other factors as they arise, and use its equitable powers to reach an appropriate result in individual cases.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 405-06 (1977); *see also* S. Rep. No. 989, 95th Cong., 2d Sess. 117-18 (1978) (same).

The enumerated examples of cause in § 1112(b) identify circumstances tending to show that a reorganization – and the concomitant benefits of a reorganization – will not be achieved within a reasonable time, and, therefore, are not worth pursuing. 7 *Collier on Bankruptcy* ¶ 1112.04[5] (Alan N. Resnick & Henry J. Sommer eds. 15th ed. rev. 2008). This can occur when "the debtor's continued effort to reorganize may be pointless . . . [such as when] the debtor has no reasonable prospect of satisfying one or more of the plan confirmation standards enumerated in section 1129."

Id. at [5][b][iii]; *see also Toibb v. Radloff*, 501 U.S. 157, 165 (1991) (stating that § 1112(b) gives the court "substantial discretion to dismiss a Chapter 11 bankruptcy case in which the debtor files an untenable plan of reorganization."); *In re Woodbrook Assocs*., 19 F.3d 312, 316 (7th Cir. 1994) ("A § 1112(b) dismissal is proper 'if the court determines that it is unreasonable to expect that a plan can be confirmed.'") (citation omitted). The burden of showing "cause" to dismiss or convert a case under 11 U.S.C. § 1112(b) is on the moving party. *Woodbrook Assocs.*, 19 F.3d at 317.

It is axiomatic that to obtain consensual confirmation of a Chapter 11 plan, all classes of creditors must vote in favor of the plan, or be unimpaired, in which case the creditor class is deemed to have accepted the plan. 11 U.S.C. §§ 1129(a)(8) ("The court shall confirm a plan only if . . . (8) With respect to each class of claims or interests– (A) such class has accepted the plan; or (B) such class is not impaired under the plan"); 1126(f) ("[A] class that is not impaired under a plan . . . [is] conclusively presumed to have accepted the plan . . . ."). If the requirement of § 1129(a)(8) is not met – meaning that an impaired class of creditors has voted against the plan – then the plan may only be confirmed under the "cramdown" provision of § 1129(b). Before being able to utilize the cramdown provisions of § 1129(b), however, § 1129(a)(10) requires that, "at least one class of claims that is impaired under the plan [must] accept[] the plan . . . ." *See, e.g.*, *In re Valencia Flour Mill, Ltd.*, 348 B.R. 573, 576 (Bankr. D.N.M. 2006) ("The Plan cannot be confirmed because it includes an impaired class of claims and no impaired class of claims has voted to accept the Plan.").

Requiring that at least one impaired class accept the plan ensures that a cramdown plan has a modicum of support from adversely affected creditors; it promotes negotiated, consensual reorganizations, and it prevents confirmation when adversely affected creditors determine it is in their best interest to oppose the proposed plan. *E.g.*, *In re Windsor on the River Assoc., Ltd.*, 7 F.3d 127, 131 (8th Cir. 1993) ("The purpose of [§ 1129(a)(10)] 'is to provide some indicia of support by affected creditors and prevent confirmation where such support is lacking.'") (citation omitted); *In re Gregory Rockhouse Ranch*, No. 05-16120, 2007 Bankr. LEXIS 4343 at *13 (Bankr. D.N.M. Dec. 21, 2007) (discussing the purpose of § 1129(a)(10)).

The Bankruptcy Code defines the meaning of an "impairment in 11 U.S.C. § 1124(1). That Section provides that "a class of claims . . . is impaired under a plan unless . . . the plan– (1) leaves unaltered the legal, equitable, and contractual rights . . . of such claim . . . ." 11 U.S.C. § 1124(1).

This language is very broad. *E.g.*, *Schwarzmann v. First Union Nat'l Bank (In re Schwarmann)*, No. 95-2512, 1996 U.S. App. LEXIS 31262 at *9 (4th Cir. Dec. 6, 1996) (unpub.) ("It is 'well established' that § 1124 defines impairment in very broad terms.") (citation omitted); *Windsor on the River Assocs*, 7 F.3d at 130 ("By this [§ 1124(1)] standard, any alteration of a creditor's rights, no matter how minor, constitutes 'impairment'").

As explained by the Court of Appeals for the Fourth Circuit in *Schwarzmann*, 1996 U.S. App. LEXIS 31262 at *9, despite the broad language of § 1124, some courts do not allow debtors to "artificially impair" a class of creditors in an effort to circumvent the requirements of § 1129(a)(10). Artificial impairment occurs when a debtor proposes "an insignificant impairment on a certain class of creditors in order to qualify them as impaired under § 1124." *Id.* The purpose of the artificial impairment is to gain support from an impaired class of creditors to have the plan approved over the objection of truly impaired creditors. *Id.* at *10. Not all courts recognize the concept of artificial impairment. *Id.* (citing *In re L & J Anaheim Assocs.*, 995 F.2d 940 (9th Cir. 1993) (holding that § 1124 does not differentiate between artificial and actual impairments)). For its part, the Court of Appeals for the Fourth Circuit has yet to rule on the issue. *Id.* at *10-11 ("We need not decide whether the vote of an artificially impaired class to accept a plan counts under § 1129(a)(10) because the impairment to CDC's claim is not artificial or insignificant."). Even when a court does not recognize the concept of an artificial impairment under § 1129(a)(10), however, confirmation may still be denied based on a lack of good faith under § 1129(a)(3) when a debtor proposes some insignificant impairment to a class of creditors in effort to obtain a cramdown plan of reorganization over the objection of truly impaired creditors in an attempt to circumvent the purpose of § 1129(a)(10). *E.g.*, *L & J Anaheim, Assoc.*, 995 F.2d at 943 n.2 ("[A]buses on the part of a plan proponent ought not affect the application of Congress's definition of impairment. The bankruptcy court can and should address such abuses by denying confirmation on the grounds that the plan has not been 'proposed in good faith'").

Here, the Debtors claim that Huntington Bank is impaired under their plan on the grounds that: (1) the debt owed to it by Cheyenne, and guaranteed by the Debtors, will be paid a few weeks or months early; and (2) Cheyenne's right to hold the Debtors personally liable on the Debtors' guarantee under the letters of credit will terminate.[3] JDL contends that these grounds are insufficient to impair Huntington Bank's claims. The court agrees.

Importantly, the promissory note between Cheyenne and Huntington Bank specifically allows

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[3] The Debtors' proposed plan provides the following treatment for Huntington Bank:

> Under the Plan, [Huntington Bank] will receive the full amount of the promissory note portion of their Claim, [($700,000)], and Cheyenne will pay the letters of credit when they become due.
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> Within fifteen days of the Confirmation Date, Debtors shall pay the promissory note portion of Huntington National Bank's Claim in full by liquidating enough shares of Van Kampen Government Securities to generate funds equal to the principal amount plus interest owed on the promissory note portion of Huntington National Bank's Claim. . . .
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> Huntington National Bank is an impaired creditor because the Plan changes Huntington National Bank's position as a creditor under the terms of the loan agreements, specifically because the claims of Huntington National Bank are not fully secured, Huntington National Bank must look to Cheyenne rather than Debtors for repayment of the letters of credit, and the Plan provides for payment in full of the promissory note before the due date of the promissory note.
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> Regarding whether Huntington National Bank is fully secured, it is clear that it is not because Huntington National Bank will continue to be obligated on the letters of credit that secure certain environmental obligations of Cheyenne. These letters of credit obligate Huntington National Bank to advance up to $172,280 to the cleanup of the real property that Cheyenne is operating on if Cheyenne defaults on its obligations to reclaim the property. That cost will not be incurred until Cheyenne ceases operation, but it will occur. After payment of the promissory note portion of Huntington National Bank's claim, Huntington National Bank will be left with $73,254.30 in collateral, which will not leave Huntington National Bank fully secured as it relates to the letters of credit.
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> Regarding payment of the letters of credit, Debtors will not pay those letters of credit under the Plan. Rather, Cheyenne will be responsible for and will pay the letters of credit when they come due, specifically when the West Virginia Department of Environmental Protection draws or causes a third party to draw upon the letters of credit. To partially protect Huntington National Bank, any stocks, securities, or certificates of deposits currently secured by Huntington National Bank's security interest that do not need to be sold to generate funds to pay the promissory note portion of Huntington National Bank's Claim will remain part of the Estate and Huntington National Bank will retain its security interest in those stocks, securities, and certificates.

(Document No. 578, p. 9-11).

for prepayment of the loan;[4] thus, no alteration of Huntington Bank's rights or liabilities under the loan agreement will occur if Cheyenne pre-pays the balance owed to Huntington Bank from the collateral posted by the Debtors. Therefore, there is no impairment to the claims of Huntington Bank on the basis of pre-payment. *See, e.g.*, *Continental Sec. Corp. v. Shenandoah Nursing Home Pshp.*, 193 B.R. 769 (W.D. Va. 1996) (holding that a creditor that is paid in full, early, in violation of a lockout agreement is not impaired under § 1124 when there was no penalty provided in the event of prepayment); *In re Public Serv. Co.*, 114 B.R. 813 (Bankr. D.N..H. 1990) (no impairment when pre-payment premiums were waived).

Also, regarding the termination of the Debtors' personal obligation on the letter of credit guarantee agreement, that personal obligation would terminate even if it were not provided for in the Debtors' proposed Chapter 11 plan. Should the Debtors confirm their proposed plan, then § 1141(d)(1) of the Bankruptcy Code, as it existed before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that "the confirmation of a plan – (A) discharges the debtor from any debt that arose before the date of such confirmation . . . ."[5] The scope of this discharge is defined, in relevant part, by § 524(a)(2), which states that a discharge "operates as an injunction against . . . an act, to collect, recover, or offset any such debt as a personal liability of the debtor . . . ." This means that personal guarantee agreements of debtors who obtain a bankruptcy

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[4] The promissory note between Cheyenne and Huntington Bank is filed as an attachment to Huntington Bank's proof of claim:

> PREPAYMENT: Borrower agrees that all loan fees and other prepaid finance charges are earned fully as of the date of the loan and will not be subject to refunds upon early payment . . . except as otherwise provided by law. Except for the foregoing, Borrower may pay without penalty all or a portion of the amount owed earlier than it is due. Early payment will not, unless agreed by the Lender in writing, relieve Borrower of Borrower's obligation to continue to make payments of accrued unpaid interest. Rather they will reduce the principal balance due.

(Claim No. 2, p, 10).

[5] The Debtors' proposed plan provides that "confirmation of the plan will discharge any and all Claims and interests in the Debtors or their assets or properties that arose at any time before Confirmation Date, including JDL's Claim." (Document No. 578, p. 28).

discharge are terminated as a matter of law. *E.g.*, *Citizens Bank v. Broyles (In re Broyles)*, 55 F.3d 980 (4th Cir. 1995) (affirming the discharge of debt incurred by personal guarantors of corporate indebtedness).

The termination of the Debtors' personal liability on their guarantee of the letters of credit as a matter of law is important because a claim is only impaired under 11 U.S.C. § 1124 when there is some provision in the plan that impairs the creditor's rights – "impairment results from what the *plan* does, not what the statute does." *In re American Solar King Corp.*, 90 B.R. 808, 819 (Bankr. W.D. Tex. 1998) (emphasis in original); *see also Solow v. PPI Enters.(U.S.) (In re PPI Enters.(U.S.))*, 324 F.3d 197, 204 (3d Cir. 2003) ("[W]e must examine whether the plan itself is a source of limitation on a creditor's legal, equitable, or contractual rights."). Section 1124(1) itself makes this distinction: "a class of claims or interests is impaired under a *plan* unless . . . the *plan*– (1) leaves unaltered the legal, equitable, or contractual rights . . . [of the creditor class]." 11 U.S.C. § 1124(1) (emphasis added). Consequently, because the termination of the Debtors' personal obligation on the guarantee for Cheyenne's letters of credit with Huntington Bank will be discharged by statute – even if such language is deleted from the Debtors' proposed plan – the court concludes that plan language providing for such a termination of personal liability is insufficient to constitute an impairment under § 1124(1). The plan language is superfluous in that regard.[6]

The proposed plan and disclosure statement currently before the court is the Debtors' third attempt at formulating a plan. Their first attempt occurred on December 8, 2008. In that proposed plan, the Debtors stated that Huntington Bank's loan to Cheyenne was not in default, and that Cheyenne would continue to make the loan payments. Huntington Bank was declared to be an

[6] Even if the court were to determine that an "impairment" existed based on the early payoff of Huntington Bank's loan, or the termination of the Debtors' personal guarantee agreement related to Cheyenne's obligation on the letters of credit, the court would still deny confirmation of the Debtors' proposed plan under §§ 1129(a)(10) and/or 1129(a)(3). Namely, the court believes that prepayment of a loan, in-full, a few weeks or months before maturity, and the discharge of personal liability on a guarantee agreement (which would occur as a matter of law), are artificial impairments that should not be considered under § 1129(a)(10). The only truly impaired creditor under the Debtors' plan is JDL, and manipulating the requirements of confirmation to achieve an ostensible dissenting impaired class runs afoul of the § 1129(a)(3) requirement that a Chapter 11 plan be proposed in good faith.

unimpaired creditor. At a January 6, 2009 hearing on JDL's motion to convert, JDL articulated their theory that Huntington Bank was not an impaired creditor under the Debtors' proposed plan and that their promised rejection would doom confirmation of the proposed plan. The Debtors then filed an amended plan and disclosure statement on January 9, 2009. In this second plan, the Debtors again proposed to have Cheyenne continue to make payments to Huntington Bank, and, this time, the Debtors claimed that Huntington Bank was impaired on the grounds that its claims were not fully secured, it had to look to Cheyenne – not the Debtors – for repayment, and the plan altered "various other rights of Huntington National Bank under the loan agreements." Huntington Bank objected to the second amended disclosure statement on the grounds that the note owed to it was going to mature on June 3, 2009, and the second amended disclosure statement did not state how Cheyenne had the capability of paying the note in full on its maturity. Thus, the Debtors filed their third disclosure statement and plan on February 24, 2009, the relevant language of which is reproduced in footnote 2, *supra*, which, among other terms, included a provision for payment in full by the Debtors of the promissory note portion of Huntington Bank's claim. Accordingly, the Debtors have had three attempts at formulating a plan capable of being confirmed. Unfortunately for the Debtors, their current plan is untenable.

In short, the court agrees with JDL that the Debtors have been unable to file a Chapter 11 plan that is capable of being confirmed. Under the circumstances of this case, however, the court will afford the Debtors 20 days to make a final attempt at proposing a plan that is capable of meeting the requirement of 11 U.S.C. § 1129(a)(10).[7] Should the Debtors fail to comply, the court will convert this case to one under Chapter 7 of the Bankruptcy Code because the only complaining, impaired creditor requests conversion of the case – not dismissal. The Debtors also may obtain some benefit from a Chapter 7 discharge, at least insofar as it relates to the termination of their personal

[7] The court is expressing no opinion as to the other grounds raised by JDL in the motion to convert, and, should the Debtors timely file an amended plan as required by the court, then the merits of the amendments addressing the requirement of 11 U.S.C. § 1129(a)(10), together with the remaining issues in the motion to convert, will be taken up by the court in conjunction with any scheduled confirmation hearing. Additionally, of course, the court would consider the amended plan as a whole pursuant to all of the confirmation requirements of § 1129.

guarantees on the debts owed by Cheyenne to Huntington Bank.

III. CONCLUSION

The court will enter a separate order pursuant to Fed. R. Bankr. P. 9021 that conditionally grants JDL's motion to convert, and that allows the Debtors a 20-day period to file an amended plan. The Debtors failure to file an amended plan within the 20-day period will result in the case being automatically converted on the 21st day without further notice or hearing.