

“Cramdown:” The Most Misunderstood Concept In Bankruptcy

Contrary to popular belief among creditors, “cramdown” is not to be feared by the general, unsecured creditors in a Chapter 11 reorganization proceeding. Frequently, general, unsecured creditors fail to understand that most debtors cannot cram an unpopular plan down the throats of their unsecured creditors. The reason “cramdown” is not available to most debtors is due to what is known as the “absolute priority rule.”

Simply stated, a plan may not be confirmed over the dissenting vote of general, unsecured creditors (i.e., “crammed down”) unless the following conditions are met: 1) each holder of a claim receives property equal to the allowed amount of such claim as of the effective date of the plan (that

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is, you are paid in full on confirmation day—a very appealing concept to most creditors); or 2) no holder of a junior claim receives anything. This latter alternative is referred to as the “fair and equitable test,” and as it is applied to unsecured creditors, as the “absolute priority rule.”

The “absolute priority rule,” simply stated, means that unless general, unsecured creditors are paid in full, no junior claim can receive anything under the plan. What claim holders are junior to general, un-

secured creditors? Well, that means the shareholders of the corporate debtor or the owner of the non-corporate debtor. In the case of a sole proprietorship, it means the sole proprietor.

Perhaps you now begin to understand why “cramdown” does not work. In order to meet the test, the debtor must pay the general, unsecured claims in full or lose any ownership right in the business. Since reorganization proceedings are normally filed in an effort to save the business for the owners or shareholders, plans are generally only capable of being “crammed down” when the plan takes the form of a sale to a third party purchaser and the former owners receive nothing from the sale.

So powerful is the absolute priority rule that Congress, in the usual manner of pork barrel politics, dreamed up Chapter 12 for farmers as a means for this favored class of debtor to be able to cram down a plan without having to abide by the absolute priority rule. Farmers can keep their farms, in other words, without paying their unsecured creditors so long as they are otherwise eligible for Chapter 12, which has no absolute priority rule.

So the next time you are threatened with cramdown by a debtor’s lawyer, just smile and vote with the other general, unsecured creditors against the plan. In most situations, a dissenting vote by the unsecured creditors as a class is enough to prevent confirmation.

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