How To Escape The Recent 9th Circ. Cramdown Craze

Law360, New York (June 05, 2012, 12:28 PM ET) -- Over the past 20 years, the U.S. Supreme Court and Ninth Circuit Court of Appeals have generally favored secured lenders in Chapter 11 real estate cases.

See, e.g., Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999) (plan of reorganization which failed to pay secured claim in full, but granted equity holders the exclusive right to contribute new value in order to retain their interests in the debtor was unconfirmable); Bakarat v. Life Insurance Company of Virginia, 99 F.3d 1520 (9th Cir. 1996) (secured lender's § 1111(b) deficiency claim could not be separately classified from general unsecured claims); In re Arnold & Baker Farms, 85 F.3d 1415 (9th Cir. 1996) (plan which transferred only a portion of collateral to creditor as the indubitable equivalent of its secured claim was not confirmable).

However, several cases have emerged within the Ninth Circuit within the last year and a half at the bankruptcy appellate panel and bankruptcy court levels that are contrary to this long-standing trend. This article focuses on several of these cases and discusses how secured lenders may best protect themselves.

Recent Case Law

In In re Industry West Commerce Center LLC (9th Cir. BAP 2011), the debtor's real property was secured by three deeds of trust. The debtor filed a plan of reorganization which proposed to pay the second deed of trust in full over three years at 12 percent interest with a $200,000 cash payment upon confirmation. However, the plan provided that the holder of the first deed of trust would be paid interest only for seven years at 4.95 percent interest with a balloon payment at the end of seven years.

The Northern District of California bankruptcy court confirmed the debtor's plan of reorganization. In support of confirmation, the court stated:

> A plan which avoids a sale is generally in the best interest of the economy as a whole, as it results in one less property available for sale, thereby assisting in maintaining overall property value. Id. at *27.

The court determined that the seven-year repayment period was reasonable and the 4.95 percent interest rate satisfied the fair and equitable requirement of § 1129 of the Bankruptcy Code. The court viewed the primary risk to the lender as the possibility that "the commercial real estate market would implode due a lack of available money on the future." Id. at *11.

However, the court felt that the 4.95 percent interest rate was sufficient because “there remains the possibility that Congress would intervene to make funds available rather than allow the commercial real estate market to tank.” Id. (emphasis supplied). The bankruptcy court’s decision did not discuss the zero amortization and balloon payment features of the plan. The bankruptcy appellate panel affirmed the bankruptcy court’s decision.

In In re VDG Chicken LLC (9th Cir. BAP 2011), the debtor had only three creditors — the FDIC, which was the senior secured creditor, a junior secured creditor and one unsecured creditor. The debtor’s plan of reorganization proposed repaying the FDIC’s $2,460,000 secured claim over 10 years. However, payments would be amortized over a 30-year period. As a result, the plan required a balloon payment of approximately $1,700,000 at the end of 10 years.

The bankruptcy court and the bankruptcy appellate panel rejected the FDIC’s argument that the Bankruptcy Code required faster amortization and a shorter repayment period. The bankruptcy appellate panel held that “although the Plan did not explain what would happen upon the termination of the 10-year term," it could be “fairly inferred that the debt will either be refinanced or the property sold at some point” based upon a 70 percent loan to value ratio at confirmation and a revenue stream that would still exist at the end of the term. Id. at *18-19.

One argument missing from the VDG decision is the contention that the bankruptcy case was little more than a two-party dispute between a solvent debtor and its lender. The debtor had no unsecured creditor body. Thus, the case was not about reorganizing a company for the benefit of a defined creditor body, it was about obtaining a court-mandated loan restructuring for the benefit of the debtor’s equity holders at the FDIC’s expense. See In re Oasis at Wild Horse Ranch LLC (9th Cir. BAP 2011) (affirming dismissal of case which was a two party dispute.)

In In re Sunnyside Slope Housing LP, Case No. 11-02441 (Bankr. D. Az. 2012), the debtor’s sole asset was an affordable living apartment complex. Notwithstanding the existence of a contract entered into by a prepetition receiver to sell the property for $7,650,000, the bankruptcy court determined that the value of the property was $2,600,000. The secured lender elected under § 1111(b) of the Bankruptcy Code to have its entire approximately $8,312,000 claim treated as a secured claim.[1]

The debtor’s plan of reorganization provided that an amount equal to the court-determined value of the property ($2,600,000) would be amortized and paid over 40 years with interest at 4.4 percent, while the remainder of the secured creditor’s claim, which was attributable to the § 1111(b) election, would be satisfied through a balloon payment, which would be due at the end of 40 years.

The bankruptcy court, in an unreported bench decision, confirmed the debtor’s plan.[2] The court indicated that feasibility is a “relatively low standard” for a debtor to meet and that the secured lender introduced no evidence that the 40-year balloon payment was not feasible.

The bankruptcy court found that the plan was feasible because: (i) 40-year loans were currently being originated in the industry; (ii) testimony that the debtor could pay debt service over the next six or seven years, "goes a very long way to establishing feasibility even for 40 years;" and (iii) the risks facing the lender were essentially the same as they were at the time the loan was originated. The bankruptcy court's confirmation order is currently on appeal to the Arizona District Court.

Most recently, in In re Loop 76 LLC, 465 B.R. 525 (9th Cir. BAP 2012), the bankruptcy appellate panel affirmed the cram down of a "new value" plan over a senior secured lender's objection. In Loop 76, the lender chose not to elect to have its secured claim treated as a fully secured claim pursuant to § 1111(b) of the Bankruptcy Code.

Under the debtor's plan, the lender's $17,000,000 secured claim was to be amortized and paid at 6.5 percent interest over 10 years, while its approximately $6,000,000 unsecured claim was to only receive a 10 percent distribution. Moreover, the lender's unsecured claim was placed in a separate class of claims from the debtor's general unsecured creditors.

The absolute priority rule of § 1129(b) of the Bankruptcy Code generally provides that equity holders may not retain any interest in the debtor unless all dissenting classes receive at least the present value of their claims. In Loop 76, the debtor relied upon the new value exception to the absolute priority rule, which permits equity holders to retain their interests in the debtor where they make a substantial infusion of new money, which is necessary to the reorganization. Under the Supreme Court's decision in 203 N. La Salle, the interest being retained must be exposed to the marketplace prior to existing equity being permitted to retain its interest.

The bankruptcy court confirmed the plan, finding, inter alia, that the new value exception had been satisfied. The bankruptcy court held that equity's interest in the debtor had been exposed to the marketplace because the debtor's exclusive time to file a plan of reorganization under § 1121 of the Bankruptcy Code had expired, and no other party in interest, including the lender, had filed a plan.[3]

In other words, under Loop 76, a secured creditor who has no obligation to file a competing plan of reorganization, may have its failure to file a plan held against it when determining whether the retained property has been exposed to the marketplace.

The bankruptcy appellate panel affirmed the bankruptcy court's confirmation order. However, the panel's decision did not address the new value exception. Instead, the decision focused on the propriety of placing the secured lender's unsecured claim in a separate class than general unsecured creditors for voting purposes.

The panel held that while the Court of Appeals in Bakarat prohibited the separate classification of a secured lender's deficiency claim, the instant case was distinguishable. According to the appellate panel, the existence of a guarantee in the present case rendered the bank's unsecured claim different from other unsecured claims and permitted separate classification. An appeal of the panel's decision is currently pending with the Court of Appeals.

Conclusion

Over the past year and a half, cases have emerged within the Ninth Circuit cramming down secured lenders. The issue becomes how, in light of this trend, can secured lender's best protect themselves from cramdown.

First and foremost, secured lenders must be vigilant in Chapter 11 proceedings. In Sunnyside Slope, the court noted that the secured lender introduced no evidence contesting feasibility of the plan, even though the debtor bore the burden of proof on such issue. In Loop 76, the bankruptcy appellate panel rejected a lender's lack of feasibility argument because the lender failed to designate sufficient documents for the record on appeal relating to feasibility. Thus, lenders need to "protect the record" by introducing evidence on issues like feasibility and risks associated with repayment.

Second, lenders should consider filing competing plans of reorganization, which provide for liquidation of the debtor's property, and at least a partial distribution on unsecured claims. While this may not be optimal in all cases because, inter alia, all administrative expenses including debtor's attorney fees, would have to be paid on the plan's effective date, confirmation of a liquidating plan may prevent confirmation of a cram down plan by the debtor.

Third, lenders should consider purchasing the claims of other creditors in order to try to block the debtor from formulating a class of claims which could vote to accept a debtor's plan.

Finally, lenders must be vigilant at the loan origination stage. Springing guarantees, pursuant to which insiders agree to be personally liable for the borrower's loan in the event the debtor files for bankruptcy, are an effective deterrent to bankruptcy filings, especially where the guarantee is secured by the guarantor's equity interest in the borrowing entity. In the end, it is up to the lender to implement these strategies in order to reduce the risk of cramdown.

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[1] Typically, under § 506 of the Bankruptcy Code, a creditor's secured claim is equal to the value of its interest in the collateral, and the remainder of its claim is treated as unsecured. Section 1111(b) allows, generally, a secured creditor to elect to have its entire claim treated as secured.

[2] A copy of the bankruptcy court's bench decision is available on the Arizona District Court's PACER website under First Southern National Bank v. Sunnyslope Housing Limited Partnership, 11-cv-02579 at Document No. 80-3, pp. 204-233. Copies of the debtor's plan of reorganization, the confirmation order and the valuation order are available on the Arizona bankruptcy court's PACER website under In re Sunnyslope LP, Case No. 11-02441 at Document Nos. 375, 379 and 265 respectively. Background facts

from the case may be obtained from the bankruptcy appellate panel's earlier decision affirming the denial of the secured lender's motion for relief from the automatic stay. See In re Sunnyslope Housing LP (9th Cir. BAP 2012).

[3] A copy of the bankruptcy court's unreported decision is available at the Arizona Bankruptcy Court's PACER website under In re Loop 76 LLC, Case No. 09-16799 at Document No. 372.

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