New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 247—NO. 42

MONDAY, MARCH 5, 2012

BANKRUPTCY PRACTICE

Expert Analysis

Seventh Circuit Affirms Secured Creditors' Cramdown Rights

On Jan. 19, 2012, the U.S. Court of Appeals for the Seventh Circuit in an opinion penned by Judge Richard Posner affirmed a bankruptcy court's dismissal of *In re River East Plaza, LLC*, a single asset real estate case, rejecting the debtor's attempt to substitute the lender's original collateral for another form of security and pay out the secured claim over time pursuant to the "cramdown" provisions of the Bankruptcy Code. The court's analysis was strongly pro-secured lender and hinged particularly on the question of whether the secured creditor should be entitled to the appreciation of future value of its original prepetition collateral.

Relevant Provisions

The Bankruptcy Code provides certain mechanisms that protect the rights of secured lenders while balancing their interests with the ultimate goal of rehabilitating and reorganizing a debtor's estate. Section 1129(b) of the Bankruptcy Code, also known as the "cramdown" provision, allows a debtor to confirm a plan of reorganization over the dissent of an impaired class of secured creditors if a court determines that the proposed cramdown is "fair and equitable" with respect to any class of creditors who have voted to reject the plan.

A court will find that the proposed treatment is fair and equitable if the plan provides that (i) the creditor retains its liens on the collateral and receives deferred payments on account thereof; (ii) in the event of a sale of encumbered property, subject to §363(k), the applicable creditor's liens attach to the proceeds of such sale; or (iii) the creditor otherwise receives the "indubitable equivalent" of its claims (the "Indubitable Equivalent Cramdown Provision").[1]

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By
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As a general rule in chapter 11 cases, pursuant to Bankruptcy Code §1111(b)(1) a non-recourse secured claim is treated as a recourse claim regardless of whether the claim is a recourse claim under applicable non-bankruptcy law. If the claim is undersecured, the portion of the debt equal to the value of the collateral is a secured claim, and the remainder is an unsecured "deficiency claim." The recourse is embodied in the deficiency claim against the debtor's unencumbered assets. The secured lender's unsecured deficiency claim, if large enough, could control the class of general unsecured creditors and effectively block confirmation of a chapter 11 plan.

The court's analysis supports the conclusion that two forms of collateral with varying risk profiles are not 'equivalent' under the Bankruptcy Code.

Alternatively, an undersecured creditor may elect under Bankruptcy Code §1111(b)(2)[2] to terminate its recourse status and have its claim secured in its entire allowed amount rather than bifurcated into a secured and unsecured deficiency claim. A creditor who makes the §1111(b)(2) election forfeits its deficiency claim and the attendant right to vote its deficiency claim in the class of general unsecured creditors. If the election applies, a creditor is entitled to have the entire amount of the related debt secured by a lien, even if the value of the collateral is less than the total amount of the debt. The plan must provide for payments, either present or deferred, of a principal face amount equal to the amount of the debt or a present value, as of the effective date of the chapter 11 plan, equal to the fair market value of the collateral. By making the §1111(b)(2) election, the secured creditor can prevent the debtor from cashing out the creditor's secured claim based upon a relatively low appraisal value.

In addition to the cramdown provisions and §1111(b), River East Plaza implicated the single asset real estate (SARE) provisions of the Bankruptcy Code, which were introduced in 2005 and apply when the debtor's assets consist of a single property or project that is either nonresidential or contains five or more apartments or residential units "on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto."[3]

The largest creditor in a SARE case is typically the secured lender that provided the funds for the debtor to acquire or improve the real property in question, and SARE bankruptcies are often filed for the sole purpose of staying a foreclosure or sale of the debtor's property.[4] To expedite the resolution of SARE cases, the SARE provisions of the Bankruptcy Code require a bankruptcy court to lift the automatic stay in such a case upon the request of a party in interest if the debtor (a) has not filed a plan of reorganization that has a "reasonable possibility of being confirmed within a reasonable time,"[5] or (b) has not commenced monthly payments to a secured creditor based on the applicable prepetition nondefault contract rate.[6]

Background

River East Plaza, LLC, the debtor in this SARE case, owned a building in downtown Chicago and financed the purchase with a loan from LNV Corporation. River East Plaza defaulted on its loan in February 2009. LNV commenced foreclosure proceedings in state court and scheduled a foreclosure sale of the property. Hours before the sale was to begin, River East filed for chapter 11 protection, thereby forestalling the sale.

LNV, River East Plaza's sole creditor, held a first mortgage lien on the debtor's building that had appreciated to $38.3 million. The debtor valued its building at $13.5 million, which left LNV with a $13.5 million secured claim and a $24.8 million unsecured deficiency claim that would likely receive only a limited recovery. Unsatisfied with this, LNV chose to exercise its election rights under §1111(b)(2), which gave it a secured claim of $38.3 million that would enable it to enjoy any future appreciation of the building past the debtor's arguably low valuation of $13.5 million.

Believing that the value of its building would appreciate in coming years, River East Plaza sought confirmation of a plan of reorganization that crammed down LNV's $38.3 million secured claim pursuant to the Bankruptcy Code's Indubitable Equivalent Cramdown Provision and replaced LNV's lien on the building with a $13.5 million lien on substitute collateral—specifically, 30-year U.S. Treasury bonds that would theoretically mature under current interest rates to yield a recovery of $38.3 million. River East Plaza asserted that this guaranteed LNV's full repayment (albeit over a 30-year period) and provided LNV with the "indubitable equivalent" to its original lien.

The U.S. Bankruptcy Court for the Northern District of Illinois rejected this plan. As more than 90 days had passed since River East Plaza commenced its case, the bankruptcy court granted LNV's request to lift the automatic stay and subsequently dismissed the bankruptcy case, thus clearing the way for the originally scheduled foreclosure sale to proceed. River East Plaza appealed the dismissal of the case directly to the Seventh Circuit, which accepted the appeal and stayed the sale pending the outcome of the appeal.

The Decision

The linchpin to River East Plaza's proposed plan was whether its provision of Treasury bonds as a form of substitute collateral constituted the "indubitable equivalent" of LNV's security. The Seventh Circuit examined the Treasury notes in question. Although such securities may have a low risk of default relative to the lender's existing collateral, the court pointed out that they also carried with them significant inflation risk. In concluding that the Treasury notes were not adequate substitutes for LNV's lien on the debtor's building, the court reasoned that "because of the different risk profiles of the two forms of collateral, they are not equivalents, and there is no reason why the choice between them should be made for the creditor by the debtor."[7]

Further, the court recognized that if a debtor attempts to substitute the collateral of its secured lender pursuant to the Bankruptcy Code's Indubitable Equivalent Cramdown Provision, an oversecured creditor may be forced to accept an involuntary shifting of its lien to substitute collateral "as long as [the substitution of collateral] doesn't increase the risk of his becoming under-secured."[8] The court aptly noted that "[s]ubstituted collateral that is more valuable and no more volatile than a creditor's current collateral would be the indubitable equivalent of that current collateral even in the case of an unsecured debt."[9] But in the Seventh Circuit's view in the situation of an undersecured creditor, "no rational debtor would propose such a substitution, because it would be making a gift to the secured creditor."[10]

The court further noted that a debtor's only motivation to offer substitute collateral to an undersecured creditor—as was the case here—would be if the debtor believed the substitute collateral to be worth less (either at the time of substitution or in the future) than the original collateral securing the creditor's claim.

> The Seventh Circuit's decision in 'River East Plaza' is reflective of a trend of pro-secured creditor decisions that have rejected the approach of some courts to curtail the secured creditor's defenses against the cramdown provisions of the Bankruptcy Code.

The Seventh Circuit found that if the value of River East Plaza's building increased to $40 million five years from now and River East Plaza then defaulted on additional loans that had been used to finance improvements to the building, LNV would then be able to foreclose on the building and would ultimately be repaid in full. The court further noted in contrast that with the substituted U.S. Treasury bonds, the lender would have to wait another 25 years to recover its $38.3 million claim. In addition, the substantial risk of future inflation and volatile interest rates, particularly given the United States' precarious financial condition, provided further justification that the long-term U.S. Treasury bonds were not the indubitable equivalent of the debtor's building.

Analysis

The Seventh Circuit's decision in *River East Plaza* is reflective of a trend of pro-secured creditor decisions that have rejected the approach of some courts to curtail the secured creditor's defenses against the cramdown provisions of the Bankruptcy Code. The Seventh Circuit noted its earlier *River Road*[11] decision where it rejected recent decisions from the Third and Fifth circuits in *In re Philadelphia Newspapers, LLC*[12] and *In re Pacific Lumber Co*.[13] Both of these decisions set forth principles whereby debtors could propose cramdown plans that would allow the sale of property free and clear of a secured creditor's lien without permitting the creditor to credit bid, and allow the sale to a third party at a depressed value below the amount of the secured creditor's total claim.

The facts in *River East Plaza* represent a variation from the facts in *Philadelphia Newspapers*, *Pacific Lumber*, and *River Road*. In each of those three cases, the debtor sought to deprive the secured lender of its right to enjoy future appreciation of its collateral by effecting a sale to a third party and cutting off the right of the secured creditor to credit bid. In *River East Plaza*, the debtor sought to deprive the secured lender of the future appreciation in its collateral through substitution of collateral with less value and more volatility. In both *River Road* and *River East Plaza*, the Seventh Circuit rejected such attempts.

Conclusion

The *River East Plaza* decision is a significant affirmation of the rights of undersecured lenders, particularly in SARE cases, and demonstrates the value §1111(b) offers to such creditors. *River East Plaza* signals the Seventh Circuit's refusal to allow a debtor expanded discretion in altering the rights of a secured creditor. Most importantly, the court's analysis supports the conclusion that two forms of collateral with varying risk profiles are not "equivalent" under the Bankruptcy Code, and the creditor cannot be forced to accept alternative collateral with a different risk profile.

1. 11 U.S.C. §1129(b)(2)(A)(i), (ii), and (iii).
2. An undersecured recourse creditor cannot choose to make such an election when its collateral is being sold pursuant to either a plan or §363, but can instead credit bid the value of its secured claim in an effort to purchase the collateral.
3. 11 U.S.C. §101(51B).
4. See H. Rep. No. 31, 109th Cong., 1st Sess. (2005).
5. 11 U.S.C. §362(d)(3)(A).
6. 11 U.S.C. §362(d)(3)(B).
7. *In re River East Plaza, LLC*, 2012 WL 169760, *6.
8. Id. at *4 (citations omitted).
9. Id. at *5.
10. Id.
11. *In re River Road Hotel Partners LLC*, 651 F.3d 642, 55 BCD 13 (7th Cir. 2011).
12. 599 F.3d 298, 52 BCD 255 (3d Cir. 2010).
13. 584 F.3d 229, 52 BCD 46 (5th Cir. 2009).