BANKRUPTCY TOPICS IN DISTRESSED REAL ESTATE

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State Bar of Texas
14TH ANNUAL
ADVANCED REAL ESTATE STRATEGIES
December 10-11, 2020

CHAPTER 2.01

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BANKRUPTCY TOPICS IN DISTRESSED REAL ESTATE

I. INTRODUCTION

Bankruptcy cases involving commercial real estate present a multitude of problems. Those problems typically arise in the context of voluntary cases filed under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101-1532 ("**Bankruptcy Code**" or "**Code**"), and involve a dispute between the business debtor and its mortgage lender. As such, this paper focuses primarily on chapter 11 of the Code, which provides for the reorganization or orderly liquidation of a debtor. Understanding each party's rights is the backdrop for a potential workout between a lender and borrower, as it clarifies each party's options inside and outside of an in-court process.

II. BAD-FAITH FILINGS

The Bankruptcy Code does not contain an explicit requirement that a voluntary chapter 11 case be filed in good faith. However, courts have read such a requirement into section 1112(b) of the Code. Indeed, the Fifth Circuit has held that inherent in any bankruptcy case is a fundamental prerequisite that the debtor file its petition in good faith. *See Elmwood Dev. Co. v. General Elec. Pension Trust* (*In re Elmwood*, 964 F.2d. 508, 510 (5th Cir. 1992); *In re Krueger*, 812 F.3d 365, 370 (5th Cir. 2016) ("Every bankruptcy statute since 1898 has incorporated literally, or by judicial interpretation, a standard of good faith for the commencement, prosecution and confirmation of bankruptcy proceedings.")

Motions to dismiss a case on bad faith grounds are common in cases in which the debtor's sole asset is a single piece of real estate, such as an apartment building, an office building, a hotel, or a shopping center, which is encumbered with a mortgage that represents virtually all of the borrower's debt. Bankruptcy courts view such cases with a jaundiced eye. *In re South County Realty, Inc. II,* 69 B.R. 611, 615 (Bankr. M.D. Fla. 1987). Unlike debtors that are in manufacturing or retail sales and have many creditors and employees, real estate debtors have few, if any, employees, or unsecured creditors, and no "real business" to reorganize. A real estate debtor's principal creditor is generally a mortgage lender that has filed, or is about to file, a mortgage foreclosure case. The mortgagee's loan typically exceeds the value of the debtor's real estate and is substantially greater than the aggregate amount of claims held by other non-insider creditors. As a result of these circumstances, secured creditors often file motions to dismiss at the outset of such cases.

Motions to dismiss on bad faith grounds are based on section 1112(b)(1) of the Code, which provides, in pertinent part, that, subject to certain exceptions, "on request of a party in interest, and after notice and a hearing, the court *shall* . . . dismiss a case under this chapter," if the movant establishes cause. 11 U.S.C. § 1112(b)(1) (emphasis added). Section 1112(b) sets forth a nonexclusive list of factors that constitute "cause" for dismissing a chapter 11 case. A court's assessment of bad faith takes into consideration "a conglomerate of factors rather than any single datum," including the financial condition of the debtor, the motives and disclosures of the debtor, and the financial reality of the case. *See In re Omni Lion's Run, L.P.*, 578 B.R. 394, 398 (Bankr. W.D. Tex. 2017. In determining whether cause exists for dismissal of a case, bankruptcy courts consider multiple factors, including:

1. Whether debtor has one asset, such as an undeveloped or developed real property, encumbered by secured liens;
2. Whether the debtor has engaged in improper prepetition behavior;
3. Whether the debtor has few unsecured creditors whose claims are relatively small;
4. Whether the property is the subject of a foreclosure action and the debtor has tried to prevent such foreclosure in state court;
5. Whether the debtor has few or zero employees other than principals;
6. Whether the debtor's financial problems involve essentially a dispute between the debtor and a secured creditor which can be resolved in a pending state court action;
7. Whether there is little or no cash flow or source of income to sustain a reorganization;
8. Whether the timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to enforce their rights; and
9. Whether the filing enabled the debtor to avoid court orders.

In re 1701 Commerce, LLC, 477 B.R. 652, 657-58 (Bankr. N.D. Tex. 2012) (citing *Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (In re Little Creek Dev. Co.,),* 779 F.2d 1068, 1072-73 (5th Cir. 1986); *Trident Assocs. Ltd. P'ship v. Metro Life Ins. Co. (In re Trident Assocs. P'ship)*, 52 F.3d 127, 131 (6th Cir. 1995)); *In re McMahan,* 481 B.R. 901, 916 (S.D. Tex. 2012); *In re Trust*, 526 B.R. 668, 681 (Bankr. N.D. Tex. 2015) (citing *Little Creek*). In addition to the *Little Creek* factors, courts also look at factors relevant to lifting the automatic stay to permit pending litigation to proceed in another forum. *Trust*, 526 B.R. at 682 (relying on six factors in *In re Sonnax Indus., Inc.*, 907 F.2d. 1280 (2d. Cir. 1990)). Not all factors have to be present, and the court can place more weight on one factor over the other. *Elmwood*, 964 F.2d. at 510. Dismissal under section 1112 is case-specific and dependent on the

circumstances of each debtor. *See United Savs. Ass'n. of Tex. V. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 808 F. 2d. 363, 371 – 72 (5th Cir. 1987).

Once a motion to dismiss is filed in a chapter 11 case, the bankruptcy court is required to commence a hearing on that motion not later than 30 days after the motion's filing date, and must decide the motion within 15 days after the hearing commences. 11 U.S.C. §1112(b)(3). These time periods can be extended only if (a) the movant expressly consents to a continuance for a specific time period or (b) "compelling circumstances prevent the court from meeting the time limits established by [Code §1129(b)(3)]." *Id.*

In *In re Omni Lion's Run, L.P.*, 578 B.R. 394, 397 (Bankr. W.D. Tex. 2017), the court reviewed bad faith claims on two single asset real estate ("**SARE**") cases that filed bankruptcy after the secured lenders had accelerated the debt and posted for foreclosure. The court found that, while filing prior to foreclosure is a *Little Creek* factor, it was not dispositive. *Id* at 398. Rather, in this case, the court found more significant—and a sign of good faith—the facts that the debtors had made progress on their chapter 11 plans, the principals had invested capital into the debtors, the debtors had a source of income to fund a plan and pay the secured lender and the cases were not intended to delay other proceedings. *Id*. According to the court, because there was hope for rehabilitation, the debtors' cases were not filed in bad faith.

In *In re Northbelt, LLC,* Case No. 19-30388, 2020 W.L. 2840232 at *38 (Bankr. S.D. Tex. May 29, 2020) (Slip. Op.), a court recently denied a bad faith claim even though several of the *Little Creek* factors were present, including a SARE debtor, with encumbered property, that had few unsecured creditors and filed during pending litigation with its secured lender. The court rejected the bad faith claim, however, because the debtor had been making monthly payments to the secured lender and the debtor was actively engaged in the bankruptcy process, having filed 2 chapter 11 plans. *Id.* Moreover, the court did not find that the debtor was misusing the bankruptcy process to resolve a two-party dispute, circumvent rulings from another court, or to avoid a pending foreclosure. *Id.*

III. TURNOVER OF PROPERTY BY CUSTODIAN

Debtors often file real estate chapter 11 cases after a receiver has been appointed in a mortgage foreclosure case. This raises the issue of whether the receiver or the debtor, as debtor- in-possession, will control the debtor's real estate.

A receiver is a "custodian" as that word is defined in §101(11) of the Code. 11 U.S.C. § 101(11). Section 543 of the Code imposes a number of obligations on a custodian who knows that a chapter 11 case has been filed. Among them is the obligation under §543(b)(1) of the Code to "deliver to the [debtor-in-possession] any property of the debtor held by . . . such custodian, or . . . rents . . . of such property . . . in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case." 11 U.S.C. §543(b)(1). A proceeding to recover property of the debtor's estate is an adversary proceeding. Fed. R. Bankr. P. 7001(1). Consequently, a debtor must file an adversary complaint to enforce a receiver's obligation to turn over property in its possession to the debtor's estate. *Id.*

Mortgagees recognize that depriving the debtor of control over its property will often place a significant impediment to the debtor's reorganization path. *See In re 245 Associates, LLC,* 188 B.R. 743, 753 (Bankr. S.D.N.Y. 1995) (stating that when property is not promptly turned over to debtor and debtor's rights to control it are thwarted, debtor is prevented "from administering its property for the benefit of the estate and with a view toward reorganization"). *See also In re KCC-Fund V, Ltd.,* 96 B.R. 237, 239 – 240 (Bankr. W.D.Mo. 1989). *Accord In re Poplar Springs Apartments of Atlanta, Ltd.,* 103 B.R. 146 (Bankr. S.D. Ohio 1989). As a result, mortgagees often invoke §543(d)(1) of the Code in response to a proceeding under §543(b)(1) of the Code to enforce a receiver's turnover obligation. Section 543(d)(1) of the Code provides, in relevant part, that a bankruptcy court "may excuse compliance with subsection . . . [543](b) . . . if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property." 11 U.S.C. §543(d)(1).

The Fifth Circuit has noted that a court should look at the best interest of the debtor or equity security holders in granting such waiver. *See In re Bodeheimer, Jones, Szwak & Winchell L.L.P.,* 592 F.3d 664, n. 26 (5th Cir. 2009). However, other courts find that the best interest of the debtor is not relevant to granting a waiver under section 543(d)(1). *See*, *e.g.*, *Foundry of Barrington P'ship v. Barrett (In re Foundry of Burlington P'ship)*, 129 B.R. 550, 558 (Bankr. N.D. Ill. 1991).

Whether a custodian's turnover of property to the debtor is in the "best interests of creditors" depends on the facts and circumstances of each case. There is not an abundance of cases in the Fifth Circuit that address section 543(d). In *In re Roxwell Performance Drilling, LLC,* No. 13-50301-RLJ-11, 2013 WL 6799118, at *3 (Bankr. N.D. Tex. Dec. 29, 2013), the court looked at the law in other jurisdictions in determining to grant a waiver under section 543(d). The court noted that relevant factors included whether (a) the debtor and management best served the creditors, (b) the debtor could effect a reorganization given its resources,

management, motives, and (c) the prosecution of avoidance actions (which a receiver cannot do) was necessary for the reorganization. (*citing In re Orchards Vill. Inus., LLC,* 405 B.R. 341 (Bankr. D. Or. 2009) (permitting receiver to stay in possession of estate property); *In re Picacho Hills Util. Co., Inc.,* No. 11-13-10742 TL, 2013 WL 1788298 (Bankr. D.N.M. April 26, 2013) (same)).

In other jurisdictions, courts consider the "best interests of creditors" factors, like (a) the likelihood of a reorganization, (b) the probability that the funds required for reorganization will be available, (c) whether the debtor will use the property turned over for the benefit of creditors, (d) whether the debtor has mismanaged the property, (e) whether there are avoidance issues with respect to the property retained by a receiver; and (f) the effect of automatic stay on state court receivership. *See In re Bryant Manor, LLC,* 422 B.R. 278, 290-92 (Bankr. D. Kan. 2010) (turnover excused when there were serious issues as to reorganization of debtor and it was questionable whether there would be funds available for reorganization); *In re Falconridge, LLC,* No. 07-bk-19200, 2007 WL 3332769 at *10 (Bankr. N.D. Ill. Nov. 8, 2007) (turnover excused when court was unsure that debtor would use property for benefit of creditors); *In re 400 Madison Avenue Limited Partnership,* 213 B.R. 888, 896 n.16 (Bankr. S.D.N.Y. 1997) (turnover excused when receiver had been in possession of property long before debtor filed bankruptcy case); *Dill v. Dime Savings Bank, FSB (In re Dill),* 163 B.R. 221, 224 (E.D.N.Y. 1994) (turnover excused when debtor had mismanaged property and lender continued to subsidize repair and maintenance costs); *Foundry of Barrington Partnership,*129 B.R. at 558 (turnover excused when debtor engaged in prepetition misconduct, receiver and undersecured mortgagee had interest in maximizing value of property, and debtor's prospects for reorganization were speculative); *KCC-Fund V, supra* (turnover excused when debtor had failed to maintain properties); *Poplar Springs Apartments, supra,* 103 B.R. at 150 (turnover excused when debtor did not have time to focus on administering assets to best interests of creditors).

On the other hand, courts have enforced a receiver's turnover obligations when the debtor has been responsible in managing its business and the debtor would use the property turned over for the benefit of creditors. *See, e.g., In re R & G Properties, Inc.,* No. 08-10876, 2008 WL 4966774 at **8 – 11 (Bankr. D.Vt. Nov. 21, 2008); *see also In re U.S.A. Parts Supply*, No. 20-bk-241, 2020 WL 4782987 (Bankr. N.D. W.Va. Aug. 17, 2020) (denying waiver of turnover under section 543(d)).

In cases where a receiver is being asked to stay in place, courts have also considered whether they should abstain from the matter pursuant to section 305 of the Code, which provides, in relevant part that a court may dismiss or suspend a bankruptcy proceeding if "the interests of creditors and the debtor would be better served by such dismissal or suspension." 11 U.S.C. § 305(a)(1).

The decision to dismiss under section 305 is discretionary, and must be made on a case by case basis. *In re O'Neil Vill. Pers. Care Corp.*, 88 B.R. 76, 79 (Bankr. W.D. Pa. 1988); *In re Corporate & Leisure Event Prods., Inc.*, 351 B.R. 724, 732-33 (Bankr. D. Ariz. 2006); 2 Collier on Bankruptcy, ⁋ 305-8 to 305-09 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2017) ("The pendency of state law liquidation proceedings . . . is relevant to an abstention decision under section 305(a)(1). For instance . . . when the debtor has been in receivership for so long that the bankruptcy case would be duplicative and wasteful, courts have deferred to state courts and abstained under section 305(a)(1).")

In *In re Packard Square, LLC,* 575 B.R. 768, 780-81 (Bankr. E.D. Mich. 2017), in response to a turnover request by the debtor under section 543(b)(1) and a waiver request by the receiver under section 543(d), the court elected instead to abstain from the proceeding under section 305, because the court had previously denied the debtor's postpetition financing and it was uncontested that the debtor needed such funding to develop the pertinent property and reorganize.

IV. DEBTOR'S USE OF MORTGAGEE'S CASH COLLATERAL

Rent will be the main source of income when a chapter 11 debtor's assets consist of an office building, an apartment building, or a shopping center. In cases involving other types of property, such as a hotel, a golf course, or a marina, the debtor's income will be classified as accounts or general intangibles. The debtor's secured lender will typically have a perfected security interest in the debtor's prepetition revenue streams. Once a chapter 11 case has been filed, the debtor must continue to use its income to pay operating expenses and taxes and to make capital expenditures. However, in order to protect the secured lender's interest in the debtor's income, the Bankruptcy Code places limitations on the debtor's ability to use that income. The friction between the debtor's need for funds to finance its post-petition operations and the secured lender's desire to protect its interest in those funds raises a number of issues discussed below.

A. Perfecting Security Interests in Rents

Generally, a threshold issue in almost every chapter 11 real estate case is whether the lender holds a perfected security interest in rents. While the case law on this subject was somewhat confused during the early years following enactment of the Code, subsequent

caselaw and the 1994 amendments to section 552(b) of the Code have dissipated that confusion.

An assignment of rents may take the form of a discrete document executed by a borrower in favor of a mortgagee at the inception of a real estate loan. Alternatively a real estate mortgage may include an assignment of rents clause. In either case, the mortgagee will record the document with the recorder of deeds of the county in which the mortgaged real estate is located.

Before 1994, the validity of an assignment of rents was governed by state law. *Butner v. United States,* 440 U.S. 48, 59 L.Ed.2d 136, 99 S.Ct. 914 (1979). In 1994, Congress amended section 552(b) of the Code by dividing that section into two subsections. Pub.L. No. 103-394, 108 Stat. 4126 (1994). The current version of section 552(b)(2) provides that if a prepetition security agreement creates a security interest in rents or hotel revenues, then that security interest extends to post-petition rents or hotel revenues, to the extent provided in the security agreement. 11 U.S.C. §552(b)(2). However, there is a line of cases holding that, because section 541(a)(6) of the Code expressly includes rents in the definition of "property of the estate," federal law now trumps state law on this issue. *See, e.g., In re Amaravathi Ltd. P'ship.*, 416 B.R. 618 (Bankr. S.D. Tex. 2009); see also Jerald Ancel et al., *Post-Petition Rents as Property of the Estate: State of Federal Law?,* Am.Bankr.Inst.J. 44 – 45, 68 (July-Aug. 2010).

In Texas, the issue over whether federal or state law applied historically led to a lot of litigation as to whether the assignment was a collateral assignment (where the borrower still owned the rents) or absolute assignment (where the lender owned the rents upon assignment). *See Matter of Village Props., Ltd.*, 723 F.2d 441 (5th Cir. 1984). This debate virtually came to a halt, however, on June 11, 2011, when Texas enacted the Texas Assignment of Rents Act ("**TARA**") on June 17, 2011, which added Chapter 64 to the Texas Property Code entitled "Assignment of Rents to Lienholder." Se *In re MRI Beltline Indus., L.P.*, 476 B.R. 917, 921 (Bankr. N.D. Tex. 2012). TARA abolishes the concept of absolute assignment of rents and now categorizes everything as a collateral assignment. TARA also codifies the creation, perfection/priority and enforcement of an assignment of rents. For example:

1. Title Issues

- Section 64.051(a) of the Texas Property Code ("**TPC**") provides that an enforceable security instrument creates an assignment of rents arising from real property described in the security agreement (even if there is no assignment of rents language).
- TPC § 64.051(b) clarifies that the assignment is a security interest only, regardless of nomenclature used in a loan document.

2. Perfection

- TPC § 64.052(b) provides that perfection is accomplished through recordation in the real property records where property is located.
- TPC § 64.052(c) provides that a perfected security interest has priority over any subsequent interests on rents or real property.

3. Enforcement

- TPC § 64.051(b) provide that an assignment of rents does not reduce the secured obligation except to the extent the lender actually collects the rents and applies it to the secured debt (fixing pro tanto rent reduction created by *Taylor v. Brennan*, 621 S.W. 2d 592 (Tex. 1981)).
- The lender may now enforce the assignment of rents by providing notice to the borrower or tenant or any other method permitted by law. Tex. Prop. Code §§ 64.054, 64.055, 64.053(a).
- On or after the date of enforcement, the lender is entitled to collect all accrued but unpaid rents and all rents that accrue thereafter. *Id.* 64.053(b).

While TARA fixed a lot of the debate surrounding the characterization of assignment of rents, courts in other states still recognize and enforce absolute assignments of rents. *See, e.g., Provident Mutual Life Insurance Co. v. Winslow Center Associates (In re Winslow Center Associates),* 50 B.R. 679 (Bankr. E.D. Pa. 1985) (applying New Jersey law). In these states, a mortgagee that defaults ceases to have an interest in rents. *See* Paul Rubin, *Absolute Assignments of Rents Survive Filings,* 30 Am.Bankr.Inst.J. 50 (2011).

B. Statutory Framework

Upon the filing of a chapter 11 case, revenue of the debtor that is subject to a perfected security interest becomes "cash collateral," pursuant to section 363(a) of the Code. The definition of "cash collateral" is very broad and covers all sources of revenue, including rents and "other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title." 11 U.S.C. §363(a).

Section 552(a) of the Code provides that, as a general rule post-petition property is not subject to a lien created by a prepetition security interest. But section 552(b) is the exception to that general rule, providing

that to the extent provided by applicable non-bankruptcy law and the terms of a security agreement, a prepetition security interest in property that also covers "proceeds, products, offspring, or profits" extends to post-petition proceeds of such property. Section 552(b)(2) makes abundantly clear that this exception includes "rents of [prepetition] property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties."

Section 363(c)(2) of the Code provides, in relevant part, that a debtor is not allowed to use, sell or lease cash collateral unless (a) the secured party consents or (b) the court approves such disposition. Section 363(c)(3) provides for both preliminary and final hearings to authorize use of cash collateral, and permits the bankruptcy court to authorize use of cash collateral at a preliminary hearing "only if there is a reasonable likelihood that the [debtor-in-possession] will prevail at the final hearing under subsection (e) of this section." 11 U.S.C. §363(c)(3).

Pursuant to Fed. R. Bankr. P. 4001(b)(2), the court may hold a final cash collateral hearing no earlier than 14 days after service of the motion. However, Fed. R. Bankr. P. 4001(b)(2) also allows the court to hold a preliminary cash collateral hearing and to authorize use of "only that amount of cash collateral as is necessary to avoid immediate and irreparable harm pending a final hearing." In most bankruptcy cases, a debtor will file a motion on the first day of the case seeking immediate authority to use cash collateral, on an interim basis, because otherwise the debtor would be able to use none of its income to continue to operate.

C. Adequate Protection

If a secured creditor holding a security interest in, or lien on, cash collateral objects to a debtor's motion for authority to use that cash collateral, section 363(e) of the Code provides that "the court, with or without a hearing, shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest." 11 U.S.C. §363(e). Adequate protection is a concept based on the protection for property interests afforded by the Fifth Amendment to the United States Constitution and is intended to compensate a secured creditor from any diminution in the value of the creditor's security interest. *See, e.g.,In re DeSardi,* 340 B.R. 790, 796-97 (Bankr. S.D. Tex. 2006) (stating "[a]dequate protection is also grounded in the belief that secured creditors should not be deprived of the benefit of their bargain"). Section 361 of the Code proves three means of providing adequate protection: (1) periodic cash payments, (2) an additional or replacement lien, and (3) "such other relief . . . as will result in the realization by [the secured creditor] of the indubitable equivalent of such entity's interest in such property." 11 U.S.C. §361(3). *See In re Murel Holding Corp.,* 75 F.2d 941 (2d Cir. 1935). Section 361(3) specifically states that an administrative expense claim under Code §503(b)(1) does not constitute adequate protection.

In order to determine if cash collateral has diminished in value, the bankruptcy court must measure the value of that cash collateral. In the past, although not precisely in this context, the Fifth Circuit has favored a flexible approach, where the valuation of collateral can occur at various points in the bankruptcy, depending on relief or remedy being sought. *Financial Security Assurance Inc. v. T-H Orleans Limited P'ship*, 116 F.3d 790, 798 (5th Cir. 1997) ("[V]aluation of the collateral and the creditor's claim should be flexible and not limited to a single point in time, such as the petition date or confirmation date."); *see also In re Giesel*, 480 B.R. 238 (Bankr. N.D. Tex. 2012). A bankruptcy court's choice of valuation method will have a significant impact on the both the amount of an undersecured lender's secured and unsecured claims and on the debtor's ability to use cash collateral to pay administrative expenses.

Adequate protection can take many forms. If a secured creditor is oversecured, *i.e.,* if the value of its collateral exceeds the amount of the creditor's claim, that excess (commonly referred to as an "equity cushion") will constitute adequate protection for the debtor's use of cash collateral. *See In re Las Torres Dev., L.L.C.*, 413 B.R. 687, 697 (Bankr. S.D. Tex. 2009) ("The record here reflects that there is more than a 20% equity cushion in the Shopping Center; and case law is clear that an equity cushion of 20% or more constitutes adequate protection.") However, since adequate protection compensates a secured creditor for diminution in the value of its collateral, an equity cushion itself is not entitled to adequate protection. *See In re Delta Resources, Inc.,* 54 F.3d 722 (11th Cir.1995) When a secured creditor holding a mortgage on real estate is undersecured, *i.e.,* the creditor's claim exceeds the value of its collateral, adequate protection takes the form of provisions in a cash collateral order requiring the debtor to use its revenues to pay (1) operating expenses, (2) the costs of maintaining the property, and (3) real estate taxes. *Federal National Mortgage Ass'n v. Dacon Bolingbrook Associates, L.P.,* 153 B.R. 204, 214 (N.D. Ill. 1993) (finding that payment of reasonable and necessary expenses of operating and maintaining project constituted adequate protection); *In re Las Vegas Monorail Co.*, 429 B.R. 317, 341 (Bankr. D. Nev. 2010) ("In a similar manner, other courts have found that a debtor's use of cash collateral to maintain properties from which rents are being generated is a sufficient form of adequate protection."). An undersecured creditor is not, however, entitled to post-petition interest as adequate protection. *See United Sv. Ass'n v. Timbers of inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988).

If the adequate protection afforded a secured creditor proves to be inadequate, the secured creditor is

entitled to a "superpriority" administrative claim under §507(b) of the Code. *See In re SCOPAC,* 624 F.3d 274, 282 – 286 (5th Cir. 2010).

D. Application of Cash Collateral to Mortgage Lender's Claim

In real estate chapter 11 cases, monthly rental income from the debtor's property frequently exceeds the monthly expenses of maintaining and preserving that property. In such cases, the adequate protection afforded to a mortgage lender in a cash collateral order may include payment of the foregoing surplus income to the mortgagee. This raises the question of how that surplus should be applied to the lender's claim.

1. Application of Surplus Cash Collateral to Claim of Undersecured Mortgage Lender

An undersecured lender is one whose claim exceeds the value of its collateral. See 11 U.S.C. § 506(a)(1) (allowed claim of creditor secured by lien on property in which estate has interest, has secured claim to extent of value of such creditor's interest in estate's interest in such property, and unsecured claim to extent that value of such creditor's interest is less than amount of such allowed claim).

Courts are divided over how to apply surplus cash collateral to the claim of an undersecured lender. One line of cases adopts the "subtraction" method for applying surplus cash collateral. Under this method, when the secured lender's property is not declining in value, surplus cash collateral is applied to reduce the secured portion of the undersecured lender's claim. Courts that have adopted the subtraction method have done so in order to prevent the undersecured lender from receiving a post-petition payment on an unsecured claim which is prohibited by section 549 of the Code. *First Federal Bank of California v. Weinstein (In re Weinstein),* 227 B.R. 284 (B.A.P. 9th Cir. 1998); *In re Kalian,* 169 B.R. 503 (Bankr. D.R.I. 1994); *In re Spacek,* 112 B.R. 162 (Bankr. W.D. Tex. 1990). However, the subtraction method confers a significant benefit on the debtor, because reducing the undersecured creditor's secured claim enhances a debtor's ability to satisfy the conditions imposed by section 1129(b)(2)(A)(i) of the Code for confirming a plan of reorganization over the objection of the lender as the holder of a secured claim by reducing both the principal amount of the claim that the debtor must repay under a reorganization plan and the amount of interest that the debtor must pay on that secured claim.

A majority of courts have adopted the "addition" method of applying surplus cash collateral to the mortgage lender's claim. Under this approach, surplus cash increases the lender's secured claim, and payment of that cash to the lender "results in a 'wash' of that discrete increase, which in turn decreases the total amount of the creditor's claim but not the secured portion of its claim as measured by the value of the real estate." *In re Union Meeting Partners,* 178 B.R. 664, 674 (Bankr. E.D. Pa. 1995); *In re Addison Properties Limited Partnership,* 185 B.R. 766, 777 (Bankr. N.D. Ill. 1995) (rents increased secured portion of lender's claim, causing unsecured portion of claim to be reduced accordingly; payment of surplus cash to lender then reduces secured claim back to value of debtor's property). *See also In re Markos Gurnee Partnership,* 252 B.R. 712 (Bankr. N.D. Ill. 1997).

When the dual valuation approach to valuing cash collateral is combined with the "addition" method of applying surplus rents from that real estate, the debtor can use surplus rents to pay its counsel's post-petition attorney's fees if (1) the debtor's property is not declining in value, (2) that property is not likely to decline in value, and (3) all other administrative expenses are likely to be paid. *See id.* at 786. *But see In re Buttermilk Towne Center, LLC,* 422 B.R. 558 (B.A.P. 6th Cir. 2010).

2. Application of Surplus Cash Collateral to Claim of Oversecured Mortgage Lender

The right of an oversecured creditor to add post-petition interest and other charges to its claim is governed by section 506(b) of the Code, which provides, in pertinent part, that "to the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." 11 U.S.C. §506(b).

a. Interest

Section 506(b) of the Code permits an oversecured creditor to recover post-petition interest at the contract rate. *United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 103 L.Ed.2d 290, 109 S.Ct. 1026 (1989) (post-petition interest allowed on nonconsensual oversecured claim of Internal Revenue Service). In some jurisdictions, there is a presumption that an oversecured creditor is entitled to default rate interest. *In re Terry Limited Partnership,* 27 F.3d 241, 243 (7th Cir. 1994) (oversecured creditor entitled to default interest rate of 17.25 percent based on equities of case and contract rate of 14.75 percent); *Florida Asset Financing Corp. v. Dixon (In re Dixon),* 228 B.R. 166 (W.D.Va. 1998) (oversecured creditor entitled to default interest at 36 percent per annum when such rate was enforceable under state law and debtor failed to present evidence that rate was inequitable); *In re Skyler Ridge,* 80 B.R. 500 (Bankr. C.D.Cal. 1987).

The Fifth Circuit has held, however, that, while the contract rate generally provides the post-petition rate of interest under section 506(b) (based on pre-Code

practice), a bankruptcy court has flexibility to adjust the rate based on the "equities of the case." *Bradford v. Cruzier (In re Laymon)*, 958 F.2d 72, 74 (5th Cir. 1992); *Southland Corp. v. Toronto-Dominion (In re Southland Corp.)*, 160 F.3d 1054, 1059 (5th Cir. 1998) (finding "no set list of equitable factors")

b. Yield Maintenance Provisions

When prevailing interest rates are high, mortgages frequently include a yield maintenance provision requiring a borrower that prepays the mortgage loan to pay a sum in addition to principal and accrued interest. This additional sum gives the lender the income stream it expected to receive if the loan had not been paid before maturity. Bankruptcy courts sometimes assess the validity of yield maintenance agreements by analogy to liquidated damage provisions. *Noonan v. Fremont Financial (In re Lappin Electric Co.),* 245 B.R. 326 (Bankr. E.D.Wis. 2000). *But see River East Plaza L.L.C. v. Variable Annuity Life Insurance Co.,* 498 F.3d 718 (7th Cir. 2007) (though not bankruptcy case, Seventh Circuit found prepayment clauses enforceable under Illinois law, but not under liquidated damages theory). If damages from an early termination of a mortgage loan are difficult to calculate when the loan is made and the sum payable using the yield maintenance formula represents the best estimate of those damages, section 506(b) of the Code permits the payment to an oversecured lender of the yield maintenance payment from the borrower. *See Great Plains Real Estate Development, L.L.C. v. Union Central Life Insurance Co.,* No. 4:05-CV- 002204, 2007 WL 6908824 at *8 (S.D. Iowa June 4, 2007) (finding prepayment provision enforceable); *Lappin Electric,* 245 B.R. at 331 (allowing secured creditor to recover $225,000 termination fee); *Connecticut General Life Insurance Co. v. Schaumburg Hotel Owner Limited Partnership (In re Schaumburg Hotel Owner Limited Partnership),* 97 B.R. 943 (Bankr. N.D. Ill. 1989) (lender entitled to collect prepayment fee when damages were difficult to calculate at inception of loan and amount of payment was less than lender's actual damages).

On the other hand, a yield maintenance agreement is not enforceable if it constitutes a penalty. *In re A.J. Lane & Co.,* 113 B.R. 821, 826 – 827 (Bankr. D. Mass. 1990) (payment of prepayment fee equal to one percent times number of years remaining until stated maturity date of loan was not reasonable in light of anticipated or actual harm denied as penalty). One court has held a yield maintenance agreement unenforceable as a claim for unmatured interest, which must be disallowed under §502(b)(2) of the Code. *In re Ridgewood Apartments of DeKalb County, Ltd.,* 174 B.R. 712, 721 (Bankr. S.D. Ohio 1994) (finding the prepayment penalty was "unmatured interest" that was disallowed under Code §502(b)(2)). A prepayment premium may also be disallowed if the secured creditor accelerates its loan following a default caused by the borrower's bankruptcy, and the loan documents do not expressly assess a prepayment premium under those circumstances. *See In re LHD Realty Corp.,* 726 F.2d 327 (7th Cir. 1984).

In the Fifth Circuit, it is questionable whether a prepayment fee will be allowed, pursuant to the recent decision in *Keystone Gas Gathering, L.L.C. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. (In re Ultra Petroleum Corp.)*, 943 F.3d 758, 765 (5th Cir. 2009), where the Court recently held that such make-whole premiums may be disallowed under section 502(b)(2) as unmatured interest. But, the Court did not per se ban make-whole premiums, and, in fact, stated that "much depends on the dynamics of the individual case" and the bankruptcy court was in the best position to decide whether the premium constitutes unmatured interest. *Id.*

3. Attorneys' Fees

If the secured creditor's note or loan documents require the borrower to pay legal fees and costs incurred by the creditor in enforcing the note, those fees can be added to the claim of an oversecured creditor. 11 U.S.C. § 506(b); *see also In re Hight,* 393 B.R. 484 (S.D. Tex. 2008). If the secured creditor's note or loan does not include a provision for attorneys' fees, section 506(b) will not permit the oversecured creditor to add such fees to its claim. *See In re Astle,* 364 B.R. 735, 737 (Bankr. D. Idaho 2007) (utility granted adequate assurance lien not entitled to attorneys' fees under state statute awarding fees to prevailing party). *See also In re Schriock Construction, Inc.,* 104 F.3d 200 (8th Cir. 1997) (§506(b) overrides state statute rendering void provision in loan agreement allowing recovery of lender's attorneys' fees).

V. AUTOMATIC STAY

A. Scope and Purpose of Automatic Stay

The filing of a bankruptcy petition operates as an automatic stay of a wide variety of actions by creditors to enforce their claims. See 11 U.S.C. §§362(a)(1) – 362(a)(8). The automatic stay is one of the fundamental debtor protections in the Bankruptcy Code. *Midlantic National Bank v. New Jersey Department of Environmental Protection,* 474 U.S. 494, 88 L.Ed.2d 859, 106 S.Ct. 755, 760 (1986). The purpose of the automatic stay is twofold: (1) to give a debtor breathing room in which to fix its business problems and prepare a plan of reorganization; and (2) to prevent creditors from taking judicial or nonjudicial actions to dismember the debtor in the process of enforcing their claims. *Garcia v. Phoenix Bond & Indemnity Co. (In re Garcia),* 109 B.R. 335, 337 n.3 (N.D.Ill. 1989). The automatic stay also promotes equality of distribution among creditors by preventing a race to the courthouse in which some creditors will obtain assets to satisfy their

claims, leaving nothing for other, similarly situated creditors. *See El Puerto de Liverpool S.A. de C.V. v. Servi Mundo Llantero, U.S.A., Inc. (In re Kmart Corp.),* 285 B.R. 679, 688 (Bankr. N.D. Ill. 2002). The stay becomes effective on the petition date whether a bankruptcy case is voluntary or involuntary. 11 U.S.C. §362(a) ("a petition filed under section 301[voluntary petition], 302 [joint petitions] or 303 [involuntary petition] . . . operates as a stay, applicable to all entities).

There is no dispute that the automatic stay halts both judicial and nonjudicial actions by creditors to foreclose liens on a debtor's real estate. The automatic stay is an injunction. Consequently, a creditor that violates the stay can be held in contempt of court. See Fed.R.Bankr.P. 9020.

What is the effect of a post-petition action, *e.g.,* obtaining a foreclosure judgment by a mortgage lender that has no notice of a bankruptcy filing by its mortgagee? Courts that have addressed this question are divided. One line of cases holds that such an act is void ab initio, while another line of cases holds that the act is merely voidable. *Compare In re Soares,* 107 F.3d 969 (1st Cir. 1997) (actions in violation of stay are void), *with Picco v. Global Marine Drilling Co.,* 900 F.2d 846, 850 (5th Cir. 1990) (actions in violation of stay are merely voidable). At least a couple federal courts of appeal have adopted a middle ground — an action in violation of the stay is void, but the offending creditor can ask to have the stay annulled. *In re Siciliano,* 13 F.3d 748, 751 (3d Cir. 1994); *Matthews v. Rosene,* 739 F.2d 249, 251 (7th Cir. 1984) (holding violations ordinarily void, but permitting courts to retroactively validate such actions based on the equitable considerations).

B. Waivers of Automatic Stay

Lenders will often include a waiver of the automatic stay in workout and forbearance agreements and in consensual chapter 11 reorganization plans with borrowers who have defaulted on commercial real estate mortgages. Unlike an agreement not to file bankruptcy, which is void as against public policy (*Fallick v. Kehr,* 369 F.2d 899 (2d Cir. 1966)), waivers of the automatic stay are not per se invalid in all jurisdictions. Bankruptcy courts consider several factors in deciding whether to enforce a prepetition stay waiver, including (1) the financial sophistication of the borrower; (2) whether the lender gave significant consideration to the debtor in exchange for the waiver; (3) the effect that enforcement of the waiver will have on any other parties having legitimate interests in the outcome of the bankruptcy case; and (4) whether there has been a material change in circumstances since the debtor executed the waiver. *See Massachusetts Mutual Life Insurance Co. v. Shady Grove Tech Center Associates Limited Partnership (In re Shady Grove Tech Center Associates Limited Partnership),* 227 B.R. 422, 425 (Bankr. D. Md. 1989) (enforcing prepetition stay waiver); *In re Darrell Creek Associates, L.P.,* 187 B.R. 908, 916 (D.S.C. 1995) (enforcing prepetition stay waiver). A court will enforce a prepetition stay waiver included in a forbearance agreement due to the strong public policy favoring out-of-court restructurings. *In re Powers,* 170 B.R. 480, 483 (Bankr. D. Mass. 1994). However, a drastic change in the debtor's circumstances following execution of the waiver may render the waiver unenforceable. *Compass Bank for Savings v. Billingham (In re Graves),* 212 B.R. 692, 694 (B.A.P. 1st Cir. 1997) (after execution of waiver, trustee obtained $1 million judgment against polluter of property that had previously been worthless due to contamination).

The enforceability of such prepetition waivers is unsettled in the Fifth Circuit, which has never expressly endorsed or banned such a waiver. *See, e.g., Tobler v. Yoder & Frey Auctioneers, Inc.*, 620 F.2d 508 (5th Cir. 1980) (reviewing a case involving a waiver, which was not at issue). Some lower courts have toyed with the issue, considering the current trend to allow them in limited circumstances. *See Wells Fargo Bank Minnesota N.A. v. Kobernick*, C.A. No. 8-cv-1458, 2009 WL 7808949, at *7 (Bankr. S.D. Tex. May 28, 2009) ("As to waivers of the automatic stay, however, the majority view, and the trend in bankruptcy decisions, is that prebankruptcy waivers of the automatic stay are sometimes enforceable."); *In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 316 and n. 10 (Bankr. N.D. Tex. 2010) (while general statutory rights are waivable, the court noted that "there is conflicting authority on whether a prepetition waiver of the automatic stay by a debtor . . . [is an] enforceable waiver[] of statutory rights (given that other parties in interests' rights may be impacted by such an agreement.")

C. Relief from Automatic Stay

1. <u>Statute and Rules</u>

a. Section 362(d)

Relief from the automatic stay is governed by §362(d) of the Code, which provides in relevant part that a bankruptcy court may lift the stay:

- for "cause," including lack of adequate protection;
- if (a) the debtor does not have equity in the property and (b) such property is not necessary to an effective reorganization;
- In SARE cases, if (a) the debtor does not file a potentially confirmable plan within 90 days (or 30 days after the court determines the case is a SARE case) or (b) the debtor started to make non-default interest payments to each leinholder of the property.

b. Federal Rule of Bankruptcy Procedure 4001(a)

Federal Rule of Bankruptcy Procedure 4001(a) implements section 362(d) of the Code. That Rule

provides that relief from the stay shall be made by a motion in accordance with Fed.R.Bankr.P. 9014. Under that rule, a stay relief motion is a contested matter. Fed.R.Bankr.P. 4001(a). The motion shall be served in the manner provided for service of summons and a complaint under Fed.R.Bankr.P. 7004. Fed.R.Bankr.P. 9014(b). Fed.R.Bankr.P. 9014(c) makes various rules governing adversary proceedings applicable to lift-stay hearings, including rules governing discovery. Notably, Fed.R.Bankr.P. 9014(c) does not make applicable to contested matters subdivisions (a)(1), (a)(2), and (a)(3) of Fed.R.Bankr.P. 7026 and Rule 26 of the Federal Rules of Civil Procedure, which govern mandatory disclosures, disclosures regarding expert testimony, and additional pretrial disclosures.

2. Time Periods

When a lift-stay motion seeks relief from the stay of an act against property, such as the stay of a mortgage foreclosure case, section 362(e) of the Code imposes stringent deadlines on both the parties and the court for the hearing on that motion. Thus, the stay automatically terminates 30 days after a request for relief from the automatic stay "unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section." 11 U.S.C. §362(e)(1). A lift-stay motion may be a preliminary or a final hearing. The court may also consolidate the preliminary and final hearings. If the court conducts a preliminary hearing on a lift-stay motion, the stay will remain in effect pending a final hearing "if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing." *Id.* Furthermore, such a final hearing "*shall be concluded not later than thirty days after the conclusion of such preliminary hearing,* unless the 30-day period is extended with the consent of the parties in interest or for a specific time which the court finds is required by *compelling circumstances.*" *Id.* (emphasis added).

3. Counterclaims

The hearing on a stay of relief motion is not "the appropriate time at which to bring in other issues, such as counterclaims against the creditor on largely unrelated matters." H.R.Rep. No. 595, 95th Cong., 1st Sess. 344 (1977); *In re Vitreous Steel Products Co.,* 911 F.2d 1223, 1232 (7th Cir. 1990). "Considering the statute's limited grounds for relief and summary nature, as well as the legislative history, most courts have found that hearings on motions for relief from the automatic stay do not involve a full adjudication on the merits of claims, defenses, or counterclaims; instead the proceeding simply involves a determination as to whether a creditor has a colorable claim to the property of the estate." *Colvin v. Amegy Mtg. Co., LLC*, 507 B.R. 169, 184 (Bankr. W.D. Tex. 2014). However, the party opposing the stay of relief may still present "evidence on the existence of claims which the court may consider in exercising its discretion. What is precluded is a determination of such collateral claims on the merits at the [lift-stay] hearing." S. Rep. No. 989, 95th Cong., 2d Sess. 55 (1978). *See also Grella v. Salem Five Cent Savings Bank,* 42 F.3d 26, 32 (1st Cir. 1994) (stating that proceedings under §362 of Code "do not involve a full adjudication on the merits of claims, defenses, or counterclaims, but simply a determination as to whether a creditor has a colorable claim to property of the estate"); *Vale Mills Corp. v. Gellert (In re Gellert),* 55 B.R. 970, 975 – 976 (Bankr. D.N.H. 1985) (extraneous grounds will only be considered in summary manner appropriate to equivalent request for restraining order or preliminary injunction). When the party opposing stay of relief does raise "extraneous matters," some courts will conduct separate hearings on the lift-stay motion and the debtor's extraneous counterclaims and defenses. *In re Waste Alternatives, Inc.,* 171 B.R. 147, 148 (Bankr. M.D.Fla. 1994); *In re Pub Dennis International, Inc.,* 115 B.R. 16, 18 (Bankr. D.R.I. 1990); *Citizens & Southern National Bank v. Georgia Steel, Inc. (In re Georgia Steel, Inc.),* 19 B.R. 523, 524 (Bankr. M.D.Ga. 1982); *Hoyt, Inc. v. Born (In re Born),* 10 B.R. 43 (Bankr. S.D.Tex. 1981).

4. Stay Relief "For Cause"

Section 362(d)(1) of the Code directs a bankruptcy court to lift the automatic stay "for cause, including the lack of adequate protection of an interest in property" of the party seeking stay relief. 11 U.S.C. §362(d)(1).

The Code does not define "cause." Consequently, bankruptcy courts have broad discretion in determining what circumstances will constitute "cause for granting stay relief." *In re Barnes*, No. 07-10557, 2008 WL 2199823, at *1 (5th Cir. May 28, 2008) (*citing Bustamante v. Cueva (In re Cueva)*, 371 F.3d 232, 236 (5th Cir. 2004)); *In re Mirant Corp.*, 440 F.3d 238, 251-52 (5th Cir. 2006) (noting that the definition "affords flexibility to the bankruptcy courts"): *In re Robbins,* 964 F.2d 342, 345 (4th Cir. 1992) (courts must determine when discretionary relief is appropriate on case-by-case basis). Among the circumstances that courts have found constitute "cause" for stay relief include (a) a debtor's bad faith in filing its bankruptcy petition, and (b) the interest of judicial economy to allow a proceeding to continue in a non- bankruptcy forum. *See In re Laguna Associates Limited Partnership,* 30 F.3d 734, 737-38 (6th Cir. 1994); *In re Pro Football Weekly, Inc.,* 60 B.R. 824, 826-27 (N.D. Ill. 1986); *see also* 3 Alan N. Resnick and Henry J. Sommer eds., COLLIER ON BANKRUPTCY ¶362.07[3][a] (16th ed. 2010) (COLLIER ON BANKRUPTCY) (multivolume set, year and edition vary by volume) (collecting cases). There is also "ample case law holding that only innocent

parties who had no knowledge of the bankruptcy can seek annulment of the stay." *In re Okedokun*, 593 B.R. 469, 531 (Bankr. S.D. Tex. 2018).

5. Lack of Adequate Protection

As was the case with cash collateral, a secured creditor's lien on the debtor's real estate is an interest in property entitled to adequate protection. *See United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.,* 484 U.S. 365, 370 (1988). *See also In re Fennell*, No. 17-20095, 2017 WL 7050633, at *3 (Bankr. N.D. Tex. Nov. 13, 2017); *In re Chrysler LLC,* 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009) (stating that lien in collateral that is property of estate is necessary prerequisite to Fifth Amendment Takings Clause claim in bankruptcy context). Adequate protection for a mortgagee's lien is lacking when the Code's automatic stay results in a diminution in the value of the secured claim. *See In re Scopac*, 624 F.3d 274, 282 (5th Cir. 2010) ("A secured creditor whose collateral is subject to the automatic stay may seek adequate protection for the diminution of the value of the property."); *In re Continental Airlines, Inc.,* 154 B.R. 176, 180 (Bankr. D.Del. 1993) (stating that Code §361 provides that adequate protection is available under Code §362(d) "when the imposition of the automatic stay results in a decrease in the value of an entity's interest in property"). However, adequate protection does not encompass either an undersecured creditor's right to post-petition interest on the secured portion of its claim or the right to foreclose and reinvest the proceeds from a foreclosure sale. *United Savings Association,* 484 U.S. at 380-81. *See also In re Blehm Land & Cattle Co.,* 859 F.2d 137, 140 (10th Cir. 1988); *In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 363-64 (5th Cir. 1987) ("We hold today that the adequate protection provisions of the Bankruptcy Code, §§ 362(d) and 361, do not require periodic postpetition payments for interest or lost opportunity cost to an undersecured creditor to compensate it for the delay of the chapter 11 reorganization proceeding . . . .") In addition to the measures described in section 361 of the Code, adequate protection of an undersecured mortgagee's lien on a debtor's real estate may take the form of maintaining the property, keeping the property insured, paying real estate taxes, and paying cash flow in excess of the foregoing expenses to the undersecured creditor. *See, e.g., Federal National Mortgage Ass'n v. Dacon Bolingbrook Associates, L.P.,* 153 B.R. 204, 214 (N.D. Ill. 1993) (citing to several cases and finding that reinvestment of rents for operation and maintenance of property satisfies requirement of adequate protection).

As noted above, section 361 of the Code prescribes three means of providing a secured creditor with adequate protection. In practice, courts have found secured creditors to be adequately protected if the creditor has an "equity cushion," *i.e.,* collateral value in excess of the lender's lien. *See In re Indian Palms Associates, Ltd.,* 61 F.3d 197, 207 – 208 (3d Cir. 1995). Junior liens are disregarded in determining the existence of an equity cushion. *Id*. A 20 percent equity cushion is generally sufficient to adequately protect a secured creditor. *See Mendoza v. Temple-Inland Mtg. Corp. (In re Mendoza)*, 111 F.3d 1264, 1272 (5th Cir. 1997) ("Case law has almost uniformly held that an equity cushion of 20% or more constitutes adequate protection"); *In re Las Torres Dev., LLC*, 413 B.R. 687, 697 (Bankr. S.D. Tex. 2009); *Equitable Life Assurance Society of the United States v. James River Associates (In re James River Associates),* 148 B.R. 790, 796 (E.D.Va. 1992). The equity in property of a non-debtor that is subject to the lien of a secured creditor can also be considered in determining the existence of an equity cushion. *See Nationsbank of Virginia, N.A. v. DCI Publishing of Alexandria, Inc.,* 160 B.R. 538, 540 (E.D.Va. 1993).

6. Code §362(d)(2) — Lack of Equity and Property not Necessary to Effective Reorganization

Even if a secured creditor's lien is adequately protected, such a creditor may seek stay relief under §362(d)(2) of the Code. This section requires the bankruptcy court to grant relief from the automatic stay if the secured creditor proves, by a preponderance of the evidence, that (a) the debtor lacks equity in the property as to which the secured creditor is seeking relief and (b) the property is not necessary for an effective reorganization. Section 362(g) of the Code provides that the secured creditor seeking stay relief has the burden of proof on the issue of the debtor's equity in the property; the party opposing stay relief has the burden of proof on all other issues.

a. Lack of Equity

As a general rule, a debtor's equity in property is determined by comparing the amount of all liens against that property with the property's current value. *See In re Indian Palms Associates, Ltd.,* 61 F.3d 197, 206-07 (3d Cir. 1995) (lower court erred in excluding junior liens in calculating equity). Only a minority of courts have held that a lien of a junior creditor can be disregarded. *See e.g., United Finance Co. v. Cote (In re Cote),* 27 B.R. 510, 513 (Bankr. D.Ore. 1983) (in determining debtor's equity in property, court disregarded lien of junior creditor that opposed stay relief). The majority view is that junior lienholders' liens must be counted in determining the debtor's equity in the property. *See* 3 COLLIER ON BANKRUPTCY ¶ 362.07[4][a][i] (16th ed.) (stating that "majority of courts correctly follow the standard equation for equity under section 362(d)(2) and hold that even if junior lienholders object to stay relief, their liens must be counted in determining whether the debtor has equity in the property for purposes of a section 362(d)(2) calculation"). *See also In re*

McManus, 30 F.3d 1491, 1994 WL 398944 (5th Cir. 1994); *In re Sutton*, 904 F.2d 327, 329 (5th Cir. 1990).

Determining whether a debtor has equity in property as to which a secured creditor seeks stay relief requires the bankruptcy court to value that property. A property's value will vary widely depending on whether it is valued on a fair market value, an orderly liquidation value, or a forced sale liquidation value basis. The Fifth Circuit has held that "[i]n considering the evaluation of property by bankruptcy courts Congress did not dictate a particular appraisal method." *See In re Sutton*, 904 F.2d 327, 330 (5th Cir. 1990). As such, "valuation is determined case-by-case, taking into account the nature of the debtor's business, market conditions, the debtor's prospects for rehabilitation, and the type of collateral. *Id.* (*citing* 2 Collier on Bankruptcy ¶ 361.02 (15th ed. 1990); H.R. Rep. No. 595, 95th Cong., 2d Sess. 339, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6295; *In re Conquest Offshore Int'l, Inc.*, 73 B.R. 171 (Bankr. S.D. Miss 1986)). Indeed, the Fifth Circuit has consistently favored a flexible approach towards valuation. *See Financial Security Assurance Inc. v. T-H New Orleans Limited P'ship (In re T-H New Orleans Limited P'ship)*, 116 F.3d 790, 798 (5th Cir. 1997). Some guidance was also provided by the Supreme Court in *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 954 (1997), where the Court found that the proposed disposition or use of collateral is of paramount importance to a valuation; *see also in re Peerman*, 109 B.R. 718, 721 (Bankr. W.D. Tex. 1989) (valuation is temporal and must account for the reason of valuation and contemplated disposition of collateral."). The Supreme Court also noted that bankruptcy courts, as tiers of fact, must identify the best way of ascertaining value based on the evidence presented. *Rash*, 520 U.S. at 965 n. 6.

A debtor opposing a secured creditor's lift-stay motion based on section 362(d)(2) of the Code generally intends to retain that property under a plan of reorganization. As a result, based on foregoing authority, in deciding whether a debtor has equity in its property, a bankruptcy court will likely use a going-concern standard in determining the value of that property. *See, e.g., In re Pelham Enterprises, Inc.,* 376 B.R. 684, 693 (Bankr. N.D. Ill. 2007).

In order to establish the going-concern value of commercial real estate, both the creditor seeking stay relief, and the debtor opposing that relief, will offer into evidence at a lift-stay hearing both written reports and oral testimony from real estate appraisers. Those appraisers, in turn, typically base their opinions of value on (1) the subject property's replacement value, (2) the sale prices paid for comparable properties in recent transactions, and (3) a discounted cash-flow analysis of the property, if, as is the case of an office building, a rental apartment building, or a hotel, the property generates revenue. Appraisers opining on the value of commercial real estate will typically give greater weight to comparable sales and a value derived from a discounted cash-flow analysis than to replacement value. Details of the process by which an appraiser derives the market value of commercial real estate is complex and beyond the scope of this paper. For a detailed discussion of this subject, the reader should consult 4 COLLIER ON BANKRUPTCY ¶¶506.03[6] and 506.03[7] (16th ed.).

b. Property Not Necessary for Effective Reorganization

In addition to proving that a debtor lacks equity in property, a secured creditor seeking relief from the automatic must also prove that the property is not necessary for an effective reorganization. 11 U.S.C. §362(d)(2)(B). Pursuant to section 362(g) of the Code, the debtor bears the burden of proof on this issue. In practice, this means that the debtor must prove, by a preponderance of the evidence (*In re W.B.S.S., L.P.,* 366 B.R. 629, 632 (Bankr. E.D.Tex. 2007)), that the debtor has a reasonable possibility of a successful reorganization within a reasonable time. *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.,* 484 U.S. 365, 98 L.Ed.2d 740, 108 S.Ct. 626, 632 (1988); *In re 8th St. Village Limited Partnership,* 88 B.R. 853, 856 (Bankr. N.D. Ill.), *aff'd,* 94 B.R. 993 (N.D.Ill. 1988). In deciding this issue, courts apply a sliding scale depending on the stage of the case at which the stay relief motion is filed. *In re Custom Designed Cabinetry & Construction, Inc.,* No. 08 B 71196, 2009 WL 603807 at *4 (Bankr. N.D.Ill. 2009):

> In the first few months after filing, the debtor is under less stringent demands to demonstrate the possibility of a successful reorganization. See *In re Ashgrove Apartments of DeKalb County, Ltd.,* 121 B.R. 752, 761 (citing *Timbers of Inwood Forest, supra,* 484 U.S. at 736; *In re Century Investment Fund VII, L.P.,* 155 B.R. 1002, 1007 (Bankr. E.D. Wisc. 1989) (stating that "the details of a possible plan need not be extensive when the bearing was held less than two months after filing"), *aff'd,* 937 F.2d 371 (7th Cir. 1991)). Yet, even at this early stage of the bankruptcy case, the debtor is still required to present some evidence that an effective reorganization is possible. *See Ashgrove Apartments,* 121 B.R. at 757 (citing *Timbers of Inwood Forest, supra,* 484 U.S. at 376; *In re New American Food Concepts, Inc.,* 70 B.R. 254, 262 (Bankr. N.D. Ohio 1987); *In re 6200 Ridge, Inc.,* 69 B.R. 837, 843 (Bankr. E.D. Pa. 1987) (stating that "11 U.S.C. § 362(d)(2)(B) requires that relief from the stay be granted if there is no

> reasonable likelihood of reorganization") (citations omitted); *In re Terra Mar Associates,* 3 B.R. 462, 466 (Bankr. D. Conn 1980)). "The court should not, at the conclusion of the debtor's case, be left to speculate about important elements and issues relating to the likelihood of an effective reorganization." *In re Anderson Oaks (Phase I) Ltd. P'ship,* 77 B.R. 108, 110 (Bankr. W.D. Tex. 1987).

In order to determine if the debtor's contemplated plan of reorganization has a realistic chance of being confirmed, the court will generally conduct, in a more or less abbreviated form (depending on the stage of the case at which the lift-stay motion is heard), what amounts to a mini confirmation hearing, even though creditors have not received or voted on a plan of reorganization.

7. Single Asset Real Estate (SARE) Cases

In 1994, Congress amended the Code to address perceived abuses involving so-called "single asset" real estate cases. *See In re 652 West 160th LLC,* 330 B.R. 455, 461 (Bankr. S.D.N.Y. 2005) (purpose of adding single asset real estate provisions to the Code in 1994 was "to put additional responsibility on a single asset real estate debtor and prevent a perceived abuse of the bankruptcy process on the part of these ventures"). Such cases typically involved (a) a debtor that owned a single piece of real estate, such as an office building or an apartment building; (b) the property was encumbered by a mortgage, the amount of which often equaled or exceeded the value of the property; (c) the debtor had few other creditors, and the claims of those creditors were insignificant compared with the amount of the mortgage debt; and (d) the debtor had defaulted on the mortgage, the mortgagee had filed a foreclosure suit, and the debtor had filed bankruptcy on the eve of the appointment of a receiver or entry of a judgment of foreclosure. In the vast majority of those cases, the debtor had no realistic prospect for reorganization. To correct this situation, the 1994 amendments added §101(51B) to the Code, which defined "single asset real estate" ("**SARE**") and a new subparagraph (3) to §362(d).

(i) What Constitutes Single Asset Real Estate

Section 101(51B) of the Code currently defines "single asset real estate" as real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor . . . and on which no substantial business is being conducted by a debtor other than . . . activities incidental thereto." 11 U.S.C. §101(51B).

Most of the litigation involving single asset real estate involves the question of whether a particular project generates "substantially all of the gross income of a debtor," and thereby falls within the definition of "single asset real estate." Courts have adopted an active versus passive test to answer that question. In *In re Golf Club Partners, L.P.,* No. 07-40096-BTR-11, 2007 WL 1176010 at *4 (E.D. Tex. Feb. 15, 2007), the bankruptcy court described that test as follows: "[W]hether the revenue is the product of entrepreneurial, active labor and effort — and thus is not single asset real estate — or is simply and passively received as investment income by the debtor as the property's owner — and thus is single asset real estate."

Thus, a marina that stores, repairs, and winterizes boats, provides showers and a pool, sells gas, and provides other activities for boaters who use the marina to moor their boats, is not single asset real estate. *In re Kkemko, Inc.,* 181 B.R. 47 (Bankr. S.D. Ohio 1995). Similarly, a hotel that operates a restaurant, bar, and gift shop falls outside the definition of single asset real estate. *Centofante v. CBJ Developement, Inc. (In re CBJ Development, Inc.),* 202 B.R. 467, 470 (B.A.P. 9th Cir. 1996). *See also In re Larry Goodwin Golf, Inc.,* 219 B.R. 391, 393 (Bankr. M.D.N.C. 1997) (property that consisted of 18-hole golf course, pro shop, driving range, swimming pool facility, and adjacent undeveloped property was not single asset real estate). In contrast to the foregoing cases, a debtor that received substantially all of its income through the sale of real property constituted single asset real estate. *Kara Homes Inc. v. National City Bank (In re Kara Homes, Inc.),* 363 B.R. 399, 404 – 405 (Bankr. D.N.J. 2007).

Whether multiple parcels of real estate constitute a single project depends on whether the parcels are "linked together in some fashion in a common plan or scheme involving their use." *In re McGreals,* 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996); *see also In re Webb Mountain LLC,* No. 07-32016, 2008 WL 656271 (Bankr. E.D. Tenn. Mar. 6, 2008) (five undeveloped parcels of real estate on which debtor conducted no active business qualified as single asset real estate); *In re Philmont Development Co.,* 181 B.R. 220, 223 (Bankr. E.D.Pa. 1995) (multiple semi-detached houses operated under common design or plan as single project constituted single asset real estate).

(ii) Monthly Payments or Plan

As mentioned, section 362(d)(3) of the Code provides that the court shall grant relief from the automatic stay against a SARE debtor within 90 days after the petition date or 30 days after the court classifies the debtor as a SARE debtor (whichever later), unless the debtor has filed a confirmable plan or starts making monthly payment to the secured lender from income generated from the property (*e.g.*, rent).

If the debtor files a plan of reorganization within 90 days of the petition date, the bankruptcy court will use the law developed under section 362(d)(2), as interpreted by the Supreme Court in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.,* 484 U.S. 365, 98 L.Ed.2d 740, 108 S.Ct. 626, 630 (1988), to determine whether property is necessary to an effective reorganization. If the debtor files a plan of reorganization, the court is unlikely to conduct a lift-stay hearing at which it would assess the probability that the plan would be confirmed. Rather, the court will probably conduct a confirmation hearing at which it will decide whether the plan can actually be confirmed.

If the debtor elects to begin making periodic payments in an amount equal to the non-default contract rate of interest, that rate will apply even if the secured creditor's lien has merged into a judgment of foreclosure. *See In re Erie Playce LLC,* 441 B.R. 905, 908 (Bankr. N.D.Ill. 2010). If the creditor is undersecured, those payments will be applied to the principal amount of the undersecured creditor's claim. *Id.*

If a debtor, such as an owner of undeveloped land that produces no income, is unable to satisfy the monthly payment provisions in section 362(d)(3)(B) of the Code, then section 362(d)(3)(A) effectively overrides section 1121(b) of the Code, which grants a debtor the exclusive right to file a plan of reorganization during the first 180 days of the case. In such a situation however, it is unlikely the debtor could file a plan having a reasonable possibility of being confirmed within a reasonable time, because the debtor would likely be unable to confirm a nonconsensual plan under the cramdown standards.

Notably, if a debtor does not check the "single asset real estate" box on its bankruptcy petition, the time periods contained in Code §362(d)(3) will not begin to run until the later of 90 days after the petition date or 30 days after the court determines that the case is a single asset real estate case. If a secured creditor does not move promptly for a determination that the debtor's case is a single asset real estate case, by the time the parties litigate the issue and the court issues a decision, the date that is 30 days after the court's determination could easily be more than 90 days after the petition date.

VI. CHAPTER 11 PLANS OF REORGANIZATION

A. Summary of Plan Confirmation Process

The primary purpose of a chapter 11 is to prepare and file a plan of reorganization or liquidation that treats all claims against the debtor and effectuates a reorganization of all liabilities of the debtor. The mandatory and permissive provisions of chapter 11 plans are set forth in Code §§1123(a) and 1123(b), respectively. Section 1129(a) of the Code sets forth 15 requirements that a plan proponent and the plan of reorganization must satisfy in order for the court to confirm a plan. One of those requirements, contained in section 1129(a)(8), is that each class of claims or interests provided for in the plan must either vote to accept the plan or be unimpaired. 11 U.S.C. § 1129(a)(8). Under section 1124(1) of the Code, a class is unimpaired if the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." 11 U.S.C. §1124(1). A class that is unimpaired is conclusively deemed to have accepted a plan (Code §1126(f)), while Code §1126(g) provides that a class that receives nothing under a plan is conclusively deemed to have rejected a plan. Subject to an important exception for claims that have been "designated" under Code §1126(e), section 1126(c) provides that a class of claims that is impaired and that will receive a distribution, under a plan, accepts the plan if holders of two-thirds in amount and more than one-half in number of allowed claims in the class vote to accept the plan. Similarly, a class of interests accepts a plan if holders of at least two-thirds in amount of allowed interests vote to accept the plan. 11 U.S.C. §1126(d). The foregoing amounts and numbers of claims and interests are calculated based on the votes actually cast and not on the total amount and number of claims in a particular class. 7 COLLIER ON BANKRUPTCY ¶1126.04 (16th ed.); *Department of Housing & Urban Development v. Westwood Plaza Apartments, Ltd. (In re Westwood Plaza Apartments, Ltd.),* 192 B.R. 693, 696 (E.D. Tex. 1996). If the plan impairs a class of claims, then at least one impaired class of claims must accept the plan without including acceptance by any insider. *See* 11 U.S.C. §1129(a)(10). The definition of "insider" in Code §101(31) is very broad. If a plan proponent and its plan satisfy all of the requirements of Code §1129(a) except for §1129(a)(8), the bankruptcy court may still confirm the plan if the plan satisfies §§1129(b)(1) and 1126(b)(2) with respect to an impaired class that has not accepted the plan.

A Chapter 11 plan of reorganization for a debtor whose principal asset is commercial real estate raises special issues, the most important of which are addressed in below.

B. Classification of Claims

In order for the bankruptcy court to confirm a plan of reorganization, section 1129(a)(1) of the Code requires that the plan comply "with the applicable provisions of this title." 11 U.S.C. §1129(a)(1). One of those "applicable provisions" is Code §1123(a)(1), which requires the plan "designate, subject to section 1122 of this title, classes of claims." 11 U.S.C. §1123(a)(1). Section 1122(a) of the Code provides, in pertinent part, that "a plan may place a claim or an interest in a particular class only if such claim or interest

is substantially similar to the other claims or interests of such class." 11 U.S.C. §1122(a). When a mortgagee is undersecured, unless the mortgagee exercises its right under §1111(b)(2) of the Code to forgo a deficiency claim and to have a lien for the full amount of its claim, Code §506(a) requires that the mortgagee's claim be bifurcated into a secured claim equal in amount to the value of the mortgagee's collateral and an unsecured claim for the deficiency. In the typical real estate Chapter 11 case, the mortgagee's deficiency claim represents substantially more than one-third of the total unsecured debt. Consequently if the mortgagee's deficiency claim is placed in the same class as other unsecured claims and the mortgagee votes to reject the debtor's plan, the class of unsecured claims will have voted to reject the plan. The debtor must then prove that the plan satisfies the "cramdown" provisions in §1129(b)(2)(B) of the Code with respect to the dissenting class of unsecured creditors, as discussed below.

Rejection of a debtor's plan by the class of unsecured creditors can doom the plan if no other impaired class of claims votes to accept the plan, because of section 1129(a)(10)'s requirement that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." 11 U.S.C. §1129(a)(10). The mortgagee's secured claim must be placed in a class by itself. *In re Keck Mahin & Cate,* 241 B.R. 583, 590 – 591 (Bankr. N.D.Ill. 1999). Most plans treat this class by paying the secured claim over time. This treatment impairs the class containing the secured claim by altering the secured creditor's rights. See 11 U.S.C. §1124(1). If, as is often the case, the class of unsecured claims is the only other impaired class, the mortgagee's votes of its secured and unsecured claims against the plan will result in no impaired class of claims accepting the plan, making the plan unconfirmable under section 1129(a)(10) of the Code.

In order to obtain acceptance of its plan from an impaired class of creditors and avoid the foregoing scenario, a debtor will often create separate classes for the undersecured creditor's deficiency claim and the claims of general unsecured creditors. This decision is based on the debtor's reasonable belief that trade creditors will vote to accept the debtor's plan. Although section 1122(a) of the Code requires that classes contain substantially similar claims, that section is silent on the question of whether substantially similar claims must be placed in the same class or can be placed separate classes. *See In re Bloomingdale Partners,* 170 B.R. 984, 990 (Bankr. N.D.Ill. 1994) (neither express language of Code §1122 nor its legislative history "aid . . . in determining the appropriate classification standard"). Courts are split on the propriety of placing general unsecured claims and an undersecured mortgagee's deficiency claim in separate classes.

A number of other courts have approved separate classification of an undersecured creditor's deficiency claim and general unsecured claims. *In re 203 North LaSalle Street Limited Partnership,* 190 B.R. 567 (Bankr. N.D.Ill. 1995) (classification of undersecured creditor's deficiency claim separate from class of unsecured trade creditors is permissible when debtor is fully encumbered single-asset partnership; because non-recourse undersecured creditor has no deficiency claim outside of Chapter 11 and would be entitled to no distribution in Chapter 7, different impact of best interests of creditors test in Code §1129(a)(7) on recourse trade debt and "artificial" non-recourse deficiency claim may require separate classification of trade and deficiency claims), *aff'd,* 195 B.R. 692 (N.D.Ill. 1996), *aff'd,* 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds,* 119 S.Ct. 1411 (1999); *In re U.S. Truck Co.,* 800 F.2d 581 (6th Cir. 1986) (court upheld plan that classified claim arising from rejection of collective bargaining agreement separate from claims of trade creditors and determined Teamsters Union had non-creditor interest, *i.e.,* bargaining with other employers, that gave Union different stake in viability of reorganized company and Union had other means of protecting its interests); *Beal Bank, S.S.B. v. Waters Edge Limited Partnership,* 248 B.R. 668, 691 (D.Mass. 2000); *In re Greate Bay Hotel & Casino, Inc.,* 251 B.R. 213 (Bankr. D.N.J. 2000) (court approved classification of undersecured creditor's deficiency claim separate from trade debt under plan that gave deficiency claimants package of debt and equity securities representing entire enterprise value of reorganized debtor while unsecured creditors received cash payout that was achievable and in line with expectations of all parties in interest); *In re Loop 76 LLC,* 442 B.R. 713 (Bankr. D.Ariz. 2010) (separate classification of lienholder's deficiency claim permitted when lienholder held guaranty from non- debtor).

In *In re Woodbrook Associates,* 19 F.3d 312 (7th Cir. 1994), the Seventh Circuit held that Code §1122(a) requires a plan to establish separate classes for general unsecured claims and the deficiency claim of an undersecured creditor holding a non-recourse claim, *i.e.,* a claim that can be satisfied only from the mortgaged property. The Seventh Circuit noted that §1111(b)(1)(A) of the Code treats non-recourse claims in Chapter 11 cases as if they were recourse claims. However, Code §1111(b)(1)(A) does not apply in Chapter 7 cases. See 11 U.S.C. §103(a). Therefore, an undersecured mortgagee with a non-recourse claim would receive no distribution in a Chapter 7 liquidation case of the debtor from the debtor's non-real estate assets. As a result, the Seventh Circuit found that the "best interests of creditors test" creates a significant difference between general unsecured claims and the

undersecured creditor's Chapter 11 deficiency claim. This difference not only justifies, but requires, separate classification of general unsecured claims and the non-recourse mortgagee's deficiency claim.

The "best interests of creditors" test is found in §1129(a)(7) of the Code. That section requires, as a condition of confirmation, that, with respect to each impaired class of claims or interests that has not unanimously accepted the plan, each holder of a claim or interest "will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7." 11 U.S.C. §1129(a)(7)(A)(ii). As noted above, the undersecured holder of a non-recourse mortgage would not have a deficiency claim if the debtor either filed its case under Chapter 7 or if the debtor's Chapter 11 case was converted to a Chapter 7 case. This means that in a Chapter 7 case, such a creditor will have no right to a distribution from proceeds of assets on which it does not have a mortgage. On the other hand, general unsecured creditors, whose claims are recourse claims, would have a right to a distribution from proceeds of assets that are not encumbered by the mortgagee's lien.

As a result of the foregoing differences between recourse and non-recourse claims in the context of the "best interests of creditors" test, the Seventh Circuit held in *Woodbrook, supra,* that those two types of claims are not "substantially similar" within the meaning of Code §1122, and must, therefore, be placed in separate classes in a Chapter 11 plan of reorganization.

Courts in other circuits have taken a different view and have denied separate classification of unsecured trade debt and an undersecured creditor's deficiency claim when the court perceived the purpose of separate classification to be "gerrymandering" classes to obtain an affirmative class vote on the reorganization plan from an impaired class of claims. *In re Barakat,* 99 F.3d 1520, 1524 – 1526 (9th Cir. 1996) (affirming bankruptcy court's refusal to allow debtor to separately classify undersecured creditor's deficiency claim when debtor offered no business or economic justification for such classification other than to obtain acceptance of reorganization plan); *In re Boston Post Road Limited Partnership,* 21 F.3d 477 (2d Cir. 1994); *In re Greystone III Joint Venture,* 995 F.2d 1274, 1279 (5th Cir. 1991), *cert. denied,* 113 S.Ct. 72 (1992); *In re Holley Garden Apartments, Ltd.,* 223 B.R. 822, 824 – 825 (Bankr. M.D.Fla. 1998); *In re Cranberry Hill Associates Limited Partnership,* 150 B.R. 289 (Bankr. D.Mass. 1993).

C. Impairment

Another commonly litigated issue in chapter 11 cases involving commercial real estate is whether a class of general unsecured creditors is "impaired" under the debtor's plan. As noted above, a real estate debtor's chapter 11 plan will almost always impair the secured claim of an undersecured mortgagee, and the holder of that claim will often vote to reject the debtor's plan. A class of general unsecured claims that is unimpaired is deemed to have accepted the plan. *See* 11 U.S.C. § 1126(f). However, "deemed acceptance" will not satisfy Code §1129(a)(10)'s requirement that at least one impaired class of claims accept the plan.

Section 1124(1) of the Code provides that a class of claims is impaired under a plan unless, with respect to each claim in that class, the plan (1) leaves unaltered the legal, equitable, and contractual rights of the claim holder or (2) with respect to each such claim, the plan (a) cures any prepetition default, (b) reinstates the maturity of the claim as such maturity existed before the default, (c) compensates the holder of the claim for any damages incurred as a result of any reasonable reliance by the claimant on such contractual provision or applicable law, and (d) does not otherwise alter the legal, equitable, or contractual rights of the claimant. Any alteration of a creditor's legal, equitable, or contractual rights constitutes impairment. Consequently, a creditor's claim will be impaired even if the treatment of the claim under the plan is more favorable than the rights granted by the creditor's contract. *In re Union Meeting Partners,* 160 B.R. 757, 771 (Bankr. E.D.Pa. 1993).

In order to satisfy section 1129(a)(10), a debtor's plan will often impair the class of general unsecured claims by slightly modifying the contractual rights of the holders of such claims. For example, if the unsecured creditors' contracts with the debtor required payment of creditors' claims 30 days after invoice date, the debtor's plan might impair that class of claims by providing for payment of those claims earlier or later than 30 days. Some courts have viewed such impairment as driven by the debtor's need to satisfy section 1129(a)(10) rather than by the economic needs of the reorganized debtor. *In re Combustion Engineering, Inc.,* 391 F.3d 190, 243 (3d Cir. 2004). These courts note that §1129(a)(10) was added to the Code to ensure that a plan has "some indicia of support by affected creditors and to prevent confirmation where such support is lacking." *In re Lettick Typografic, Inc.,* 103 B.R. 32, 38 (Bankr. D. Conn. 1989). Many of these courts have found de minimis impairment to be "artificial." A class is considered to be artificially impaired when the debtor intentionally alters the class members' rights in order to manipulate voting on the plan, but the class is legitimately impaired if creditors' rights are altered for proper business purposes. *Beal Bank, S.S.B. v. Waters Edge Limited Partnership,* 248 B.R. 668, 690 – 691 (D. Mass. 2000).

Acceptance of a plan by an artificially impaired class of creditors does not satisfy the requirement of section 1129(a)(10) that at least one impaired class of

claimants accept a plan. *See In re Windsor on the River Associates, Ltd.,* 7 F.3d 127, 132 (8th Cir. 1993). In *Windsor,* the debtor created a class for $13,000 of unsecured claims owed to 34 creditors. This debt was miniscule in relationship to the mortgagee's claim of $9.8 million. The debtor's plan proposed to pay the holders of unsecured claims in full 60 days after the effective date of the plan, although it seems clear that the debtor could have treated that class in a manner that would have left its members unimpaired. The debtor argued that this treatment constituted impairment because it altered the legal, equitable, and contractual rights of the claimants to be paid within a shorter period of time. The Eighth Circuit found that the debtor's impairment of the class of unsecured creditors was "manufactured at the will of the debtor 'just to stave off the evil day of liquidation.' " 7 F.3d at 130. The Eighth Circuit went on to conclude that allowing manipulation of claims in a chapter 11 case would be contrary to the purposes of the Code. In effect, allowing artificial impairment would undermine the requirement of section 1129(a)(10) that at least one class of impaired creditors accept the plan. *Combustion Engineering, supra.* The *Windsor* court observed that "[c]onfirmation of a plan where the debtor engineers the impairment of the only approving impaired class 'so distorts the meaning and purpose of [section 1129(a)(10)] that to permit it would reduce (a)(10) to a nullity.' " 7 F.3d at 131, quoting *Lettick Typografic, supra,* 103 B.R. at 38.

Other courts have rejected the concept of artificial impairment. These courts examine the degree of impairment and the debtor's motivation for treating unsecured creditors in a particular fashion under the good-faith requirement contained in section 1129(a)(3). *In re 203 North LaSalle Street Limited Partnership,* 190 B.R. 567 (Bankr. N.D. Ill. 1995), *aff'd,* 195 B.R. 692 (N.D. Ill. 1996), *aff'd,* 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds,* 119 S.Ct. 1411 (1999); *In re 7th Street & Beardsley Partnership,* 181 B.R. 426, 431 (Bankr. D. Ariz. 1994).

Some plans impair unsecured creditors by paying their claims in full without interest when the claimants are entitled to interest under state law. Prior to 1994, such treatment would not have constituted impairment. However, Congress amended the Bankruptcy Code in 1994 to delete subsection (3) of section 1124, which had treated as unimpaired a class of creditors that was paid in full, but without post-petition interest. Subsequent to that amendment, most courts have concluded that a class of creditors which receives payment in full on the effective date of the plan without interest is impaired within the meaning of section 1124 of the Code. *In re Atlanta-Stewart Partners,* 193 B.R. 79 (Bankr. N.D.Ga. 1996). *See also In re Crosscreek Apartments, Ltd.,* 213 B.R. 521 (Bankr. E.D.Tenn. 1997). Based on the 1994 amendment to the Code which deleted section 1124(3), a number of courts have concluded that a claim need not and cannot be artificially impaired. *In re Greate Bay Hotel & Casino, Inc.,* 251 B.R. 213, 238 – 240 (Bankr. D.N.J. 2000). *See generally In re South Canaan Cellular Investments, Inc.,* 427 B.R. 44, 78 – 81 (Bankr. E.D.Pa. 2010).

D. Designation of Votes Under Code §1126(e)

Section 1126(e) permits the bankruptcy court to "designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith." 11 U.S.C. §1126(e). A claim that has been "designated" in not counted in determining if a class of creditors has voted to accept or reject a plan of reorganization. 11 U.S.C. § 1126(c); *In re Figter Limited,* 118 F.3d 635, 638 (9th Cir. 1997). The bankruptcy court's exercise of its power to designate can have serious consequences for a creditor that has purchased claims for the purpose of acquiring the debtor assets or for purposes of preventing confirmation of the debtor's plan.

The Code does not define "good faith." In this context, however, the court in *In re Applegate Property, Ltd,* 133 B.R. 827, 833-34 (Bankr. W.D. Tex. 1991), summarizing caselaw defining "good faith" in the context of section 1126(e) of the Code and its predecessors, observed that there is a lack of good faith in the voting process when one casts his vote (1) using "obstructive tactics and hold-up techniques"; (2) "with a purpose of coercing payment to him of more than he might reasonably perceive as his fair share of the debtor's estate"; or (3) for an ulterior motive, such as "pure malice, 'strikes' and blackmail [or] to destroy an enterprise in order to advance the interests of a competing business." The *Applegate* court designated votes cast by the debtor's sister company that purchased claims for the purpose of voting to defeat a competing plan. The court found that "[t]he purchasing of claims by an affiliate or insider of the Debtor for the sole or principal purpose of blocking a competitor from purchasing such claims is an obstructionist tactic done in contemplation of gaining an unfair advantage over other creditors." 133 B.R. at 835. *See also In re DBSD North America, Inc.,* 634 F.3d 79 (2d Cir. 2011) (court designated vote to reject debtor's plan cast by holder of debtor's senior lien debt that had ulterior motive and acted as "strategic investor" rather than as "traditional creditor"); *In re Allegheny International, Inc.,* 118 B.R. 282, 289-90 (Bankr. W.D. Pa. 1990) (court designated votes of party that purchased claims for purposes of defeating debtor's plan and confirming purchaser's competing plan).

Creditors, however, are not required to vote their claims with selfless disinterest. Thus, a creditor that purchased claims for the purpose of "securing the approval or rejection of a plan does not of itself amount to 'bad faith.' " *In re 255 Park Plaza Associates Limited Partnership,* 100 F.3d 1214, 1219 (6th Cir. 1996),

quoting *Allegheny, supra,* 118 B.R. at 289; *In re Marin Town Center,* 142 B.R. 374 (N.D.Cal. 1992) (vote cast for purpose of blocking confirmation of plan not cast in bad faith when creditor believed that debtor's liquidation would be more economically beneficial than confirmation of debtor's plan).

E. Cramdown — Confirmation Notwithstanding Rejection by Impaired Class

Section 1129(a)(8) of the Code requires that each class of claims or interests in a plan has either accepted the plan or is not impaired under the plan. However, the Code permits a plan to be confirmed notwithstanding rejection of the plan by an impaired class of claims or interests if the plan meets the requirements of section 1129(b)(1) of the Code, which requires a plan (a) to be fair and equitable and (b) not discriminate unfairly with respect to an impaired class that has not accepted the plan.

1. <u>Fair and Equitable</u>

Congress used the word "includes" in section 1129(b)(2)'s definition of "fair and equitable." The word "includes" is not limiting. 11 U.S.C. §102(3). As a result, courts have given the phrase "fair and equitable" a broad construction. *See In re Dow Corning Corp.,* 244 B.R. 678, 694 (Bankr. E.D. Mich. 1999). In determining whether a plan is fair and equitable, the court must consider the entire plan in the context of creditors' rights under state law and the particular facts and circumstances of the case. *See In re D & F Construction, Inc.,* 865 F.2d 673, 675 (5th Cir. 1989). A debtor seeking confirmation of a plan under section 1129(b) of the Code has the burden of demonstrating that the plan is fair and equitable. *In re Sagewood Manor Associates Limited Partnership,* 223 B.R. 756, 767 (Bankr. D. Nev. 1998). Most courts have held that the debtor must show a plan is fair and equitable by a preponderance of the evidence. *Dow Corning,* 244 B.R. at 694. Others, however, have held that the debtor must make the fair and equitable showing by clear and convincing evidence. *See In re New Midland Plaza Associates,* 247 B.R. 877, 883 (Bankr. S.D. Fla. 2000).

2. <u>Unfair Discrimination</u>

Most Chapter 11 reorganization plans involving commercial real estate create separate classes for general unsecured claims and an undersecured creditor's unsecured deficiency claim. Such plans also provide different treatment for the two classes, by paying general unsecured claims in full on or shortly after confirmation, and by paying the undersecured creditor either a small percentage of its claim quickly or a larger percentage when the reorganized debtor sells or refinances its property. This raises an issue of whether the plan violates Code §1129(b)(1)'s prohibition against unfair disparate treatment.

The prohibition on unfair discrimination is intended to "ensure[] that a dissenting class will receive relative value equal to the value given to all other similarly situated classes." *In re Johns- Manville Corp.,* 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986). The Code does not define unfair discrimination. However, given the language of section 1129(b)(1), some degree of discrimination between classes of unsecured creditors must be permissible. *See In re Young Broadcasting Inc.,* 430 B.R. 99, 139-40 (Bankr. S.D.N.Y. 2010) (plan unfairly discriminates when it treats similarly situated classes differently without reasonable basis for disparate treatment); *In re Aztec Co.,* 107 B.R. 585, 588-89 (Bankr. M.D. Tenn. 1989) (rejecting decisions holding that "all unsecured claimholders must be paid the same percentage of claims" because "Section 1129(b)(1) prohibits only unfair discrimination, not all discrimination"). The test for determining whether disparate treatment of unsecured creditor classes constitutes unfair discrimination was described well by the bankruptcy court in *In re 203 North LaSalle Street Limited Partnership,* 190 B.R. 567, 585 (Bankr. N.D.Ill. 1995), *aff'd,* 195 B.R. 692 (N.D.Ill. 1996), *aff'd,* 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds,* 119 S.Ct. 1411 (1999). According to that court, in a chapter 11 case, courts must engage in a two-step process for measuring the fairness of discrimination. First, the court must determine whether the discrimination is supported by a legally acceptable rationale. The court must then determine whether the extent of discrimination is necessary in light of that rationale. 190 B.R. at 585-86. Thus, a plan that paid trade creditors in full without interest and provided for payment of the unsecured creditor's deficiency claim from proceeds of a sale or refinancing of the property before the debtor's insiders received any payment under the plan did not discriminate unfairly against the holder of the deficiency claim. 190 B.R. at 586. The discrimination in that case was based on a compelling rationale, *i.e.,* the best interests of creditors test, which would have allowed unsecured creditors to be paid in a chapter 7 but would have eliminated the non-recourse undersecured creditor's deficiency claim in a chapter 7 case, thereby leaving the holder of the deficiency claim without a right of payment. *See id.*

In contrast to *203 North LaSalle Street,* the plan in *Aztec,* was found to have discriminated unfairly against the holder of the deficiency claim when the plan proposed to pay three percent of that claim while other unsecured creditors were to be paid in full. *See also In re Salem Suede, Inc.,* 219 B.R. 922, 934 (Bankr. D. Mass. 1998) (unfair discrimination for plan proponent to pay claims of equal, non-bankruptcy priority different distribution by providing one class of creditors with more favorable distribution than class of same legal rank without legitimate and rational basis for disparate treatment).

3. Cramdown on a Class of Secured Claims

A debtor seeking to confirm a reorganization plan over the objection of a class of secured claims will often utilize section 1129(b)(2)(A)(i) of the Code. Such a plan will provide that the secured creditor retains its liens on the property and receive a secured note in the principal amount of its secured claim (*i.e.,* the value of the secured creditor's collateral) with interest at the prevailing market rate for a specified number of years. As a result, the underscecured creditor will receive a stream of payments totaling the allowed amount of its secured claim, and having a present value equal to the value of its collateral. *In re Airadigm Communications, Inc.,* 547 F.3d 763, 768-69 (7th Cir. 2008). Unless the undersecured creditor elects under section 1129(b)(2) of the Code to retain a lien for the full amount of its claim, the undersecured creditor will also have an unsecured claim equal in amount to the difference between the face amount of its claim and the value of its collateral. In order to determine the propriety of such treatment, the court must determine whether the debtor has used an appropriate rate of interest. Over the years, courts have developed a number of different approaches to the selection of a proper interest rate.

In an attempt to resolve the different approaches adopted by various courts, the Supreme Court addressed the issue of the appropriate cramdown interest rate in *Till v. SCS Credit Corp.,* 541 U.S. 465, 158 L.Ed.2d 787, 124 S.Ct. 1951 (2004). *Till* was a Chapter 13 case in which the debtor had borrowed $6,400 representing 100 percent of the purchase price of a used truck. The interest rate on the loan was 21 percent payable over two and a half years. The debtor filed a chapter 13 case approximately one year after purchasing the truck, at which time the loan had been paid down to $4,900. The debtor's plan proposed to retain the truck and make deferred payments over two years based on the agreed-upon replacement value of $4,000. The debtor proposed to pay an interest rate of 9.5 percent. This rate was 1.5 percent above the 8 percent prime rate in effect at the time. The secured creditor argued that the appropriate interest rate under the plan was the 21 percent contract rate of interest. The bankruptcy court adopted the debtor's formula approach to selecting a cramdown interest rate and confirmed the debtor's plan. The Seventh Circuit reversed, holding that the proper rate was the 21 percent rate specified in the note. A four justice plurality of the Supreme Court adopted the bankruptcy court's formula approach and rejected the Seventh Circuit's contract rate approach. Justice Thomas joined the plurality in a concurring opinion that also rejected the Seventh Circuit's contract rate approach. However, Justice Thomas read §1325(a)(5)(B)(ii) of the Code (which is virtually identical to Code §1129(b)(2)(A)(i)), to require an adjustment only for the time value of money and not for a risk premium. In the context of a Chapter 11 case, the Court surmised that an efficient market might provide the appropriate interest rate. 124 S.Ct. at 1960 n.14.

When applying *Till* in chapter 11 cases, bankruptcy courts have attempted to determine whether an efficient market exists for cramdown loans. In the absence of such a market, some courts have adopted the *Till* formula approach. *In re American HomePatient, Inc.,* 420 F.3d 559 (6th Cir. 2005); *Mercury Capital Corp. v. Milford Connecticut Associates, L.P.,* 354 B.R. 1, 13 (D.Conn. 2006). *See In re 20 Bayard Views, LLC,* No. 09-50723-ess, 2011 WL 797442 (Bankr. E.D.N.Y. Mar. 7, 2011) (collecting cases). In order to determine the appropriate adjustment to the national prime rate, courts consider "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Till, supra,* 124 S.Ct. at 1961. According to the court in *20 Bayard, supra:* Additional "risk factors to consider include the debt service coverage ratio, the loan- to-value ratio, and the quality of any guarantors." *See also In re Griswold Bldg. LLC,* 420 B.R. 666, 693 (Bankr. E.D. Mich. 2009). *See In re Gramercy Twins Assocs.,* 187 B.R. 112, 124 (Bankr. S.D.N.Y. 1995) (noting that "the relatively high loan to value ratio in this case, which is approximately 85%, increases the risk factor"); *Deep River Warehouse,* 2005 WL 2319201, at *11 (observing that "[r]isk is increased significantly when the loan to value ration is 100%, but a high grade tenant positively affects that risk"). 2011 WL 797442 at *24.

In *Till,* the court observed that risk adjustments of one to three percent are common. 124 S.Ct. at 1962. Some courts, however, have used adjustments as high as five percent and five and three-quarters percent. *See In re Griswold Building, LLC,* 420 B.R. 666, 696 (Bankr. E.D. Mich. 2009) (five percent); *In re Northwest Timberline Enterprises, Inc.,* 348 B.R. 412, 434 (Bankr. N.D. Tex. 2006) (five and three quarters).

Some chapter 11 reorganization plans provide for so-called negative amortization of a secured claim. Negative amortization occurs when part or all of the interest on a secured claim is not paid currently, but rather is deferred and allowed to accrue, with accrued interest added to principal. *Great Western Bank v. Sierra Woods Group,* 953 F.2d 1174 (9th Cir. 1992). Most courts have held that such plans are not per se invalid. *See In re McCombs Properties VIII, Ltd.,* 91 B.R. 907 (Bankr. C.D. Cal. 1988); *In re Club Associates,* 107 B.R. 385 (Bankr. N.D. Ga. 1989), *aff'd,* 956 F.2d 1056 (11th Cir. 1992). Instead, the court must consider a variety of factors in determining whether the negative amortization plan is fair and equitable. *In re Apple Tree Partners, L.P.,* 131 B.R. 380 (Bankr. W.D.Tenn. 1991). In *Club Associates,* the court approved a negative amortization plan as fair and equitable when (a) the original mortgage note contained a negative amortization provision, thereby justifying the

conclusion that negative amortization was a risk originally bargained for by the mortgagee, (b) the plan extended the maturity and mortgagee's risk for five years, but for a reduced principal amount as a result of the allocation of post-petition payments, and (c) the plan provided for a slightly higher rate of interest than that provided in the original note.

Under section 1129(b)(2)(A)(ii) of the Code, a plan may be confirmed over the dissent of a class of secured creditors if the plan provides for sale of the secured creditors' collateral free and clear of the creditors' liens, provided that (a) the secured creditors can credit bid at the sale and (b) the secured creditors' liens attach to the sale proceeds. Recently, two courts of appeal have approved plans that cram down on secured creditors under section 1129(b)(2)(A)(iii) of the Code by providing for the sale of the secured creditors' collateral free of the creditors' liens, but without permitting the secured creditors to credit bid at the sale. The courts reached these decisions by a literal reading of the alternatives set forth in §§1129(b)(2)(A)(i) – 1129(b)(2)(A)(iii) of the Code, and by finding that the plans in question provided the secured creditors with "the indubitable equivalent" of their secured claims. *See In re Philadelphia Newspapers, LLC,* 599 F.3d 298 (3d Cir. 2010); *In re Pacific Lumber Co.,* 584 F.3d 229 (5th Cir. 2009).

4. Fair and Equitable Treatment of Dissenting Class of Unsecured Creditors— The New Value to the Absolute-Priority Rule

Another hotly litigated issue in commercial real estate bankruptcies is whether a plan that allows prepetition equity holders to retain their interest in the reorganized debtor over the dissent of a class of unsecured creditors in exchange for a contribution of new value violates section 1129(b)(2)(B)(ii). The issue arises when a class of unsecured creditors, such as the class containing an undersecured creditor's deficiency claim, votes to reject a plan of reorganization under which old equity holders retain their interests in exchange for a contribution of new capital. This scenario triggers application of section 1129(b)(2)(B)(ii), which incorporates the absolute-priority rule into the Code. Under the absolute-priority rule, a class of equity holders, which is junior to a class of unsecured creditors, may not receive or retain any property if the unsecured creditor class is impaired and rejects the plan. 11 U.S.C. § 1129(b)(2)(B)(ii). That section provides, in pertinent part, as follows:

In the scenario outlined above, old equity wishes to preserve its interest, primarily to avoid adverse tax consequences that flow from the elimination of those equity interests if the plan is not confirmed and the automatic stay is lifted to allow the mortgagee to foreclose. In order to avoid this result, old equity will offer to contribute new capital that can be used to pay down secured or unsecured debt, or to provide necessary working capital. The undersecured creditor who wishes to defeat the plan and foreclose will argue that the old equity's retention of its interest when the undersecured deficiency claim is not being paid in full and has rejected the plan, constitutes receipt or retention under the plan, on account of a junior equity interest, of property, namely, the old equity position, in violation of Code §1129(b)(2)(B)(ii).

A series of pre-Code United States Supreme Court cases suggested, in dicta, that prepetition equity holders could retain an interest in the reorganized company in exchange for a contribution of new capital in the form of money or money's worth that was new, necessary, and reasonably equivalent to the interest being retained. *Northern Pacific Ry. v. Boyd,* 228 U.S. 482, 57 L.Ed. 931, 33 S.Ct. 554 (1913); *Kansas City Terminal Ry. v. Central Union Trust Company of New York,* 271 U.S. 445 (1925); *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 84 L.Ed. 110, 60 S.Ct. 1, 10 (1939). Subsequent to enactment of the Bankruptcy Code in 1978, the Supreme Court addressed the existence of the so-called new value corollary to the absolute-priority rule in *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197 (1988). In that case, a farmer offered to contribute his future services as new value. Without deciding whether the new value corollary to the absolute-priority rule survived enactment of the Code, the Court held that "sweat equity" did not satisfy the new value corollary, even if the corollary existed. Circuit courts of appeal subsequently split on the existence of a new value corollary. The Ninth Circuit has ruled that the new value corollary did survive enactment of the Code while the Second, Fourth, and Fifth Circuits have ruled otherwise. *In re Bonner Mall Partnership,* 2 F.3d 899, 908 (9th Cir. 1993); *In re Coltex Loop Central Three Partners, L.P.,* 138 F.3d 39 (2d Cir. 1998), *In re Bryson Properties, XVIII,* 961 F.2d 496 (4th Cir. 1992), and *In re Greystone III Joint Venture,* 995 F.2d 1274 (5th Cir. 1992).

The new value corollary reached the Supreme Court again in *Bank of America \& Savings Ass'n v. 203 North LaSalle Street Partnership,* 526 U.S. 434, 143 L.Ed.2d 607, 119 S.Ct. 1411 (1999). In that case, the bankruptcy court had confirmed a reorganization plan for a limited partnership owning an office building in downtown Chicago. The debtor's limited partners faced a $20 million tax liability if they lost their equity in the property as a result of a foreclosure following maturity of the mortgage on the building. Due to a cyclical decline in commercial real estate values, the debtor was unable to refinance the $93 million mortgage. In order to prevent foreclosure and gain breathing room to restructure the undersecured mortgagee's secured and unsecured claims, the debtor filed a chapter 11 petition. The debtor's plan of reorganization bifurcated the mortgagee's $93 million claim into a $54 million

secured claim and a $39 million unsecured deficiency claim. The plan classified the deficiency claim separately from claims of general unsecured creditors. Old equity holders offered to contribute $6 million of new capital and to defer any return on, or of, their new equity contribution pending payment in full of the secured and unsecured portions of the mortgagee's claim. Relying on the new value corollary, the bankruptcy court confirmed the plan notwithstanding rejection of the plan by the class containing the undersecured creditor's deficiency claim, and its decision was affirmed on appeal to the district court and the Seventh Circuit Court of Appeals.

The Supreme Court reversed. While implicitly recognizing the continued existence of a new value corollary to the absolute-priority rule, the Supreme Court found that the debtor's plan failed to satisfy that corollary. The Court determined that old equity holders' exclusive right to contribute new value to the reorganized enterprise constituted property that those equity holders had received or retained on account of the holders' prepetition equity interest. In order to satisfy the new value corollary, the Court held that the price paid by old equity holders for equity in the reorganized entity must be subjected to a market test, rather than to a determination of adequacy by the bankruptcy court, in order to determine that old equity holders were paying "top dollar" for their interest in the reorganized company. If old equity was paying "top dollar" for the new equity, then the old equity holders would be receiving their equity interest in the reorganized company not on account of their prepetition equity position, but rather on account of their having paid top dollar for the equity in the reorganized enterprise. While the Court did not specify a mechanism for determining whether old equity holders were paying "top dollar" for their interest in the reorganized company, the Court suggested that either an auction of the equity of the reorganized company or termination of the debtor's exclusive right to file a plan (thereby permitting competing plans) would allow a new value plan to satisfy the absolute-priority rule.

Subsequent to the Supreme Court's decision in *203 North LaSalle Street,* lower courts have had several opportunities to interpret that decision. In *In re PWS Holding Corp.,* 228 F.3d 224 (3d Cir. 2000), the debtor's plan released certain fraudulent transfer claims against equity holders and others arising from a prepetition leveraged recapitalization. The Third Circuit held that the release of claims did not constitute receipt by old equity holders of property on account of their old equity position when (a) there was no direct evidence that junior equity holders persuaded the debtors to release them "on account of" their equity interest in the debtors, (b) the fraudulent transfer claims would be costly to pursue as a result of the high cost of defending and paying indemnification cross-claims and counterclaims arising from pursuit of those fraudulent transfer claims, and (c) an examiner had found that the fraudulent transfer claims had little or no value. The Third Circuit held that the examiner's findings were an "appropriate surrogate for a market test and an acceptable safeguard" notwithstanding a dissenting creditor's offer to purchase fraudulent transfer claims for $100,000 plus a percentage of any recovery. 228 F.3d at 242.

In *In re Zenith Electronics Corp.,* 241 B.R. 92, 106 – 107 (Bankr. D. Del. 1999), *appeal dismissed,* 250 B.R. 207 (D. Del. 2000), the debtor filed a prepackaged plan that eliminated prepetition equity. The plan gave a large creditor, which was also the debtor's majority shareholder, an exclusive right to purchase 100 percent of the reorganized debtor's equity in exchange for $60 million in cash and waiver of $200 million in debt. The court held that the plan did not violate the absolute-priority rule because the former equity holder was receiving its right to purchase new equity on account of its creditor status and not on account of its equity interest.

In *In re Global Ocean Carriers Ltd.,* 251 B.R. 31 (Bankr. D. Del. 2000), the bankruptcy court held that a plan violated the absolute-priority rule when it permitted an existing controlling shareholder to determine without benefit of a public auction or a competing plan who would own the reorganized debtor's equity and what the purchase price for that equity would be. The court found that the plan gave the controlling shareholder the exclusive right to determine the identity of the new equity owner and the price of new equity "on account of" its position as a controlling shareholder. *See In re Armstrong World Industries, Inc.,* 432 F.3d 507 (3d Cir. 2005) (plan that provided for class of unsecured asbestos-related creditors to share its distribution with junior class of interests over objection of class of unsecured trade creditors violated absolute-priority rule). A Massachusetts court reached a different result on similar facts in *Beal Bank, S.S.B. v. Waters Edge Limited Partnership,* 248 B.R. 668 (D. Mass. 2000), where the district court affirmed a bankruptcy court order confirming a plan of reorganization that sold the equity of the reorganized debtor to a third-party plan sponsor who was an insider by virtue of a familial relationship. The plan did not violate the absolute-priority rule when there was no evidence that old equity was using the insider as a straw man to retain its investment and no evidence that the plan sponsor was funded by or acted on behalf of old equity. *See also In re Greenwood Point, L.P.,* No. 10-00569-AJM-11, 2011 WL 721549 (Bankr. S.D. Ind. Feb. 4, 2011) (sale of new equity to old equity holder's wife did not violate absolute-priority rule); *Penn Mutual Life Insurance Co. v. Woodscape Limited Partnership (In re Woodscape Limited Partnership),* 134 B.R. 165, 174 (Bankr. D. Md. 1991) (no prohibition against private sale of equity

to insider under plan); *Troy Savings Bank v. Travelers Motor Inn, Inc.,* 215 B.R. 485, 494 – 495 (N.D.N.Y. 1997) (affirming confirmation of equity sale to debtor's friend). *Cf. In re DBSD North America, Inc.,* 634 F.3d 79 (2d Cir. 2011) ("gift" of warrants from secured creditors to existing shareholder over dissent of class of unsecured creditor violated absolute-priority rule); *In re Iridium Operating LLC,* 478 F.3d 452 (2d Cir. 2007) (settlement under which unsecured creditors might receive distribution from secured creditor's collateral ahead of administrative claimant might violate absolute-priority rule).

If a debtor's plan provides for an auction of the reorganized debtor's equity, the secured creditor will not be able to credit bid its secured debt at the sale if the secured creditor's lien attaches only to property of the debtor and not to the equity interests in the debtor. *Beal Bank, supra; In re Homestead Partners, Ltd.,* 197 B.R. 706, 719 n.15 (Bankr. W.D. Ga. 1996); *In re Bjolmes Realty Trust,* 134 B.R. 1000, 1010 n.22 (Bankr. D. Mass. 1991). Nevertheless, if the undersecured creditor has a substantial deficiency claim and other unsecured claims are relatively small, which is typically the case in real estate Chapter 11 cases, the secured creditor can achieve the functional equivalent of credit bidding for the reorganized debtor's equity by bidding cash, as long as that cash payment is returned to the undersecured secured creditor under the plan by a payment on its unsecured deficiency claim. *See Homestead Partners, supra,* 197 B.R. at 719 n.15; *In re Moonraker Associates, Ltd.,* 200 B.R. 950 (Bankr. N.D. Ga. 1996). So called "roundhouse" bidding by a secured creditor can sometimes be defeated if insiders hold substantial recourse claims. Such claims must be paid in full before a recourse deficiency claim created by Code §1111(b)(2) in favor of the holder of a non-recourse mortgage can receive any distribution. *In re 203 North LaSalle Street Partnership,* 126 F.3d 955, 969 (7th Cir. 1997), *rev'd on other grounds,* 119 S.Ct. 1411 (1999).

An auction sale of a reorganized debtor's equity to a third party for cash rather than in exchange for debt will fall outside the scope of Code §1145(a)(1), which exempts from registration under the Federal Securities Act of 1933 and state securities laws, securities offered or given in exchange for a claim against or an interest in the debtor, an affiliate participating in a joint plan, or a successor to the debtor under the plan. *See Homestead Partners,* 197 B.R. at 717 – 718.