

## Seventh Circuit Vindicates Secured Lenders' Right to Full Payment

By Michael L. Cook

The U.S. Court of Appeals for the Seventh Circuit held on May 5, 2009, that two secured lenders were fully secured, "entitled to a full recovery" from the debtor ("UAL") despite the bankruptcy court's improper valuation of the collateral (improved airport terminal space) securing the lenders' underlying \$60 million loan. *In re United Air Lines, Inc.*, \_\_\_ F.3d \_\_\_, 2009 U.S. App. LEXIS 9648 (7th Cir. 5/5/09) (Easterbrook, Ch. J.). The lower courts had valued the lenders' collateral at \$35 million, leaving them with a \$25 million unsecured claim. According to the Seventh Circuit, the bankruptcy and district courts had not only ignored critical evidence showing comparable terminal space with a higher value, but the bankruptcy court had also used an improper discount rate when valuing the space rentals over the term of the loan. In the court's words, "[r]eal prices are much more informative than lawyers' talk." *Id.* at 13.

### RELEVANCE OF RULING

*UAL* deals with the so-called "absolute priority" rule's requirement that secured creditors be paid in full before junior creditors receive anything under a Chapter 11 reorganization plan. In a recent article, law professor Todd J. Zywicki complained bitterly that a proposed sale procedure in the Chrysler reorganization threatened the rule. See "Chrysler and the Rule of Law," *The Wall Street Journal*, May 13, 2009. In his article, the professor made three major points:

- Although the absolute priority rule requires secured creditors to receive first payment priority, in Chrysler they have "been browbeaten by an American president into accepting only 30 cents on the dollar of their claims." Junior creditors, on the other

hand, "will get about fifty cents on the dollar."

- A "linchpin of bankruptcy law," the absolute priority rule provides a "procedural mechanism for the efficient resolution of financial distress" because it preserves "the substantive property and contract rights of creditors."
- Disregarding the absolute priority rule upsets the process by reconfiguring the redistribution of the bankruptcy estate, subjugating the rights of secured creditors to those of junior creditors.

Putting aside the hyperbole, how secured creditors fare in reorganization cases has regularly been the subject of intense litigation.

### THE ABSOLUTE PRIORITY RULE

The Bankruptcy Code ("Code") makes the absolute priority rule applicable only to dissenting classes. Code § 1129(b)(2)(A), dealing with secured claims, is based on the principle that a senior secured creditor "must get the full amount of [its] claims as of the effective date of the plan — a present value concept — or junior classes must get nothing. Junior classes can receive something on account of their former rights against the [debtors] only if one of two conditions are met: 1) the senior classes, by class-wide vote, consent to their participation; or 2) the senior classes receive payment in full." D.G. Baird, *Elements of Bankruptcy*, at 216 (3d rev. ed. 2001). Moreover, "junior classes ... have the right to invoke [valuation] procedures in every case." *Id.* The threat of a valuation fight, however, usually convinces not only the senior creditors, but also other parties, all of whom wish to avoid a costly valuation fight.

### FULL PAYMENT

What does it mean for a secured lender to be paid in full? In *UAL*, the secured lenders had to be paid "the full value of the assets that served as security," with any remaining deficiency claim to be treated

as "unsecured debt" under the confirmed reorganization plan. 2009 U.S. App. LEXIS 9648, at \*1-2. The issue, of course, turned on "the full value of the assets," for that determines the amount of the secured claims. 11 U.S.C. § 506(a)(claim "secured to the extent of the value of" the lender's collateral). See, e.g., *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997)(replacement cost of encumbered property to debtor). The treatment of the lenders in *UAL* thus had to be "completely compensatory." *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935)(Hand, J.) (citing "constitutional limitations," senior mortgagee cannot be forced in a plan to accept a substitute of anything less than "the most indubitable equivalence"). Only then may the reorganized debtor retain the collateral after plan confirmation.

### OTHER PARTIES CHALLENGE SECURED CREDITORS' RECOVERY

*UAL* is yet another recent appellate ruling showing how junior creditors and reorganization debtors have fought a secured lender's supposedly full recovery. Appellate courts in the past two years alone have had to repair damage sought to be inflicted by junior creditors on senior secured creditors. For example:

- Insiders with secured claims had their claims wrongly subordinated by lower courts on equitable grounds. *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5th Cir. 2008) (no harm shown);
- The insider secured lenders in the same case had their cash collateral wrongly dissipated by the lower courts' orders. *Wooley*, 542 F.3d 131, 142 (5th Cir. 2008) (vacated lower court orders to ensure that "secured claims ... fully recognized");
- A secured lender was wrongly denied a claim for a default rate of interest. *General Electric Capital Corp. v. Future Media Productions, Inc.*, 536 F.3d 969, 974 (9th Cir. 2008); and

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- A secured lender was wrongly denied its post-bankruptcy contractual interest on equitable grounds in order to benefit the debtor's shareholders. *Urban Communicators PCS Limited Partnership v. Gabriel Capital, L.P.*, 394 B.R. 325 (S.D.N.Y. 2008) (modified bankruptcy court's order).

To realize a full recovery or to avoid subordination of their claims, therefore, lenders have often had to prosecute the appeals, as these cases show.

### **UAL Facts**

The debtor, UAL, had borrowed \$60 million for improvements to its space (345,167 square feet) at Los Angeles International Airport ("LAX"). UAL had "lease[d] rather than own[ed] space at airports." *Id.* at \*2. Because "there is no liquid market for ... improved space at airports," valuation of the lenders' collateral, reasoned the court, was not "straightforward." *Id.*

### **The Lower Courts' Faulty Valuation**

The bankruptcy court valued the debtor's improved space subject to the lenders' lien at "an annual value of \$17 per square foot ... as of 2004." *Id.* It then "added up the imputed rentals [with projected increases] through 2021 (when the loan comes due), and discounted the result at 10% per annum." *Id.* at \*2-\*3. Reaching "a present value of roughly \$35 million for the lenders' security," the bankruptcy court "treated [\$25 million] as unsecured debt and [wrote it] down according to the [previously confirmed] plan of reorganization," and the "district judge affirmed." *Id.* at \*3.

### **Finding the Correct Annual Rental Rate**

The bankruptcy court mistakenly found "that \$17 per square foot per year is the market for terminal space" at LAX "because that is what ... the airport charges to willing buyers (the airlines)." *Id.* at \*4. The \$17 per square foot rental "is a price for unimproved terminal space," however, and was inappropriate. *Id.* at \*5. "A price for unimproved space does not measure the value of the collateral," reasoned the Seventh Circuit, for the lenders' "security is in the improved space." *Id.* at \*6 (emphasis in original text). Indeed, if the lenders "foreclosed and took over the space," they "could rent the gates to" another airline "at more than \$17 a square foot — at perhaps four times that much, to go by prices at the airport's one terminal that leases fully built-out gates." *Id.* The debtor had originally borrowed \$75 million from the lenders to make improvements on the space here, and would not have done so "unless it increased the

space's value by at least that much ... . Any valuation method that treats improvements as worthless can't be appropriate." *Id.* at \*7. In short, the bankruptcy court had unjustifiably disregarded "the fact that air carriers willingly pay \$63 per square foot for space at [LAX], the only estimate in the record of improved space's going price." *Id.* at 11. Because "[a]ny potential rental price higher than \$30 would make the collateral worth at least \$60 million, and thus make the loan fully secured, even with the ['bankruptcy court's improper] 10% discount rate," the lenders were held "entitled to collect 100 [cents] on the dollar, plus interest." *Id.* at \*11-\*12.

### **Finding the Correct Discount Rate**

Holding "that the 10% discount rate is too high," the Court of Appeals found that "the bankruptcy judge [had merely] added the two estimates" proffered by the parties' opposing experts, "and divided by two." *Id.* at \*12. Instead of splitting "the difference between the parties," the bankruptcy judge "should choose the right discount rate ... ." *Id.* Because LAX "is operating at capacity, and can raise money at 8% without giving security, [was] all [the Seventh Circuit] need[ed] to know to conclude that the discount rate cannot exceed 8%." *Id.* at \*13. "With the discount rate at 8%," the lenders would be "fully secured" even if the space were rented at "roughly \$23 per square foot." *Id.* at \*14. Improved space at LAX, however, "fetches almost three times the price" needed to make the lenders' loans "fully secured," entitling them "to a full recovery." *Id.*

### **COMMENTS**

#### **A Trial Court Cannot Ignore Material Facts**

The Court of Appeals had no trouble in reversing the bankruptcy judge's fact finding as to annual rental rate. When, as here, a lower court disregards material evidence in the record to reach a contrary conclusion, there is clear error. *United States v. U.S. Gypsum Co.*, 333 US 364, 394-96 (1948) (finding clearly erroneous "when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed ... . Where ... testimony is in conflict with contemporaneous documents we can give it little weight."); *Jiminez v. Mary Washington College*, 57 F.3d 369, 384 (4th Cir. 1995) (appellate court "left with the definite conviction that the factual findings of the district court [were] clearly erroneous ... [because it] ignored substantial evidence or failed to evaluate substantial contrary evidence in mak-

ing its findings of fact."); *Weissman v. Freeman*, 868 F.2d 1313, 1322 (2d Cir. 1989) (district court's decision clearly erroneous because it "implausibly overlooked" and "failed to give detailed consideration" to key evidence).

#### **A Trial Court Cannot Merely 'Split the Difference'**

Secured lenders, like other parties, are entitled to reasoned judicial findings based on facts in the record, not guesses. Again, the Seventh Circuit easily rejected the bankruptcy court's superficial splitting of "the difference between the parties." 2009 U.S. App. LEXIS 9648, at \*12. "An arbitrator might choose such a method, and perhaps a jury would do so behind closed doors, but a judge should choose the right discount rate ... ." *Id.* at 12.

#### **Secured Lenders Must Be Prepared to Litigate Through The Appellate Process**

UAL shows that secured lenders often have to appeal in order to vindicate their rights. Unsecured creditors, represented by trustees, creditors' committees and even debtors, not only challenge the validity of asserted liens, but also the lenders' right to full payment. Bankruptcy judges can be understandably sympathetic to unsecured creditors, but appellate courts may have no such sympathies.

Appellate judges should be aware that subtle incentives exist for trustees and bankruptcy courts to enlarge the bankruptcy estate for a number of reasons — for example, trustees ... draw additional fees when the estate is enlarged"; [majority reached] "unjust and unlawful result by arbitrarily causing the lender to lose the entire value of a perfectly valid mortgage for money the lender had advanced to the debtor in good faith"; [appellate courts] "must look carefully at [statutory] interpretations ... that enlarge the estate at the expense of secured creditors.

*In re Lee*, 530 F.3d 458, 475 (6th Cir. 2008) (2-1) (dissent) (Merritt, J.). In short, being a senior secured lender is not enough. The senior lender has to defend its position at every stage.

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