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Case Study: In Re River East Plaza

Law360, New York (February 02, 2012, 3:04 PM ET) -- The U.S. Court of Appeals for the Seventh Circuit affirmed a bankruptcy court's dismissal of a single asset real estate case on Jan. 19, 2012, reasoning that the debtor's proposed substitute collateral "was not the indubitable equivalent of the [undersecured lender's] mortgage." In re River East Plaza LLC (7th Cir. Jan. 19, 2012) (Posner, J.).

In the court's words, the debtor "wanted [the lender] out of there and decided to seek confirmation of a [reorganization] plan ... that would replace the [lender's] lien on [a Chicago office] building with a lien on $13.5 million in substitute collateral, namely 30-year Treasury bonds that would be bought by an investor in the reorganized firm." Id. at *4.

The court's concise opinion provides a sensible, clear guide to: (1) the so-called "cramdown" of secured claims; (2) the Bankruptcy Code ("Code") § 1111(b) election available to secured lenders; and, most important, (3) what constitutes the "indubitable equivalent" of a lender's collateral under Code § 1129(b)(2)(A)(iii).

Facts

The debtor owned a Chicago office building subject to the lender's first mortgage. After the debtor defaulted in 2009, it later filed a Chapter 11 petition in February 2011, "just hours before" a scheduled foreclosure sale. Id. at *1. Although the debtor owed the lender $38.3 million, it valued the building "at only $13.5 million," a valuation that the Seventh Circuit believed may have been "too low." Id. at *3.

Rather than asserting a $13.5 million secured claim plus a $24.8 million unsecured claim as lenders often do[1], the lender made the critical § 1111(b)(1)(B)(2) election, leaving it with a "secured claim for $38.3 million and no unsecured claim." Id. at *3.

Rationale for § 1111(b) Election

The court concisely explained why the lender here exchanged its secured and unsecured claims for a single secured claim equal to the face amount of the unpaid mortgage balance. "The swap [i.e., § 1111(b) election] is attractive to a mortgagee who believes both that the property that secures his mortgage is undervalued and that the reorganized firm is likely to default again — which often happens ..." Id. at *3.

The election thus enables the creditor, in the event of a further default after the value of the property has risen, "to apply a higher value of the collateral to the satisfaction of the debt than if he had accepted a secured claim equal to the lower value of the collateral at the time of bankruptcy." Id.

In other words, had the lender not made the § 1111(b) election, "it would receive some fraction of its unsecured claim ..., and would continue after the bankruptcy to have a $13.5 million claim secured by the building ... In contrast, given [the election here], if the value of the building rose ... to $20 million by the time the former debtor again defaulted, [the lender] ... would realize all $20 million because [its] secured claim would exceed that amount." Id. The relevant real estate market here had been depressed, causing the lender to expect the property's value to rise.

Cramdown

The word "cramdown" is bankruptcy parlance for a drastic measure enabling a reorganization plan proponent to get the bankruptcy court to confirm a plan despite the opposition of a creditor class — here, the senior secured lender. Among other things, Bankruptcy Code § 1129(b) requires, as a threshold matter, that the proposed plan not only be "fair and equitable" (defined by case law) as to the dissenting class, but that the plan also not "unfairly discriminate" against the dissenting class. In addition, the Seventh Circuit in River East described the three alternative ways how a plan "can be crammed down [the lender's] throat under one of the three subsections of" Code § 1129(b)(2)(A):

"... (i), the reorganized debtor keeps the property and may be allowed to stretch out the repayment of the debt beyond the period allowed by the loan agreement, but the lien remains on the property until the debt is repaid.";

"... (ii), the debtor auctions the property free and clear of the mortgage but the creditor is allowed to 'credit bid,' meaning to offer at the auction, not cash, but instead a part or the whole of [its] claim, ... so that, for example, [the lender in River East] could bid $20 million for [the debtor's] building just by reducing its claim from $38.3 million to $18.3 million."; or

"(iii), the lien is exchanged for an 'indubitable equivalent.' ... ."

"[This] last subsection is the one River East invoked in its proposed plan of reorganization — unsuccessfully." Id. at *2.

The bankruptcy court in River East had rejected the debtor's proposed plan, permitted the lender to foreclose, and dismissed the reorganization case. By affirming, the Court of Appeals found that the debtor had avoided "the requirement in a subsection [(§ 1129(b)(3)(A)] (i) cramdown of maintaining the mortgage lien on the debtor's property by transferring [the lender's] lien to different collateral ... in the name of indubitable equivalence." Id. at *2. But, as the court explained, "the substitute collateral ... was not the indubitable equivalent of [the] mortgage." Id.

Why the Substitute Collateral Failed the Indubitable Equivalent Test

The debtor tried to argue that the substitute collateral, $13.5 million in U.S. treasury bonds with a thirty-year maturity, "would grow in value ... through the magic of compound interest to $38.3 million, thus guaranteeing that [the lender] would be repaid in full," and making the "substitute collateral ... equivalent to" the lender's lien. Id. at *4.

The debtor also argued that the lender "wanted to thwart the bankruptcy" case; "to foreclose its mortgage and ... thus become the building's owner" so as to benefit from any appreciation in value should the real estate market recover. Id. According to the Court of Appeals, however, "there is nothing wrong with a secured creditor's wanting the automatic stay lifted so that it can maximize the recovery of the money owed it." Id.

The lender here, by making the § 1111(b) election, gave up its unsecured claim, a critical fact in the court's analysis as to why the substitute collateral was not the "indubitable equivalent" of the original mortgage. As the court explained,

"... [t]he lien on the Treasury bonds proposed by River East would not be equivalent to [the lender's] retaining its lien on the building. Suppose the building turns out to be worth $40 million five years from now, yet [the debtor], having borrowed heavily in the interim to finance improvements to bring the building's value up to that level, defaults. With its lien intact and the bankruptcy court unlikely in this second round of bankruptcy to stay foreclosure, [the lender] would be able to foreclose, and so would be paid in full. In contrast, if its lien were transferred to the substituted collateral, it would have to wait another 25 years to recover the $38.3 million owed it. Over that long period there almost certainly would be some inflation, so that in real terms the substituted collateral would turn out to be worth less." Id. at *5.

Substituted collateral may only constitute the "indubitable equivalent" if it is "more valuable and no more volatile than a creditor's current collateral ..." Id. The problem in River East was that "long-term Treasury bonds carry a substantial inflation risk, which might or might not be fully impounded in the current interest rate on the bonds." Id. at *6.

Although the bonds might eventually be more valuable than the building itself, "because of the different risk profiles of the two forms of collateral, they are not equivalents, and ... the choice between them should [not] be made for the creditor by the debtor." Id. Indeed, the debtor's "aim may have been to cash out [the lender's] lien in a period of economic depression and reap the future appreciation in the building's value when the economy rebounds. Such a cashout is not the indubitable equivalent of a lien on the real estate, and to require it would be inconsistent with § 1111(b) of the Code ..." Id.

"By proposing to substitute collateral with a different risk profile, in addition to stretching out loan payments," the debtor was essentially "proposing a defective" cramdown plan under Code § 1129(b)(2)(A)(i) (debtor keeps property subject to lien until full repayment and makes installment payments with present value equal to creditor's secured claim). Id. Although "subsection (i) is friendly to debtors," the debtor in River East "wanted to make it friendlier still by squeezing a modified form of a subsection (i) cramdown into subsection (iii)." Id. at *7.

Single Asset Real Estate Cases Are Time-Sensitive

Code § 362(d)(3)(A) requires the bankruptcy court in a single asset real estate case to "grant relief from the [automatic] stay [of foreclosure], such as by terminating, annulling, modifying or conditioning such stay" unless within 90 days of the commencement of the reorganization case, "the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time."

The debtor's substitute collateral proposal was the second reorganization plan that the bankruptcy court had rejected. Id. at *4. As a result, the statutory 90-day deadline had expired, requiring the bankruptcy court to vacate the automatic stay, enabling the lender to proceed with its foreclosure sale, leaving the debtor with nothing to reorganize, and requiring dismissal of the entire case. Despite the debtor's proposing yet a third plan in River East, "the bankruptcy judge had lost patience," "refused to consider" it, "lifted the automatic stay, and dismissed" the case. Id. at *7.

According to the Seventh Circuit, the bankruptcy judge had not abused his discretion "because there was bound to be a wrangle [in the third plan proposal] over the current value of the building and the proper interest rate." Id. Moreover, the debtor had already undermined "its credibility by submitting two plans that sought to circumvent the statute, and the 90-day" deadline had expired. Id. In the words of the Court of Appeals, the lender had been forced to wait "years to enforce its lien, [and] the bankruptcy judge was not required to stretch out the Chapter 11 [case] any longer." Id.

Comments

1. The Court of Appeals and bankruptcy judge saw through the debtor's attempted manipulation of the reorganization process. In short, the debtor and its investors were seeking to reap the anticipated increase in the property's value. "[They] [p]robably ... expected the value of the building to appreciate and didn't want to share that appreciation with [the lender]. Id. at *4.

2. River East confirms the wisdom of having an exit strategy before filing a Chapter 11 petition. A single asset real estate case does not give the debtor time to experiment with alternative reorganization proposals, as the debtor in River East tried to do. Indeed, losing credibility with the court in any reorganization is usually fatal.

3. The Seventh Circuit also noted that the "logic" of its earlier June 28, 2011, River Road[2] decision forbids the "end run" tried in River East. Id. at *2. In the earlier case, now before the Supreme Court, the debtor "sought to avoid the creditor's right to credit bid under [Code §§ 1129(b)(2)(A)](ii) by invoking indubitable equivalence." Id. In River East, the debtor tried "to avoid the requirement in a [Code § 1129(b)(2)(A)] (i) cramdown of maintaining the mortgage lien on the debtor's property by transferring [the lender's] lien to different collateral, also in the name of indubitable equivalence." Id. Because the proposed "substitute collateral ... was not the indubitable equivalent" of the original mortgage, the bankruptcy court could not confirm the River East plan, regardless of how the Supreme Court rules in River Road. Id.

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[1] An undersecured lender ordinarily would have "a secured claim for the value of the collateral at the time of bankruptcy and an unsecured claim for the balance." Id. at *3, citing Code § 1111(b)(1)(A).

[2] In re River Road Hotel Partners LLC, 651 F.3d 642 (7th Cir. 2011), cert. granted sub nom. Rad LAX Gateway Hotel LLC v. Amalgamated Bank (Dec. 12, 2011)

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