ALERTS

Split Ninth Circuit Refines Cramdown Valuation Rule

June 23, 2017

The Bankruptcy Code ("Code") "requires the use of replacement value rather than a hypothetical [foreclosure] value … that the reorganization is designed to avoid," held a divided U.S. Court of Appeals for the Ninth Circuit on May 26, 2017. *In re Sunnyslope Hous. Ltd. Partnership*, 2017 U.S. App. LEXIS 9198, *5 (9th Cir. May 26, 2017) (*en banc*) (8-3) (*Sunnyslope II*)). The court affirmed the bankruptcy court's confirmation of the Chapter 11 debtor's reorganization plan that had valued a lender's collateral (an apartment complex) based on the debtor's "continued use after reorganization as low-income housing." *Id.* The lender had unsuccessfully argued for a higher foreclosure value that would have eliminated restrictive use covenants, which depressed the collateral's value.

The Ninth Circuit *en banc* panel reversed an earlier three-judge panel's divided opinion. *In re Sunnyslope Hous. Ltd. Partnership*, 818 F.3d, 937, 940 (9th Cir. 2016) (2-1) (*Sunnyslope I*) ("Under [Code] §506(a)(1)," replacement cost "is a measure of what it would cost to produce or acquire an equivalent piece of property;" "replacement value of … apartment complex does not take into account … a restriction on the use of the complex."). In *Sunnyslope II*, the three-judge dissent also argued that "the appropriate value is the market price of the building without restrictive covenants." 2017 U.S. App. LEXIS 9198, at *23 (Kozinski, J.). As the *Sunnyslope II* dissent stressed, the "majority's valuation falls well below what the secured creditor would obtain from an immediate sale." *Id.* at *25.

Relevance

"Cramdown is messy … . Valuation in bankruptcy, in turn, is also messy. Courts are often placed in the position of assigning a monetary value to an asset for which there is either no seller or no buyer, and often no market." Bruce A. Markell, "Fair Equivalents and Market of Prices: Bankruptcy Cramdown Interest Rates," 33 Emory Bankr. Dev. J. 91, 92 (2016).

The so-called "cramdown" power enables a bankruptcy court to confirm a reorganization plan when a secured creditor class dissents from its treatment under the plan. Because of the Code's "absolute priority" rule, the court may not confirm the plan unless the dissenting secured creditor class is paid in full. Markell, at 94, citing 7 Collier, *Bankruptcy* ¶1129.03 [4][a][ii], at 1129-83 (16th rev. ed 2009). For a secured lender to be fully paid does not require a cash payment, but may consist of a promise to pay. Markell, at 94. As the Supreme Court noted 20 years ago, the cramdown power poses "double risks" for lenders: "The debtor may again default and the property may deteriorate from extended use." *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 962 (1997).

Facts

The debtor owned an apartment complex subject to secured loans from a lender $8.5 million (first priority), the City of Phoenix (second priority) and the State of Arizona (third priority). The U.S. Department of Housing and Urban Development guaranteed the lender's loan.

The secured financing and tax benefits associated with the apartment complex required that it be used for low-income housing. When the debtor defaulted on the lender's first priority $8.5-million loan, another institution ("Bank") bought the loan for $5.03 million subject to "covenants, conditions and restrictions" requiring the complex to be used for low-income housing. 2017 U.S. App. LEXIS 9198, at *6-*7. If the Bank were to foreclose, however, the restrictions would end.

The debtor's filing of a Chapter 11 petition stayed the Bank's pending foreclosure proceeding. The debtor later proposed a cramdown plan providing for it to retain the apartment complex, treating the Bank's claim as secured "to the extent of the value of such creditor's interest" in the collateral, consistent with Code § 506(a)(1). *Id.* at *8. When the debtor argued that the apartment complex should be valued as low-income housing with its pre-existing use restrictions, the Bank countered that the low-income housing restriction should be disregarded for purposes of

valuation under Code § 506(a)(1), reasoning that its collateral would have a much higher value if the property were not subject to these restrictions.

The bankruptcy court valued the apartment complex as low-income housing, *id.* at *8-*9, and declined to include tax credits available to the debtor in valuing the property. The court later confirmed the debtor's reorganization plan, "which provided for payment in full of the [Bank's] claim over 40 years, at an interest rate of 4.4%." *Id.* at *9. The district court affirmed the bankruptcy court's valuation with the low-income housing restrictions, but held that the tax credits should have been included in the analysis. *Id.* at *10.

A split panel of the Ninth Circuit reversed the bankruptcy court's confirmation order in *Sunnyslope I*. It held that the court should have valued the apartment complex based on its foreclosure value, i.e., without the restrictive "affordable housing requirements," which lowered the property's value. *Id.* at *11. The Ninth Circuit vacated the panel opinion in *Sunnyslope I* when it granted the debtor's petition for rehearing *en banc*.

En Banc **Opinion**

The Ninth Circuit relied on *Rash*, where the "Supreme Court adopted a 'replacement-value standard' for § 506(a)(1) cram-down valuations," holding that "replacement value, 'rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's 'disposition or use.'" *Id.* at *4, quoting *Rash*, 520 U.S. at 963. Agreeing with the dissent in *Sunnyslope I*, the majority in *Sunnyslope II* reasoned that *Rash* "compels valuing [the Bank's] collateral … in light of [the debtor's] proposed use of the property in its plan of reorganization as affordable housing." *Id.* at *11, quoting *Sunnyslope I*, 818 F.3d at 950. Thus, it was proper to value "the apartment complex assuming its continued use after reorganization as low-income housing." *Id.* at *12.

1. *Valuation*. When a debtor retains property subject to a lien under a reorganization plan, the court must use replacement value, not foreclosure value. *Id.*, citing *In re Taffi*, 96 F.3d 1190, 1192 (9th Cir. 1996) (*en banc*). In the words of the court, the debtor is "in, not outside of bankruptcy," so "[t]he foreclosure value is not relevant" because the creditor "is not foreclosing." *Id.* Following *Taffi*, the Supreme Court held in *Rash* that "§506(a) directs application of the replacement value standard," rather "than foreclosure value." *Id.* at *13, quoting *Rash*, 520 U.S. at 956. Because "the debtor will continue to use the collateral, …

valuation must therefore occur 'in light of the proposed repayment plan reality: no foreclosure sale.'" *Id.* at *13-*14, quoting *Rash*, 520 U.S. at 963. The "actual use is the proper guide." *Id.*, "Absent foreclosure, the very event that the Chapter 11 plan sought to avoid, Sunnyslope cannot use the property except as affordable housing, nor could anyone else." *Id.* at *15.

The court also rejected the argument made by other banks ("amici") that "valuing the collateral with the low-income restrictions in place would discourage future lending on like projects." *Id.* at *17. Protecting creditors' interests may be important, but "the Supreme Court has made clear that successful debtor reorganization and maximization of the value of the estate are the primary purposes" in Chapter 11 cases. *Id.* at *17, quoting *In re Bonner Mall P'ship*, 2 F.3d 899, 916 (9th Cir. 1993), abrogated on other grounds by *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015). Not only is the debtor able to rehabilitate its business and maximize the value of its estate, but the Bank here "bought the Sunnyslope loan at a substantial discount, knowing of the risk that the property would remain subject to the low-income housing requirements," subjecting it "to no more risk than it cautiously undertook." *Id.* at *17.

1. *Plan Fairness*. After finding that the Bank's collateral had been properly valued by the lower court, the Ninth Circuit addressed "whether the bankruptcy court [erroneously found] that the plan provides for payments equal to the present value of the [Bank's] secured claim." *Id.* at *18. The court approvingly noted the bankruptcy court's reliance on "expert testimony" when it found

"the 4.4% interest rate on the plan payments [to] result in [the Bank's] receiving the present value of its $3.9 million security over the term of the reorganization plan. The relevant national prime rate was 3.25%, and the bankruptcy court adjusted that rate upward to account for the risk of non-payment. The court also heard testimony that the market loan rate for similar properties was 4.18%. In setting the 4.4% rate, the bankruptcy court carefully explained its reasoning, noting that interest rates had decreased significantly since the [original] loan was made … . [Also,] the risk to the lender had similarly decreased since then because, when the loan was made, the apartment complex had not yet been built." *Id.* at *19.

According to the Ninth Circuit, the bankruptcy court followed the Supreme Court's "formula approach" for calculating the appropriate interest rate. *Till v. SCS Credit Corp.*, 541 U.S. 465, 478-79 (2004). That

approach "begins with the national prime rate and adjusts up or down according to the risk of the plan's success." *Id.* at *18.

Comment

The Ninth Circuit followed the Supreme Court's approach, articulated in *Till*, when approving the cramdown interest rate in *Sunnyslope II*. As the Fifth Circuit has noted, "the vast majority of bankruptcy courts have taken the *Till* plurality's invitation to apply the *prime*-plus formula under Chapter 11." *In re Texas Grand Prairie Hotel Realty, LLC*, 710 F.3d 324, 333 (5th Cir. 2013). Although lenders have argued against a non-market rate, the Fifth Circuit explained the current rationale for cramdown interest rates:

While [the lender] is undoubtedly correct that no willing lender would have extended credit on the terms it was forced to accept under the §1129(b) cramdown plan, this "absurd result" is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations."

Texas Grand Prairie, 710 F.3d at 336. *See also Till*, 541 U.S. at 488 (Thomas, J. concurring) ("... the use of the prime rate, even with a small risk adjustment, 'will systematically undercompensate secured creditors for the true risks of default.' This systematic undercompensation might seem problematic as a matter of policy. But, it raises no problem as a matter of statutory interpretation."); *In re MPM Silicones, LLC* 2014 WL 4436335, *23-25 (Bankr. Sept. 9, 2014), *aff'd* 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. Filed June 1, 2015) ("Congress likely intended bankruptcy judges ... to follow essentially the [*Till*] approach when choosing an appropriate [cramdown] interest rate ... The purpose is *not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan."). *Contra*, *In re American Home Patient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005) ("... the market rate should be applied in Chapter 11 cases where there exists an efficient market.") Even in *Texas Grand Prairie*, where the parties "stipulate[d] that the *Till* plurality's formula approach govern[ed]" that case, the court declined to require it in future cases. 710 F.3d at 331. *Scurria*, "Momentive [MPM] Win Shifts Balance of Power In Chapter 11 Process," Law 360 (May 6, 2015) (*MPM* "tips the playing field in Chapter 11 away from secured creditors ... and toward private equity sponsors eager to preserve equity stakes.").

Authored by Michael L. Cook.

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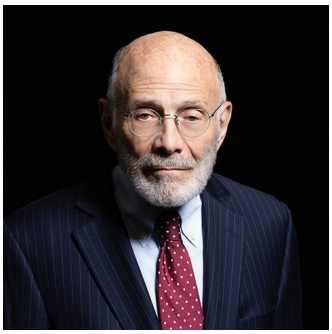

Michael Cook

Of Counsel

New York

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