The Law of Distressed Real Estate

Foreclosure, Workouts, Procedures

By Baxter Dunaway

This article is a reprint of Chapter 24 of The Law of Distressed Real Estate, and includes the latest information in real estate workout, foreclosure and bankruptcy law. It is an exhaustive analysis and dissection of the bankruptcy reorganization process under Chapter 11 of the Bankruptcy Code and focuses on single-asset real estate entities and cases. This chapter was written by John C. Murray, Esq., Vice President-Special Counsel, First American Title Insurance Company. Mr. Murray handles transactional, underwriting, corporate relationship, and other responsibilities for the company's Chicago National Commercial Division, has authored numerous pieces on various real estate, environmental, bankruptcy, taxation, and title insurance topics, and is a frequent speaker and guest lecturer.

Chapter 24: Bankruptcy—Reorganization Under Chapter 11 is an updated and expanded version of John C. Murray, *The Lender's Guide to Single Asset Real Estate Bankruptcy*, 31 Real Prob. & Tr. J. (Fall 1996).

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§24.01 Introduction

[1] Relationship to Other Book Chapters

This Chapter covers Chapter 11 reorganization of real estate. Chapter 24D "Bankruptcy—Single Asset Real Estate Cases" is more specific and covers cases under 11 USC §362(d) (3) which encompasses a statutorily defined class of "Single Asset Real Estate" cases with secured debts in an amount no more than $4 million. Chapter 23 is an overview of bankruptcy under Chapter 11 and other chapter filings. Specific aspects of Chapter 11 are covered in Chapter 24C "Bankruptcy—Cram Down in Chapter 11," Chapter 25 "Bankruptcy—Trustee's Avoiding Powers," Chapter 26 "Bankruptcy—Effect on Leases and Executory Contracts," Chapter 26B "Bankruptcy—anticipatory Lease Drafting Strategies," Chapter 26C "Bankruptcy—Equitable Subordination," Chapter 24B "Bankruptcy—Effects on the Foreclosure Process," Chapter 26D "Bankruptcy—Conflicts Between Banking Regulators and Bankruptcy Trustee." For tax questions, see Chapter 28 "Tax Consequences to Borrowers, Investors and Lenders."

Workouts are covered in Part B in Chapters 2A (0verview) 3 (practical and business aspects) 4 (construction mortgages) 4A (farm and ranch loans) 4B (lender liability) 4C (accounting and regulatory implications) and 5 (deeds in lieu of foreclosure).

See Chapter 7 "Rights to Possession, Receivers, and Rents After Default," including the rights in bankruptcy.

Environmental questions are covered in Chapter 30 "Liability for Hazardous Waste," Chapter 30A "Insurance Coverage for Environmental Damage," Chapter 30B "Environmental Concerns in Purchase and Sale of Real Property," and Chapter 30C

"Environmental Due Diligence: A Guide to Liability Risk Management in Commercial Real Estate Transactions."

Filings under other bankruptcy chapters are covered in specific chapters of the book. Chapter 24A "Bankruptcy—Chapter 13 Adjustment of Debts by Individuals" covers Chapter 13. Chapter 26A "Bankruptcy—Farms and Ranches" deals with Chapter 12 bankruptcies. Chapter 7 filings are covered in Chapter 23 "Bankruptcy—Overview," Chapter 25 "Bankruptcy—Trustee's Avoiding Powers," Chapter 26 "Bankruptcy—Effect on Leases and Executory Contracts." For a listing of all chapters, see "Summary of Contents" at the beginning of each volume.

[2] Background

In the 1980s, institutional lenders eagerly sought out mortgage loans on commercial real estate properties such as office buildings, apartment projects, shopping centers, and hotels—often making mortgage loans to single asset limited partnerships on a nonrecourse basis. Unfortunately, in the early 1990a, depreciating property values, a declining economy, and corporate downsizing combined to render many of these transactions economically infeasible. These factors contributed to souring relations between lenders and borrowers, resulting in missed payments, inadequate maintenance and operation of the property, and retention of property income by borrowers for their own purposes. The loans then become nonperforming assets on the lenders' books and are transferred to the lenders' workout groups.

When confronted with a defaulted mortgage loan, lenders must determine whether to negotiate with the borrowers or to commence proceedings to recover the property. Foreclosure is the logical alternative when negotiations prove fruitless. The lender will exercise this option if the borrower has threatened the lender with lender liability claims,[1] if the lender has concerns regarding the borrower's management and leasing ability or motivation, or if the borrower has allowed the property to deteriorate physically. In addition, if the lender anticipates a significant negative change in the market, in the borrower's financial condition, or in the condition of the property during the remaining loan term, foreclosure may be the only solution.

From the borrower's perspective—especially in connection with a single asset limited partnership when the loan is nonrecourse—the threat of a foreclosure by the lender raises significant timing and tax issues.[2] Postponing the sale to a future year, or attempting to prohibit the sale from being held at all, may allow investors in the borrowing entity to postpone or even to avoid a significant recapture of certain valuable tax benefits. Borrowers know that lenders cannot, in any event, even as part of workout negotiations, force them to give up their rights to file for bankruptcy. Therefore, even if the lender negotiates on a friendly basis to postpone the sale of the property until the following year, the borrower could file for bankruptcy at the last moment. Unfortunately, the deteriorating economic environment has made bankruptcy a practical and acceptable business choice for the owners or real estate secured by mortgages.

[1] See Chapter 4B "Liability of Lender for Controlling Debtor and for Other Acts" *supra*.

[2] See Chapter 28 "Tax Consequences to Borrowers, Investors, and Lenders" *infra*.

Once lenders have filed foreclosure proceedings, they will usually seek to immediately obtain a receiver for the real property that is securing the loan.[3] Lenders do this because, assuming the loan is nonrecourse, the real property security and the property's rents are the only sources of loan repayment. Facing no alternative to the loss of the property and the risk of the recapture of all or a portion of the tax benefits obtained as a result of the original transaction, borrowers often file for Chapter 11 bankruptcy shortly after the filing of a foreclosure action or on the eve of the scheduled court hearing for the appointment of a receiver.

Although the Bankruptcy Reform Act of 1994[4] (1994 Reform Act) was widely heralded by Congress and commentators as a victory for secured creditors in connection with single asset Chapter 11 real estate bankruptcy cases, the Act has actually done little to protect secured creditors from single asset filings.[5] This lack of protection results, in part, because the definition of single asset real estate encompasses only a real estate business operation having less than $4 million in secured debt.[6]

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[3] See Chapter 7 "Rights to Possession, Receivers, and Rents After Default" *supra*.

[4] Pub. L. No. 103-394, §202, 108 Stat. 4106, 4121 (1994) (codified as amended in scattered sections of Title 11 of the United States Code. The 1994 Reform Act was passed on October 22, 1994. With a few exceptions the 1994 Reform Act applies to bankruptcy cases filed on or after October 22, 1994. 108 Stat. At 4150-51. The Reform Act modified many of the troubling real estate related provisions of the Bankruptcy Code and contains numerous sections that affect commercial real estate, including the s0-called *DePrizio* rule, the perfection of security interests, the rejection of leases by a bankruptcy lessor, single asset real estate, and the priority of tax liens over mortgages. See In re DePrizio Const. Co., 86 B.R. 545 (N.D. Ill. 1988); Baxter Dunaway, *Effect of the Bankruptcy Reform Act of 1994 on Real Estate*, 30 Real Prop. Prob. & Tr. J. 601 (1996).

[5] See Chapter 24D "Single Asset Real Estate Cases" *infra*.

[6] See Chapter 24D "Single Asset Real Estate Cases" *infra*. Section 101(51B) of the Bankruptcy Code, as amended by section 218 of the 1994 Reform Act, 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 the business of operating the real property . . . [if the] aggregate noncontingent, liquidated secured debts [on the date of the bankruptcy petition do not exceed] $4,000,000. 11 USC §101(51B) (1994). See In re Kkemko, Inc., 181 B.R. 47, 50 (Bankr. S.D. Ohio 1995) (providing a brief summary of the case law involving single asset real estate issues prior to the incorporation of the term into the 1994 amendments); Centofante v. CBJ Dev., Inc., (In re CBJ Dev., Inc.), 202 B.R. 467 (Bankr. 9th Cir. BAP 1996) (holding that relief from the automatic stay is mandatory in single asset real estate bankruptcy cases where the provisions of the statute have not been complied with; the court found that a hotel does not constitute single asset real estate under §101(51B) of the Code); In re LDN Corp., 191 Bankr. 320, 327 (Bankr. E.D. Va. 1996) (same); In re Philmont Dev. Co., 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995) (stating that §101(51B) of the Code enumerates four criteria that must be satisfied before real property may be considered single asset real estate); In re Archway Apartments, Ltd., 206 B.R. 463, 465-66 (Bankr. M.D. Tenn. 1997) (ruling that under §362(d)(3)(A) of the Code, the bankruptcy court is free to fashion the relief appropriate to meet the requirements of this section; although the debtor had filed its single-asset real estate bankruptcy plan one week beyond the ninety-day period referenced in §362(d)(3), there was no attempt by the debtor to delay or impede the secured creditor's rights and the appropriate relief was to condition the stay upon a drop-dead date for confirmation); In re Pensignorkay, Inc., 204 B.R. 676, 682-83 (holding that the determination of the extent to which a claim or "debt" is secured, for purposes of §101(51B), depends on the value of the collateral to which the creditor's lien attaches); cf. In re Planent 10, 213 B.R. 478, 479 (Bankr. E.D. Va. 1997) (single asset definition applied to undeveloped land); In re Oceanside Mission Associates, 192 B.R. 232, 236-38 (Bankr. S.D. Cal. 1996) (finding that the §101(51B) requirement of "aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000" refers to the total amount of all secured claims without regard to the value of the property securing such claims); In re

This chapter briefly examines the background and purpose of the bankruptcy statutes as well as the process of reorganization under Chapter 11. It then examines in detail the secured creditor's options, strategies, and remedies when faced with a Chapter 11 filing by a single asset real estate debtor. This Chapter also provides a detailed explanation of the secured creditor's right of election under section 1111(b) of the Bankruptcy Code as well as a time line for a typical Chapter 11 filing.

§24.02 Background and Ostensible Purpose of the Bankruptcy Code

Bankruptcy law stems from the U.S. Constitution, which empowers Congress to establish "uniform [l]aws on the subject of Bankruptcies throughout the United States."[7] Congress overhauled the system in 1978 by adopting a new federal bankruptcy statute (Bankruptcy Code) in response to abuses in the 1960s and early 1970s.[8]

Bankruptcy filings track the course of the economy. Relatively few bankruptcy cases were filed in the early and mid-1980s. In the late 1980s and early 1990s, the barrage of new filings challenged the system and tested rulings and precedents. New forms of system abuse came to light.[9] The 1994 Reform Act,[10] which made sweeping amendments to the Bankruptcy Code, was enacted to address many of the perceived new abuses brought on by increased bankruptcy filings, especially in connection with single asset real estate cases. The 1994 Reform Act contains several provisions that benefit real estate lenders.

[1] Bankruptcy Reform Act of 1994

[a] Security Interest in Rents

Section 214 of the 1994 Reform Act amended section 552 of the Bankruptcy Code to provide that, for bankruptcy purposes, a lenders prepetition security interest in rents will apply to postpetition rents to the extent provided in the security agreement.[11] This is true even if some additional action other than recording (such as written notification to tenants, the appointment of a receiver, or

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Standard Mill Ltd. Partnership, 1996 Bankr. LEXIS 1120 (Bankr. D. Minn. 1996) (stating its general agreement with the holding in In re Oceanside Mission Associates, *supra*).

[7] U.S. Const. art. I, §8, cl. 4. "At the adoption of the Constitution the English and Colonial bankruptcy laws were limited to traders and to involuntary proceedings." Ashton v. Cameron County Water Improvement Dist. Number One, 298 U.S. 513, 535 (1936) (Cardozo, J., dissenting).

[8] Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 USC §§101-1328) (1994).

[9] In September 1992, the American Bankruptcy Institute reported that during the year ending in June 1992, more individuals and businesses filed for bankruptcy than in any other twelve-month period in history. The United States saw 972,490 bankruptcy filings in that year—more than double the number of filings in 1985 and a 10.5 percent increase over the period from June 1990 to June 1991.

[10] See *supra* §24.01 "Introduction." The *New York Times* described the 1994 Reform Act as "the first comprehensive overhaul of the nation's bankruptcy laws in 16 years." Keith Bradsher, *Bankruptcy Bill Passed By Senate*, N.Y. Times, Oct. 8, 1994, §1, at 39. See also Baxter Dunaway, *Effect of the Bankruptcy Reform Act of 1994 on Real Estate*, 30 Real Prop. Prob. & Tr. J. 601 (1996).

[11] 11 USC §552(b)(2).

taking possession of the property) is normally required of a secured creditor under applicable state law to perfect its interest in the rents prior to the bankruptcy filing. Section 214 further provides that hotel revenues, whether designated as fees, charges, accounts, or otherwise, that are subject to a prepetition security interest are expressly considered case collateral and, therefore, may not be used by the debtor without the lender's consent. Although this section essentially creates a federal law of perfection for rents and makes state law requirements regarding perfection inapplicable, it does not make such state law requirements irrelevant. To determine the extent of the creditor's postpetition security interest in the rents, one must still review applicable nonbankruptcy law as well as the creditor's agreement with the debtor.[12]

[b] Automatic Stay in Single Asset Real Estate Cases

Section 218 of the 1994 Reform Act also modifies the automatic stay procedures of section 362 of the Bankruptcy Code. This section creates special rules for single asset real estate cases that are applicable to Chapter 11 debtors whose primary source of income is a single asset real estate project with secured debts that do not exceed $4 million.[13] Under section 218, the bankruptcy court *must* lift the automatic stay unless the debtor (1) proposes a plan of reorganization that has a reasonable chance of confirmation within ninety days after the entry of an order for relief from the automatic stay or (2) commences monthly interest payments to mortgagees and other lienholders on real estate, except judicial liens and unmatured statutory liens, in an amount equal to the fair market interest rate on the lender's secured claim. Monthly interest payments do not have to be based on the full balance due or on the contract rate; rather, they are based on the value of each lender's interest in the real estate at a current fair market rate.[14]

[c] *DePrizio* Case

Section 202 of the 1994 Reform Act amends section 550 of the Bankruptcy Code and effectively overrules *Levit v. Ingersoll Rand Finance Corp.*[15] (the *DePrizio* case) and its progeny. Under *DePrizio*, courts extended the preference avoidance period from ninety days to a full year for noninsider creditors when the transfers in question nevertheless benefited an insider. In particular, *DePrizio* permitted a bankruptcy trustee to recover preferential payments consisting of loan

[12] 11 USC §552(b)(2) (1994). See cases cited *infra* notes for §24.06[1][a] "Assignment of Rents and Use of Cash Collateral" *infra*.

[13] See Chapter 24D "Bankruptcy—Single Asset Real Estate Cases" *infra*.

[14] 11 USC §362(d) (1994).

[15] In re V.N. De Prizio Constr. Co., 874 F.2d 1186 (7th Cir. 1989). Several circuits have adopted the *DePrizio* reasoning. See Galloway v. First Ala. Bank (In re Wesley Indus., Inc.), 30 F.3d 1438 (11th Cir. 1994); Official Unsecured Creditors Comm. V. United States Nat'l Bank (In re Suffola, Inc.), 2 F.3d 977 (9th Cir. 1993); Southmark corp. v. Southmark Personal Storage, Inc. (In re Southmark Corp.), 993 F.2d 117 (5th Cir. 1993); In re C-L Cartage Co., 899 F.2d 1490 (6th Cir. 1990); Manufacturers Hanover Leasing Corp. v. Lowry (In re Robinson Bros. Drilling, Inc.), 892 F.2d 850 (10th Cir. 1989). See also In re Northeastern Contracting Inc., 182 B.R. 673, 679 n.3 (Bankr. D. Conn. 1995) ("[T]he Bankruptcy Act purports to legislatively overrule the *DePrizio* line of cases).

payments made to a noninsider lender during this extended one-year preference period when the debt was guaranteed by an insider of the debtor.[16] Section 202 expressly overrules *DePrizio* by stating that payments to a noninsider lender are only subject to the ninety-day preference period.[17]

[d] Rights of Nondebtor Lessee When Lease Is Rejected

Section 205 of the 1994 Reform Act amends section 3659h0 of the Bankruptcy Code and further protects the rights of a nondebtor lessee when the lease is rejected by a debtor-lessor.[18] Under section 3659h0 a debtor-lessor is permitted to assume or to reject[19] executory contracts and unexpired leases. However, if a debtor-lessor rejects a lease, the lessee has the option of vacating the premises or remaining in possession. Section 205 of the 1994 Reform Act clarifies the rights of a nondebtor lessee by allowing the lessee to remain in possession for the balance of the lease term and for any extension term.[20] The lessee has the right to retain, preserve, and protect all rights under the lease, including the amount and timing of rent payments and other amounts payable by the lessee. Further, the lessee may protect any right of use, possession, hypothecation, subletting, assignment, and quiet enjoyment. In addition, section 205 provides that the lessor-debtor's rejection of a shopping center lease does not affect the enforceability of any provision relating to radius, use, location, exclusivity, tenant mix, or balance. This section particularly benefits banks and other lending institutions that provide leasehold financing and that generally take an assignment of a tenant's interest in a ground lease or master lease as security for the financing. As the result of several bankruptcy court rulings prior to the passage of the 1994 Reform Act, lenders were concerned that a borrower-lessee's assignment of a lease as collateral could be found unenforceable after rejection of

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[16] An insider is one who is a principal of, related to, or affiliated with the debtor. 11 USC §101(31) (1993).

[17] Some commentators believe that negative consequences to lenders may still exist. These commentators believe that section 202 of the 1994 Reform Act eliminated only the right to recover the preference and that the preference may still be avoidable, notwithstanding the clear intention of Congress to overrule the *DePrizio* line of cases and to protect noninsider transferees for transfers received more than ninety days prior to the filing of bankruptcy. See Robert Milliner, *Is Deprizio Dead . . . or Just Wounded? Lien Avoidance as a Post-Reform Act Remedy for Trilateral Preferences*, Lender Liability News (LRP Publications), May 19, 1995, at 12-13; Lawrence Ponoroff, *Now You See It, Now You Don't: An Unceremonious Encore for Two-Transfer Thinking in the Analysis of Indirect Preferences*, 69 Am. Bankr. L.J. 203 (1995); Richard C. Josephson, *The* DePrizio *Override: Don't Kiss Those Waivers Goodbye Yet*, 4 Bus. L. Today 40 (1995); Adam A. Lewis, *Did It or Didn't It? The* DePrizio *Dilemma, 10 Am. Bankr. Inst. J. 20 (1995)*. On August 2, 1996 the U.S. Senate passed the proposed "Bankruptcy Technical Corrections Act of 1996," which contains a provision that is intended to correct the perceived deficiencies in section 202 of the 1994 Reform Act by amending section 330(c) of the Bankruptcy Code. Bankruptcy Technical Corrections Act of 1996, S. 1559, 10th Cong. (1996).

[18] See generally Chapter 26 "Bankruptcy—Effect on Leases and Executory Contracts" *infra*.

[19] When the debtor-lessor assumes the lease or executory contract, it remains in force. When the debtor-lessor rejects the lease or executory contract, the rejection is considered to be a breach of the lease or executory contract. The breach is effective as of the filing date of the bankruptcy petition.

[20] 11USC §365(h)(1)(A)(ii).

the lease by the debtor-lessor, thus stripping the lender of the collateral.[21] Section 205 effectively overrules these cases.

[2] Chapter 7 and Chapter 11

Bankruptcy encompasses a fresh start policy that enables troubled debtors to restructure their liabilities in an orderly fashion under the protection of the federal court system. One court has stated that a central purpose of the Bankruptcy Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt."[22] The Bankruptcy Code allows businesses to file for liquidation under Chapter 7 or for reorganization under Chapter 11.[23]

In the Bankruptcy Code, Chapter 7 and Chapter 11 are based on two different valuation approaches. Chapter 7 uses liquidation value and Chapter 11 generally uses going concern value.[24] In a Chapter 7 proceeding, the bankruptcy strips debtors of their assets and liabilities as of the filing date. The trustee sells the assets and liabilities as of the filing date. The trustee sells the assets and distributes the proceeds to creditors in accordance with their priority. In Chapter 11 proceedings, in which

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[21] See In re Harborview Dev. 1986, Ltd., 152 B.R. 897 (Bankr. D.S.C. 1993) (holding that while the lessee has the right to remain in possession of the premises for the remainder of the lease term if the debtor-lessor rejects the lease, the lessee does not have the right to permit a sublessee to remain in possession); In re Carlton Restaurant Inc., 151 B.R. 353 (Bankr. E.D. Pa. 1993) (ruling that a lessee that remains in possession does not have the right to subsequently assign the lease to another party); In re Arden & Howe Assocs., Ltd., 152 B.R. 971 (Bankr. E.D. Cal. 1993) (holding that a lessee that remains in possession cannot enforce a restrictive covenant under the lease).

[22] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934). *Accord*, Grogan v. Garner, 498 U.S. 279, 286 (1991); Perez v. Campbell, 402 U.S. 637 (1971); Lines v. Frederick, 400 U.S. 18 (1970); Harris v. Zion Sav. Bank & Trust Co., 317 U.S. 447, 451 (1943); Stellwagen v. Clum, 245 U.S. 605, 617 (1918); Williams v. United States Fidelity & Guar. Co., 236 U.S. 549, 554-55 (1915); United States v. Goodstein, 883 F.2d 1362, 1370 (7th Cir. 1989); In re 801 S. Wells St. Ltd. Partnership, 192 B.R. 718, 725 (Bankr. N.D. Ill. 1996); In re Cynthia Clark, No. 95-C6152, 1996 U.S. Dist. LEXIS 210 (N.D. Ill. Jan. 11, 1996); Bay Area Factors v. Calvert (In re Calvert), 177 B.R. 583, 588 (Bankr. W.D. Tenn. 1995); Chase Manhattan Bank v. Ford (In re Ford), 186 B.R. 312, 316 (Bankr. N.D. Ga. 1995); Reeds v. Reeds (In re Reeds), 145 B.R. 703 (Bankr. N.D. Okla. 1992); In re Schmelzer, 350 F. Supp. 429, 435 (S.D. Ohio 1972). The House Report, which is part of the legislative history of the Bankruptcy Code, states that:

> [T]he purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.

H.R. Rep. No. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

[23] Businesses may also be liquidated under Chapter 11 and often are when such a liquidation would be more cost-effective or would achieve a greater price for the assets than a liquidation carried out by a bankruptcy trustee under Chapter 7. Freuhauf Corp. v. Jartran, Inc. (In re Jartran, Inc.), 886 F.2d 859, 868 (7th Cir. 1989). Individuals not engaged in a business activity may also file for protection under Chapter 11 of the Bankruptcy Code. See Toib v. Ratliff, 501 U.S. 157, 163 (1991) (relying on the plain language of section 109 of the Bankruptcy Code, the Court held that individual nonbusiness debtors are permitted to file under Chapter 11).

[24] See §24.08[3][b] "Approaches to Valuation" *infra*.

reorganization rather than liquidation is sought, the bankruptcy strips debtors of their liabilities but allows them to keep their assets. The assets are used in the reorganization plan to generate the liquidation value of the assets for prepetition creditors. The plan of reorganization must include repayment of certain existing liabilities, generally consisting of statutorily defined administrative and priority claims.[25] Postpetition creditors and the debtor receive the excess of the going concern value over the liquidation value. The Bankruptcy Code sets forth specific rules under which the debtor may use either Chapter 7 or Chapter 11.

Because in Chapter 7 bankruptcies the property is generally abandoned to the lender or sold to pay the lender in full, this chapter discusses bankruptcy under Chapter 11.

§24.03 Powers Granted Under Chapter 11

[1] Automatic Stay

The Bankruptcy Code assists the debtor in the reorganization process by providing the debtor with many powers that do not exist under state law. For example, section 362(a) of the Bankruptcy Code, which provides for an automatic stay of litigation against the debtor and for the enforcement of liens against the property of the estate,[26] allows the debtor time to reorganize assets and to renegotiate contracts. Under section 362(a) of the Bankruptcy Code, the following actions are stayed by a bankruptcy filing:[27]

> (1) the commencement or continuation of any proceeding (judicial or otherwise) to recover a claim against the debtor that arose before the commencement of the case . . .; (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case . . .; (3) any act to obtain possession of the property of the estate . . .; (4) any act to create, perfect, or enforce against property of the debtor any lien against property of the estate; (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case . . .; (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case . . .; (7) the setoff of any debt owing to the debtor that arose before the commencement of the case . . . against any claim against the debtor; and (8) the commencement or continuation of a proceeding before the U.S. Tax Court concerning the debtor.[28]

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[25] 11 USC §507 (1988).

[26] Property is broadly defined as all legal and equitable interests of the debtor, as of the commencement of the proceeding. 11 USC §541(a)(1) (1988).

[27] See §23.05 “Automatic Stay” and §23.06[4][g] “Requirements of Adequate Protection and Relief from the Stay” *supra*.

[28] 11 USC §362(a) (1993).

[2] Preferential Transfers and Fraudulent Transfers

Section 547(b) of the Bankruptcy Code provides for the recovery of preferential transfers and fraudulent conveyances.[29] When debtors know that their financial problems are worsening, they will often prefer one creditor over another to keep an essential service or to reduce a debt which is personally guaranteed by a partner or shareholder. Therefore, the Bankruptcy Code tries to eliminate the potential for creditors to race to improve their positions shortly before a filing. As a result, under section 547(b) the debtor or a trustee may set aside any transfer to a creditor that was made within ninety days of the filing of the bankruptcy petition on account of an antecedent debt if the debtor was insolvent at the time of the transfer and the transfer gives the creditor more than the creditor would obtain in a Chapter 7 liquidation. A transfer would include a cash payment to the creditor as well as the perfection of a security interest or the obtaining of a lien.[30] If the transfer is made to or benefits an insider,[31] provided that the debtor was insolvent at the time of the transfer and that the transfer gives the creditor more than the creditor would obtain in a Chapter 7 liquidation absent the transfer, the debtor may set aside any such transfer that occurred within one year prior to the bankruptcy filing, subject to the 1994 Reform Act amendments regarding *DePrizio* payments to noninsider creditors.[32] Typically, only unsecured creditors receive preferential transfers because fully secured creditors would receive full payment in a Chapter 7 liquidation unless their security interests were granted during the preference period. If the transfer is set aside, the debtor and the creditor are put back in the positions that they held prior to the transfer.

[3] Subordination on Equitable Grounds—§510(c)

The Bankruptcy Code also permits the bankruptcy court to subordinate, on equitable grounds, all or part of a lender's allowed claim or interest, to transfer any lien securing a subordinated claim to the bankruptcy estate, or to disallow the claim

[29] See Chapter 25 "Bankruptcy—Trustee's Avoiding Powers" *infra*. To constitute a preferential transfer, the transfer must be made for the benefit of a creditor, made for or on account of an antecedent debt, made while the debtor was insolvent, and made to enable the creditor to obtain more than the creditor would have received in a Chapter 7 liquidation had the transfer not been made. 11 USC §547(b) (1988). Under §548 of the Bankruptcy Code, fraudulent conveyances may be set aside if they are made within one year prior to the filing of a petition in bankruptcy. To constitute a fraudulent transfer under §548, the transfer must be made with actual intent to hinder, delay, or defraud a creditor. *Id*. §548(a)(1) (1993). A transfer can also be fraudulent if it was made for less than a reasonable equivalent value and if the tranferor (1) was insolvent at the time of the transfer, (2) became insolvent because of the transfer, (3) was engaged in a business that maintained an unreasonably low level of capital, or (4) intended to incur debts beyond its ability to pay. *Id*. §548(a)(2). The purpose of §548 is to avoid the debtor's ability to transfer assets (often to relatives or related entities) in order to protect assets from being included in the debtor's estate and, therefore, subject to the claims of creditors. Fraudulent conveyances may also occur under the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act because §544 gives the debtor or the trustee the status of a creditor as of the date of the petition. The debtor or trustee may have a time period of four or six years to assert such a claim, depending on state law.

[30] 11 USC §101(54) (1988).

[31] *Id*. §101(31) (1993).

[32] *Id*. §547(b)(4)(B)-(b)(5)(A) (1993) (amended 1994).

entirely, in the appropriate circumstances, even if no preferential transfer or fraudulent transfer has occurred.[33] The bankruptcy court generally invokes these sanctions when the lender has engaged in overreaching or lender control, which occurs when the lender steps beyond the traditional role of a lender and participates in the debtor's business or engages in other egregious conduct that justifies the use of the court's equitable powers.[34] In these situations, a court may decide to subordinate

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[33] *Id*. §510(c) (1993). See Chapter 26C "Bankruptcy—Equitable Subordination" *infra*.

[34] See United States v. Noland, 116 S. Ct. 1524 (1996) (reversing and remanding decision by Sixth Circuit that IRS penalty claim was subject to equitable subordination under section 510(c) notwithstanding absence of misconduct by IRS); Pepper v. Litton, 308 U.S. 295 (1939) (ruling that the bankruptcy court has exclusive jurisdiction over subordination, allowance, and disallowance of claims, and that the court may reject a claim in whole or in part according to the equities of each case); Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.), 2 F.3d 128 (5th Cir. 1993) (finding sufficient evidence of inequitable conduct when an insider with full knowledge that the debtor was undercapitalized and insolvent advanced funds to the debtor in the form of loans when no other third party lender would have don so); Cosoff v. Rodman (In re W.T. Grant Co.) 699 F.2d 599 (2d Cir. 1983) (distinguishing between the severity of the conduct required for equitable subordination of fiduciary claims and nonfiduciary claims), *cert. denied*, 464 U.S. 822 (1985); Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d (5th Cir. 1977) (describing the three-part test for equitable subordination that was superseded in part by §510(c) as stated in Diasonics, Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990); Rodolakis v. Chertoff (In re 1236 Dev. Corp.), 188 B.R. 75, 82 (Bankr. D. Mass. 1995) (stating that the trustee has the burden of producing sufficient evidence of a prima facie case of equitable subordination of a creditor's claim, after which the burden shifts to the claimant to prove the fairness and good faith of the challenged transaction); 80 Nassau Assocs. v. Crossland Sav. Bank (In re 80 Nassau Assocs.), 169 B.R. 832, 820 (Bankr. S.D.N.Y. 1994) (holding that claim of a noninsider fiduciary in a commercial case can only be subordinated based on inequitable conduct, if the claimant has substantially breached a duty arising under contract, tort, or other area of law); Aluminum Mills Corp. v. Citicorp N. Am., Inc. (In re Aluminum Mills Corp.), 132 B.R. 869 (Bankr. N.D. Ill. 1991) ("The quality of conduct considered to be 'inequitable' under §510(c) depends on the nature of the legal relationship between the creditor and the debtor"); Ambassador Riverside Inv. Group v. Namer (In re Ambassador Riverside Inv. Group), 62 B.R. 147 (Bankr. M.D. La. 1986) (subordinating a mortgagee's $4 million first mortgage on equitable principles because the mortgagee's agent misrepresented the availability of a construction loan and a take-out loan); Bank of New Richmond v. Production Credit Assoc. (In re Osborne), 42 B.R. 988 (Bankr. W.D. Wis. 1984) (holding that a mortgagee's secured claims were subordinate to the unsecured claims of a trade creditor as a result of the mortgagee's misrepresentations regarding the debtor's ability to pay the trade creditor); In re Werth, 37 B.R. 979 (Bankr. D. Colo. 1984) (finding that an oral loan agreement existed and that the mortgagee had breached the agreement; the court disallowed the mortgagee's claim in full), *aff'd*, 54 B.R. 619 (Bankr. D. Colo. 1985); Bergquist v. First Nat'l Bank (In re American Lumber Co.) 5 B.R. 470 (Bankr. D. Minn. 1980) (ruling that because of the mortgagee's control of the mortgagor's plant and cash disbursements, the mortgagee had received a voidable preference; the court entered judgment against the mortgagee, subordinating the mortgagee's claim to other creditors); In re After Six, Inc., 177 B.R. 219, 227, 232 (Bankr. E.D. Pa. 1995) (holding that the fact that the lender sought to advance its own legitimate interests contrary to those of other creditors did not render the lender's actions unconscionable; the court noted that the Uniform Commercial Code prohibition against commercially unreasonable dispositions of collateral does not apply to "the creation or transfer of an interest in real estate"); In re Just For the Fun of It of Tennessee, Inc., 7 B.R. 166, 180-81 (Bankr. E.D. Tenn. 1980) ("before a creditor's claim may be disallowed or its status lowered, it must appear that the creditor has been guilty of some breach of duty or misrepresentation whereby other creditors were deceived to their damage"; the court noted that equitable subordination is available to ensure that the debtor's assets are distributed fairly among creditors); In re Dry Wall Supply, Inc., 111 B.R. 933, 937-39 (Bankr. D. Colo. 1990) (rejecting equitable subordination based on allegations that the creditor knew that the loan transaction would render the borrower insolvent); In WCC Holding Corp., 171 B.R. 972, 988 (Bankr. N.D. Tex. 1994) (finding that a lender's claim cannot be subordinated on the basis of the debtor's undercapitalization of or because the lender should have known that the company would fail); In re

or to disallow a transaction that would not constitute a fraudulent transfer under section 548 or a preferential transfer under section 547.[35] A claim for equitable subordination must be brought by an adversary proceeding, and may generally be initiated only by a trustee or debtor in possession unless a bankruptcy court authorizes another party to initiate such a proceeding.[36]

[4] Fraudulent Transfers

A debtor may transfer assets before the bankruptcy filing, often to relatives or related entities, to protect these assets from the claims of creditors. Under section 548 of the Bankruptcy Code, any transfer by the debtor for inadequate consideration, made within one year (most state laws provide for a longer period) of the bankruptcy filing date, while the debtor was insolvent, or which rendered the debtor insolvent, may be set aside as a fraudulent transfer.[37] The property would then be transferred back to the estate, subject to a lien for whatever price was paid for the asset.[38]

Holywell Corp., 913 F.2d 873, 880-81 (11th Cir. 1990) (holding that with respect to an insider, once some inequity has been demonstrated, the burden then shifts to the insider to demonstrate the underlying fairness of the transaction); Helen D. Chaitman, *The Equitable Subordination of Bank Claims*, 39 Bus. Law. 1561 (1984) (exploring the doctrine as applied to bank creditors and the available remedies); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417 (1985) (providing a discussion of equitable subordination and its application to nonmanagement creditors).

[35] Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.), 990 F.2d 551 (10th Cir. 1993); Kahm & Nate's shoes No. 2, Inc. v. First Bank, 908 F.2d 1351 (7th Cir. 1990); Smith v. Associates Commercial Corp. (In re Clark Pipe & Supply Co.), 893 F.2d 693 (5th Cir. 1990); Holt v. FDIC (In re CTS Trust, Inc.), 868 F.2d 146 (5th Cir. 1989); Wood v. Richmond (In re Branding Iron Steak House), 536 F.2d 299 (9th Cir. 1976); Unsecured Cred. Comm. V. Pioneer Commercial funding Corp. (In re Pacific Express, Inc.), 69 B.R. 112 (Bankr. 9th Cir. 1976); In re Paolella & Sons, Inc., No. 86-00495F, 1991 Bankr. LEXIS 1181, at *46 (Bankr. E.D. Pa. 1991); Pinetree Partners, Ltd. v. Retirement Sys. (In re Pinetree Partners, Ltd.), 87 B.R. 481 (Bankr. N.D. Ohio 1988); In re Technology for Energy Corp., 56 B.R. 307 (Bankr. E.D.N.Y. 1983). See also Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 293 (1982) (discussing equitable subordination under §510). There is an emerging view that courts may invoke §510(c) without any proof of inequitable conduct. See, for example, In re Virtual network Servs. Corp., 902 F.2d 1246 (7th Cir. 1990) (holding that the subordination of nonpecuniary tax law claims of the Internal Revenue Service (IRS) was warranted even though the IRS's actions were within the law; the court stated that equitable subordination no longer requires, in all circumstances, a showing of inequitable conduct on the part of a creditor whose claims are to be subordinated); In re Vitreous Steel Prods. Co., 911 F.2d 1223 (7th Cir. 1990) (ruling that the lower court on remand should consider all the circumstances in determining whether a mortgagee's claim should be subordinated to the claims of general creditors; the court stated that, in regard to *Virtual Network Services*, it would not be necessary to find that a mortgagee engaged in misconduct, and that the inquiry should focus on "fairness to the other creditors"); In re Kelton Mortors, Inc., 121 B.R. 166 (Bankr. D. Vt. 1990) citing with approval, In re Virtual Net. Servs. Corp.); In re new Era Packaging, Inc., 186 B.R. 329, 335 (Bankr. D. Mass. 1995) ("[W]hile the legislative history states that a bankruptcy court is authorized to subordinate a claim by reason of the claimant's misconduct . . ., it also suggests that a bankruptcy court's power to subordinate a claim on equitable grounds is more extensive.").

[36] In re 9281 Shore Rd. Owners Corp., 187 B.R. 837, 852 (Bankr. E.D.N.Y. 1995).

[37] See Chapter 25, §25.03 "Voidable Fraudulent Conveyances" *infra*.

[38] 11 USC §548(a) (1988).

Inadequate consideration would not apply to sales at the market price that would generally benefit creditors and are not voidable.

The Bankruptcy Code fraudulent transfer provision applies not only to transfers made by the debtor within one year before the commencement of the bankruptcy case, but also incorporates state law fraudulent conveyance statutes.[39] In Illinois, for example, the period for setting aside a state fraudulent transfer is four years.[40] In single asset real estate cases, fraudulent conveyance or fraudulent transfer statutes may be of particular use when the debtor, during the fraudulent transfer period, makes distributions to partners even though the debtor is otherwise insolvent.

[5] Rejection of Unexpired Leases and Executory Contracts

Under Chapter 11, the trustee may reject unexpired leases and executory contracts that are not economically favorable to the debtor.[41] Generally, while the lease or contract will no longer be enforceable, the nondebtor contracting party retains an unsecured claim for damages against the estate.

[6] Debtor Use of Assets—Adequate Protection

A Chapter 11 bankruptcy permits debtors to use, in the ordinary course of business, all of their assets, including the collateral of the secured lenders, even though the secured lenders are stayed from collecting their debts or enforcing their rights and remedies. However, a lender's security interests in real estate, cash, and other assets must be adequately protected by the debtor against any decline in value during the bankruptcy case.[42] In a multiasset, going concern case, a Chapter 11 bankruptcy generally preserves the debtor's assets as a group, allowing the debtor to maintain jobs for the debtor's employees and enhancing the value of the debtor's

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[39] *Id*. §544(a)-(b) (1993). State fraudulent conveyance statutes do not require that the transfer be made within one year prior to the filing of the petition in bankruptcy because the action is independent of bankruptcy. However, if the trustee elects to proceed under state fraudulent conveyance laws, state statutes of limitation control.

[40] 740 Ill Comp. Stat. 160/10 (West 1996). The Uniform Fraudulent Transfer Act (UFTA) 7A U.L.A. 643 (1985) which has been adopted by Illinois and a majority of other states, contains its own statute of limitation. Under sections 9(a) and 9(b) the UFTA extinguishes any claim not brought within four years after the transfer was made or the obligation was incurred. Under Section 9(c) challenges to insider preferences must be brought within one year. Because the substantive claim terminates at the end of a specified time period, a bankruptcy trustee or an agent of the federal government, such as the IRS, may be barred from asserting remedies under the UFTA after the expiration of the specified time period even though general statutes of limitation are unenforceable against the federal government in some cases.

[41] 11 USC §365(a) (1988). See Chapter 26 "Bankruptcy—Effect on Leases and Executory Leases" *infra*.

[42] See §24.06[1][c] "Relief from Automatic Stay" *infra*. Adequate protection may require payments of cash, additional or replacement liens, or any other relief that will adequately protect the value of the property that is securing a claim or interest in property. The debtor is required, under §363(a) of the Bankruptcy Code, to provide for protection of the secured creditor's interest in the property. Failure to so provide is a ground, or cause, for relief from the automatic stay under §362. If the lender is oversecured, the equity cushion may serve as adequate protection. 11USC §§362, 363 (1993).

assets. Chapter 11 bankruptcy allows this type of preservation because assets are generally worth more as part of a going concern.

§24.04 Economic Benefits to Debtor

Use of Chapter 11 enables a debtor to recognize a variety of economic benefits with almost no downside to the debtor. A debtor may use bankruptcy as a means of obtaining capital discounts,[43] as a means of extending the time to repay, and as a way to modify certain mortgage provisions, such as due-on-sale, default, and prepayment provisions. When there is illiquidity of capital markets, bankruptcy is a convenient way to compel a refinancing. The lender may consent to this refinancing or, under certain circumstances, the refinancing may be crammed down[44] on the lender when the lender disagrees with the terms.

Chapter 11 bankruptcy protects the franchise and fee income of current management, including legal fees. This protection continues until relief from the automatic stay is obtained or until the lender is able to convince the court that such expenses are not arms' length, reasonable, beneficial to the creditors of the bankruptcy estate, or necessary for preservation of the collateral.

Chapter 11 bankruptcy also provides protection from market forces. Some bankruptcy judges may be inclined to play an activist role and attempt to pressure the parties to settle. The court's leverage consists of tactics such as granting the debtor's requests for continuances, allowing professional fees, including attorneys' fees, that are incurred by the debtor, extending the exclusivity period for filing a plan,[45] denying adequate protection payments, and threatening a court-imposed cram down.

One should also consider a variety of other benefits that Chapter 11 bankruptcy provides for debtors. For example, the bankruptcy process is self-financing if there are unencumbered assets. Administrative and priority claims, including the debtor's legal costs, often have top priority for repayment by the estate.[46] Unsecured creditors have second priority.[47] Bankruptcy also provides for the cancellation of debt and interest expense. Unmatured interest claims on unsecured or undersecured debt are not allowed subsequent to the filing of the bankruptcy petition.[48] Second mortgage lenders often become unsecured lenders who must share whatever encumbered assets remain. Finally, general partners may gain protection against claims by their limited partners. General partners often interpret their fiduciary duties toward their limited partners as requiring

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[43] A capital discount is the re-writing of debt to market rates that are usually lower or more favorable to the debtor.

[44] In a cramdown, a plan may be confirmed by the court even though a class of creditors does not vote to accept the plan, provided that the plan complies with §1129(b). The plan must not discriminate unfairly and must be fair and equitable to each class of impaired creditors, including those that have not accepted the plan. 11 USC §1129(b) (1993) (amended 1994).

[45] Under §1121(b) of the Bankruptcy Code, the debtor has the exclusive right to develop and to file a disclosure statement and a plan of reorganization in the 120-day period after the commencement of the case. Upon the filing of the plan, the debtor is granted an additional sixty days to obtain confirmation under §1121(c)(3). 11 USC §1121(b), (c) (1993).

[46] 11 USC §507(a)(1).

[47] 11 USC §507(a).

[48] 11 USC §502(b)(2) (1994).

them to pursue the best business outcome of the investment and to delay tax recapture. By resorting to bankruptcy the general partners may be able to fulfill this duty by protecting the investment.

§24.05 Who Controls the System

The bankruptcy judge, subject to ambiguous statutory restrictions, ultimately determines the viability and fairness of the debtor's reorganization plan. Judges may make these decisions without considering the votes of certain classes of impaired creditors if at least one class of impaired, noninsider creditors votes for confirmation of the plan.[49]

The federal bankruptcy system consists of four levels of courts. The first level contains the federal bankruptcy courts.[50] Each state has one or more federal judicial districts. For example, New York has a Southern District and a Northern District, Illinois has a Southern District and a Northern District, Pennsylvania has an Eastern District and a Western District, Massachusetts has only one district, and California has four or more districts. Local bankruptcy judges are nominated by judicial conference, which is a panel of their peers and are appointed by the U.S. Court of Appeals for fourteen-year terms. Bankruptcy court decisions may be appealed to the U.S. district courts, or to a bankruptcy appellate panel (BAP) in circuits with BAPs, and thereafter to the U.S. Courts of Appeals. Finally, the cases may be appealed to the U.S. Supreme Court.

Most bankruptcy judges state that they are bound only by decisions that have been handed down by the U.S. Supreme Court and their respective circuit court of appeals. Cases from other circuit courts, from other district courts, and even from other bankruptcy courts within the same district, may be persuasive, but are not binding on bankruptcy judges. In most courts, bankruptcy judges are assigned cases randomly, with one case rotating to each judge as the cases are filed.

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[49] 11 USC §1129(a)(10). In a cramdown, a plan may be confirmed by the court even though a class of creditors does not vote to accept the plan, provided that the plan complies with §1129(b). The plan must not discriminate unfairly and must be fair and equitable to each class of impaired creditors, including those that have not accepted the plan. 11 USC §1129(b).

[50] The Bankruptcy Code divides claims in bankruptcy proceedings into the categories "core" and "noncore" (or "related"). In re Manville Forest Prods. Corp., 896 F.2d 1384, 1389 (2d Cir. 1990). Bankruptcy judges have the authority to "hear and determine all . . . core proceedings arising under title 11 . . . and may enter appropriate orders and judgments, subject to review under section 158 of [title 28]." 28 USC §157(b)(1). See Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598 (1982). With respect to noncore claims, unless the parties consent, the bankruptcy court can only make recommended findings of fact and conclusions of law which are subject to de novo review in the district court. 28 USC §§157(c)(1) and (2). Section 157 sets forth a nonexhaustive list of "core proceedings," including such obvious matters as "allowance[s] or disallowance[s] of claims," 28 USC §157(b)(2)(B), as well as matters more relevant to this case, namely: "matters concerning the administration of the estate" and "other proceedings affecting the liquidation of the assets of the estate," 28 USC §157(b)(2)(A), (O). S.G. Phillips Constructors, Inc. v. City of Burlington, Vt., 45 F.3d 702, 704 (2d Cir. 1995). See §23.02[2] "Jurisdiction of Bankruptcy and District Courts."

Section 157(c) of title 28, United States Code was amended by the Bankruptcy Reform Act of 1994 to clarify that bankruptcy judges may conduct jury trials if specially designated to exercise such jurisdiction by the district and with the consent of all parties. See §23.03[4] "Right to Conduct Jury Trials." Because of the requirement of consent, it is doubtful that many jury trials will be conducted.

The second level of the federal bankruptcy system consists of the U.S. district courts.[51] There is one district court for each federal judicial district. District court judges hear civil and criminal cases that are filed in their courts, and only a small percentage of their time is spent on bankruptcy appeals. Where the circuit has instituted a BAP consisting of three bankruptcy judges from the circuit, the district courts are replaced as the first level of bankruptcy appeals. The Ninth Circuit was the first to establish a BAP. The 1994 Reform Act requires that all circuits establish a BAP unless there are insufficient resources to do so.[52] The Act further provides that a bankruptcy judge serving on a BAP may not hear an appeal that originated in the district for which such judge is appointed or designated.[53] All parties must consent to a BAP appeal. Thus, a party may elect to appeal to the district court and bypass the BAP.

Finally, the federal bankruptcy system consists of twelve U.S. courts of appeals, including the D.C. Court. A party can apply to any court of appeals in its circuit as a matter of right, but further appeals to the U.S. Supreme Court are, of course, discretionary.

§24.06 General Overview of the Bankruptcy Process

[1] Filing Petitions, Early Motions, and Responses

The debtor begins the process by filing a simple petition for relief under the U.S. Bankruptcy Protection laws. Immediately, secured creditors of the debtor must consider their responses to the filing or to the debtor's successive motions. A variety of motions are commonly filed.

For example, a debtor can file a motion for the use of cash collateral. When a debtor must continue to operate an ongoing business, usually the debtor immediately files a motion to use cash collateral such as rents and receivables for operating expenses and reorganization costs. Indeed, cash or cash equivalents are the only type of collateral for which the debtor must receive either the secured creditor's consent or the bankruptcy court's approval *before* the debtor may use it. Immediately following the debtor's motion for the use of cash collateral, a lender who has a security interest in the cash collateral will customarily object on the basis that the security interest is not adequately protected.

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[51] The district courts have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11. 28 USC §1334(b). See also §23.03[2] "Jurisdiction of Bankruptcy and District Courts." The district court in the interest of justice, or in the interest of comity with State courts or respect for State law, is not prevented from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11. 28 USC §1334(c)(1). See §23.03[2] "Abstention."

[52] 28 USC §158(b)(1)(A) (1994).

[53] 28 USC §158(b)(5), *as amended by* §104 of the 1994 Reform Act.

[a] Assignment of Rents and Use of Cash Collateral

Cash collateral is cash or cash equivalents that the debtor receives in which the lender has a security interest.[54] Thus, the debtor is restricted from using the cash unless the lender consents to such use or the court finds that the lender's security interest in the cash is adequately protected.[55] When a mortgagee has previously recorded a mortgage or assignment of rents, the cash should be the mortgagee's collateral in most real estate bankruptcy cases. Prior to the passage of the 1994 Reform Act, perfection of the lender's assignment of rents under applicable state law was often an issue for determination under section 552 of the Bankruptcy Code.[56] In addition to recording a security interest in the rents, some courts held that, under applicable state law, before a security interest in the rents would be deemed perfected, a secured creditor was required to take additional action prior to the commencement of the bankruptcy case, such as notifying the tenants, taking possession of the property, or obtaining the appointment of a receiver.[57] In these jurisdictions, postpetition rents were not considered to be

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[54] See §24.11 "Obtaining an Interest in Cash Collateral" *infra*.

[55] 11 USC §363(a) (1988). The Bankruptcy Code does not define adequate protection. Instead, it sets forth three examples of adequate protection in §361 that are not intended to be exclusive or exhaustive. The first method of adequate protection consists of a cash payment or periodic cash payments to an entity that is holding an interest in property of the bankruptcy estate to the extent of a decrease in such entity's interest in the property. The second method requires the debtor to provide an addition or replacement lien on the property to the extent of the decrease in the value of such property. The third method gives the parties and the courts flexibility by allowing such other relief (other than an administrative expense priority) as will result in the realization by the protected entity of the "indubitable equivalent" of its interest in such property. The House Report, which is part of the Bankruptcy Code's legislative history, states the following regarding §361:

> The section, and the concept of adequate protection, is based as much on policy grounds as on constitutional grounds. Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy law. Thus, this section recognizes the availability of alternate means of protecting a secured creditor" interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 338-39 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6295. See also In re Vienna Park Properties, 112 B.R. 597 (Bankr. S.D.N.Y. 1990), *aff'd*, 976 F.2d 106 (2d Cir. 1992) (holding that a creditor with an assignment of rents had an absolute right to the possession of the encumbered property upon default). See *supra* §24.03[6] "Debtor's Use of Assets-adequate Protection" (briefly defining adequate protection).

[56] The confusion and inconsistency throughout the federal courts regarding the question of when a creditor had obtained a perfected interest in property rents was created in part by the Supreme Court's opinion in Butner v. United States, 440 U.S. 48 (1979). In *Butner*, the Court held that the issue of the real property rents in bankruptcy cases should be determined by reference to the applicable state law.

[57] Left unresolved between and within the states is the issue of whether possession (or some other affirmative action, such as the appointment of a receiver) is a method of perfection or of making a perfected lien choate, that is, whether possession merely enforces or activates the lien so that the mortgagee is entitled to collect the rents. See In re Cadwell's Corners Partnership, 174 B.R. 744 (Bankr. N.D. Ill. 1994) (holding that perfection obtained by recording the mortgage or the assignment of rents establishes priority without a determination of the title of the rents); 5028 Wis. Ave. Assocs. Ltd. Partnership v. Copy King, Inc. (In re 5028 Wis. Ave. Assocs. Ltd. Partnership), 167 B.R. 699, 704 (Bankr. D.C. 1994) (concluding that possession makes a perfected lien choate); In re KNM Roswell Ltd.

Partnership, 126 B.R. 548, 552-53 (Bankr. N.D. Ill. 1991) (holding that possession makes a perfected lien choate); In re Coventry Commons Assocs., 143 B.R. 837, 838 (Bankr. E.D. Mich. 1982) (holding that the mortgagee had a perfected security interest in the rents at the time that the assignment of rents document was recorded but that the mortgagor retained an interest in the rents under state law until such time as the mortgagee completed all of the necessary five steps under Michigan law for complete enforcement); cf. In re Strouse Greenberg Properties V, Ltd.., No. 95-10461DAS, 1995 WL 115880 (Bankr. E.D. Pa. Mar. 9, 1995) (holding that, under applicable state law, rents are the property of the debtor's estate as well as cash collateral of the mortgagee when the mortgagee has merely a prepetition security interest in the rents); Bullard v. Turner, 192 N.E. 223, 225 (Ill. 1934) (finding that possession is equivalent to recording as a means of perfection). See generally Bonnie K. Donahue & David Edwards, *The Treatment of Assignments of Rents in Bankruptcy: Emerging Issues Related to Perfection, Cash Collateral, and Plan Confirmation*„ 48 Bus. Law 633 (1993) (providing an overview of assignment of rents and the effects of bankruptcy on a secured creditor); Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents As Security for the Mortgage Loan*, 46 Rutgers L. Rev. 349 (1993) (arguing that rents should be treated as accounts in bankruptcy); Patrick Randolph, *Recognizing Lender's Rents Interests in Bankruptcy*, 27 Real Prop. Prob. & Tr. J. 283 (1992) (discussing the effect of bankruptcy on a secured lender's right to collect rents).

The perfection of a lien places third parties on notice that the mortgagee has an interest in the rents that is superior to that of other secured creditors. Perfection thus establishes priority but not a determination as to title and the right to possession of the rents, as between the parties, to the recorded security instrument. In Illinois, for example, perfection is attained through recordation, obtaining possession through foreclosure proceedings, or obtaining a recorded notice of foreclosure that provides constructive notice of a lien on the property. Cadwell's Corners, 179 B.R. at 754. See also In re Century Inv. Fund VIII Ltd. Partnership, 937 F.2d 371 (7th Cir. 1991); Jones v. Salem Nat'l Bank (In re Fullop), 6 F.3d 422, 430 (7th Cir. 1993).

The Illinois cases uniformly recognize that a mortgagee must either obtain the appointment of a receiver, obtain possession of the property through foreclosure or a deed in lieu of foreclosure or obtain an injunction or other court authorization to enforce or to activate the mortgagee's perfected right to collect the rents from the mortgagor. See In re Wheaton Oaks Office Partners ltd. partnership, 27 F.3d 1234, 1243 (7th Cir. 1994) (holding that a mortgagee had a valid prepetition security interest in rents, and that the rents constituted cash collateral); Bank of Edwardsville v. J.D. Monarch Dev. Co. (In re J.D. Monarch Dev. Co.), 153 B.R. 829, 832-33 (Bankr. S.D. Ill. 1993) (concluding that the bank was entitled to adequate protection for its security interest in rents collected); Bellevue Place Assocs. v. Caisse Centerale Des Barquis Populaires (In re Bellevue Place Assocs.), Case No. 94-B-9270, Adv. No. 94-A-00891, 1994 WL 612328 at *13 (Bankr. N.D. Ill. Nov. 1, 1994); Comerica Bank Ill. V. Harris Bank Hinsdale, Nos. 94-CH-4616 & 94-CH-7059, 1996 Ill. App. LEXIS 826 (Ill. App. Ct., 4th Div., Nov. 7, 1996); Kelley/Lehr & Assocs., Inc. v. O'Brien, 551 N.E.2d 419, 414 (Ill. App. Ct. 1990) (ruling that a mortgage does not allow a mortgagee to collect rents until the mortgagee actually takes possession of the property). Other jurisdictions also require that certain steps must be taken by the mortgagee, in addition to the recording of the mortgage or the assignment of rents instrument, before it will be entitled to collect the rents from the property. See In re Lyons, 193 B.R. 637, 649 (Bankr. D. Mass. 1996); In re McCann, 140 B.R. 926, 927 (Bankr. D. Mass. 1992); In re Ashford Apartments Ltd. Partnership, 132 B.R. 217, 219 (Bankr. D. Mass. 1991). The unique nature of an assignment of rents has led some courts to misconstrue the term "perfect" and to use it when actually referring to enforcement or to activation of the right to collect rents. For example, if a mortgagee records an assignment of rents, the lien created thereby is perfected as to intervening lien creditors who are charged with constructive notice of the lien as of the recording date. See FirstSouth F.A. v. LaSalle Nat'l Bank, 766 F. Supp. 1488, 1489 (N.D. Ill. 1991) (holding that under Illinois law, the recording date of a mortgage controls for purposes of determining the priority of security interests). The mortgagee must then take the additional step of being placed in actual possession or constructive possession, through a receiver, of the property before the mortgagee is entitled to actually collect the rents. The perfection issue is crucial when determining the priority of competing liens and the avoiding powers of a trustee or debtor-in-possession under §544 of the Bankruptcy Code. If a mortgagee fails to properly perfect its lien on rents, then a trustee or debtor-in-possession, who succeeds to the position of a hypothetical lien creditor under §544 of the Bankruptcy Code, can avoid the

subject to the prepetition mortgage or to the assignment of rents and, therefore, were not subject to the Bankruptcy Code's special restrictions on the use of cash collateral. As a result, the debtor would often argue that the security interest in the cash was not perfected under applicable state law and that the debtor should be able to use the cash to pay expenses incurred in the ordinary course of business without having to provide adequate protection to the creditor claiming a security interest in the rents. The lender would argue against the debtor's use of the collateral at the cash collateral hearing or during out-of-court negotiations for a stipulation on the interim use of cash. Section 218 of the 1994 Reform Act has eliminated the uncertainty resulting from case law that failed to recognize a creditor's continuing interest in rents subsequent to the commencement of a debtor's bankruptcy case. State law regarding perfection is now inapplicable if the debtor and creditor entered into a prepetition security agreement covering rents from the debtor's property and if the agreement was properly recorded.[58]

[b] Jurisdiction and Venue

After the debtor files the Chapter 11 bankruptcy petition, the creditors commonly file motions improper venue or jurisdiction. The bankruptcy court has broad discretion to either retain jurisdiction or transfer the case to another venue. In making its determination, the court considers the following factors: (1) the location of the property; (2) the domicile of the managing general partner or the limited partners; (3) the domicile of the creditors; (4) where the debtor was originally organized or currently does business; (5) the interests of justice; and (6) the convenience of the parties.[59] Obviously, debtors attempt to select a venue with the most prodebtor judge. Motions to change venue or to dismiss for lack of

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lien, and the mortgagee then becomes a general creditor of the estate. Cadwell's Corners, 174 B.R. at 753.

[58] 11 USC §552(b)(2) (1988), *as amended by* §214 of the 1994 Reform Act. Section 552(b)(2) provides that if the debtor and an entity enter into a security agreement before the bankruptcy filing, and the security interest created by the security agreement extends to the rents (including hotel revenues) of the property, then the security interest extends to all postpetition rents to the extent provided in the agreement, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

[59] Determinations of venue motions are left to the discretion of the trial court. Gulf States Exploration Co. v. Manville Forest Products Corp. (In re Manville Forest Prods. Corp.), 896 F.2d 1384, 1390-91 (2d Cir. 1990); Vienna Park Properties, 128 B.R. at 373. A district court may transfer a case or a proceeding under chapter 11 to a district court for another district in the interest of justice or for the convenience of the parties. 28 USC §1412 (1994). The factors employed by courts in determining whether a transfer of venue is appropriate are set forth in Puerto Rico v. Commonwealth oil Refining Co. and are: (1) the proximity of all creditors to the court; (2) the proximity of the debtor to the court; (3) the proximity of witnesses necessary to administer the estate; (4) the location of the assets; (5) the economic administration of the estate; and (6) the necessity for ancillary administration in the event of liquidation. (In re Commonwealth Oil Refining Co.), 596 F.2d 1239, 1247 (5th Cir. 1979), *cert. denied*, 44 U.S. 1045 (1980).

jurisdiction are usually made within the first seven to ten days of the bankruptcy filing.[60]

[c] Relief from Automatic Stay

[i] In General Under §362(d)

In response to a creditor's motion for relief from the automatic stay, the court may grant relief under section 362(d) of the Bankruptcy Code if the debtor cannot provide adequate protection,[61] or if the creditor can successfully argue that there are other reasons for granting relief from the stay. For example, the creditor may argue that the value of the colateral is less than the amount of the debt and that the property is not necessary for a successful reorganization.[62] In other words, the debtor cannot propose a feasible reorganization plan even with the ownership and use of such collateral. Under the Bankruptcy Code, as amended by the 1994 Reofrm Act, the bankruptcy judge assigned to the case must hold a preliminary hearing on a relief-from-stay motion within thirty days of the filing date of the motion for relief. The final hearing on the motion must be *concluded* within thirty days after the preliminary hearing has ended, unless the parties consent to extend the period or the court orders an extension based on compelling circumstances, such as a participant's bona fide illenss or the occurrence of an event beyong the parties' control.[63]

[ii] Under §362(d)(3) as Single Asset Real Estate

In accordance with the 1994 reform Act, when single asset Chapter 11 real estate cases involve secured debts that do not exceed $4 million, the bankruptcy court must lift the automatic stay within ninety days of the filing date unless the debtor has filed a plan that has a reasonable possibility of being confirmed within a reasonable time or unless the debtor commences paying monthly interest to the secured creditor in an amount equal to the fair market interest rate on the secured claim.[64] The 1994 Reform Act also provides that a creditor may maintain or continue the perfection of prepetition security interests without violating the automatic stay. Therefore, filing a UCC

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[60] Fed. R. Bankr. P. 1014(a)(1) states:

> If a petition is filed in a proper district, on timely motion of a party in interest, and after hearing on notice to the petitioners, the United States trustee, and other entities as directed by the court, the case may be transferred to any other district if the court determines that the transfer is in the interest of justice or for the convenience of the parties.

[61] See §24.11[1] "Grounds for Relief" *infra*.

[62] See §24.11[1][d] "Relief due to No Equity, and the Property is Unnecessary for a Reorganization" *infra*.

[63] 11 USC §362(e), *as amended by* §101 of the 1994 Reform Act. Prior to passage of the 1994 Reform Act, the final hearing had to be *commenced* within thirty days after the conclusion of the preliminary hearing. *Id*.

[64] *Id*. §362(d)(3), *as amended by* §218 of the 1994 Reform Act. See Chapter 24D "Bankruptcy—Single Asset Real Estate Cases" *infra*.

Continuation statement[65] during bankruptcy will not violate the automatic stay.[66]

[2] Reorganization by Debtor or Trustee

The Chapter 11 reorganization can be administered by a court appointed trustee or by the debtor. After filing a Chapter 11 petition, debtors remain in control of their businesses unless creditors or other parties request that a bankruptcy court examine whether the management of the debtors' estates should be transferred to a trustee.[67] Debtors who continue to administer their businesses during the reorganization are referred to as debtors in possession (DIP). A motion for the appointment of a trustee is usually made by one or more creditors and often entails allegations of gross mismanagement, waste, fraud, or incompetence, if, for example, the DIP has failed to protect and conserve the property of the estate for the benefit of its creditors.[68] A trustee may be appointed for cause, or if such appointment is in the interest of creditors. Sufficient cause has been found to include: (1) fraud;[69] (2) the intent to provide inaccurate financial statements;[70] (3) the unauthorized transfer of property of the estate;[71] (4) the debtor's breach of fiduciary duties;[72] (5) failure to seek recovery

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[65] Morton V. National Bank, 866 F.2d 561 (2d Cir. 1989).

[66] 11 USC §362(b)(3) *as amended by* §204 of the 1994 Reform Act.

[67] *Id*. §1104(a) (1993).

[68] *Id*. §§1103(c)(4), 1104(a) (1993). See Sumitomo Trust & Banking Co. v. Holly's Inc. (In re Holly's Inc.), 140 B.R. 643, 686 (Bankr. W.D. Mich. 1992) (" 'cause' under §1104(a) focuses on the interests of the entire body of creditors"); In re Parker Grande Dev., Inc., 64 B.R. 557, 561 (Bankr. S.D. Ind. 1986) ("[t]he duties of a debtor in possession . . . include the duty to protect and to conserve property in his possession for the benefit of creditors"). The legislative history of §1104 states that "[t]he twin goals of the standard for the appointment of a trustee should be protection of . . . the interests of creditors and . . . facilitation of a reorganization that will benefit both the creditors and the debtors . . . ." H.R. Rep. No. 95-595, at 232-33 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192. A bankruptcy judge may appoint a trustee sua sponte in a Chapter 11 case, if the court finds the debtor engaged in fraudulent activities. Fukutomi v. United States Trustee (In re Bibo, Inc.), 76 F.3d 256 (9th Cir. 1995).

[69] See, *e.g.*, Wilmington Sav. Fund Soc'y v. 1025 Assocs., Inc. (In re 1025 Assocs., Inc.), 106 B.R. 805 (Bankr. D. Del. 1989) (stating that fraud might justify relief from the automatic stay under the Bankruptcy Code).

[70] 11 USC §523(a)(2)(B) (1993); see also Knoxville Teachers Credit Union v. Parkey (In re Parkey), 790 F.2d 490, 491-92 (6th Cir. 1986) (stating that discharge of debtor will be denied if debtor intended to deceive the bank); In re Grossman, 174 B.R. 972, 983 (Bankr. N.D. Ill. 1994) (quoting 11 USC §523 which prohibits debtor from being excused from debts obtained by a fraudulent writing); Hoffman & Kuhn, Inc. v. Branham (In re Branham), 126 B.R. 283, 287 (Bankr. S.D. Ohio 1991) (stating that use of a written statement that is materially false is an exception to discharge under the Bankruptcy Code; Modern Dist. V. Gray (In re Gray), 22 B.R. 676, 680 (Bankr. W.D. Wis. 1982) (stating that debts procured by means of a false financial statement shall not be discharged); 3 Collier on Bankruptcy ¶523,09[5][b] (15th ed. 1996); Alden State Bank v. Anderson (In re Anderson), 29 B.R. 184, 191 (Bankr. N.D. Iowa 1983) (stating that debtor's failure to notify creditor of falsity of reports is intent to deceive and an exception to discharge).

[71] See In re Bequette, 184 B.R. 327, 337 (Bankr. S.D. Ill. 1995) (stating that relief from the stay is not necessary when commencing tax deed proceedings); In re Baldwin, 91-50764, slip op. At 9-10 (Bankr. S.D. Ill., Nov. 21, 1991); In re Wells Properties, Inc., 102 B.R. 685, 691 n.3 (Bankr. N.D. Ill. 1989) (stating that an act to exercise control over property in bankruptcy may be stayed); Brand Assoc. v. CGR, Ltd. (In re CGR, Ltd.), 56 B.R. 305, 307 (Bankr. S.D. Tex. 1985).

of avoidable prepetition transfers;[73] (6) failure to abide by the orders of the bankruptcy court;[74] (7) gross mismanagement of the debtor's finances and financial affairs;[75] and (8) unreasonable delay in presenting a reorganization plan.[76]

Sufficient cause to appoint a trustee has not been found in the following instances: (1) When the debtor's management was knowledgeable, notwithstanding some evidence of mismanagement and the debtor had a good working relationship with employees and suppliers;[77] (2) when the bare allegations of misconduct were not supported by any factual showing;[78] and (3) when the only purpose of the motion was to have someone investigate intercompany transactions.[79]

[3] Involuntary Petitions

Like a secured creditor, an unsecured creditor may file an involuntary petition against a debtor. If the debtor has twelve or fewer creditors, only one creditor needs to sign the petition. Otherwise, three creditors must sign the petition and allege that

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[72] 11 USC §523(a)(4) (1993). See also Holly's Inc., 140 B.R. at 686 (stating that when a DIP breaches a fiduciary duty the remedy is to remove the debtor and install a trustee to run the estate); Nelson v. Tsamasfyros (In re Tsamasfyros), 114 B.R. 721, 724 (D. Colo. 1990); LSP Inv. Partnership v. Bennett (In re Bennett), 970 F.2d 138, 141 (5th Cir. 1992).

[73] See Hitt v. Glass (In re Glass), 164 B.R. 759, 765 (Bankr. 9th Cir. 1994) (stating that the action of the trustee was instrumental in securing the return of the estate of the fraudulently conveyed property), *aff'd*, 60 F.3d 565 (9th Cir. 1995); In re Sharon Steel Corp., 86 B.R. 455, 465 (Bankr. W.D. Pa. 1988) (holding that the fraudulent conveyance of property may cause the appointment of a trustee).

[74] Farmers & Merchants Bank & Trust v. Trail West, Inc., 28 B.R. 389, 394 (Bankr. D.S.D. 1983) (holding that failure to obey the orders of the bankruptcy court are sufficient grounds for vacating an automatic stay order).

[75] See In re New Era Co., 125 B.R. 725 (Bankr. S.D.N.Y. 1991) (focusing on whether alleged mismanagement by debtor contributed to a reduction in value of the secured creditor's collateral); Homestead Sav. & Loan Ass'n v. Associated Investors Joint Venture (In re Associated Investors Joint Venture), 91 B.R. 555, 556-57 (Bankr. C.D. Cal. 1988); Parker Grande Dev., Inc., 64 B.R. 557, 561 (Bankr. S.D. Ind. 1986) (stating that the DIP's past conduct must be scrutinized when determining whether a trustee can better accomplish the goals of Chapter 11); Powers Aero Marine Servs. v. Merrill Stevens Dry Dock Co. (In re Powers Aero Marine Servs., Inc.), 42 B.R. 540, 545-46 (Bankr. S.D. Tex. 1984) (stating that the instances of the debtor's mismanagement influenced the court to allow the receiver to remain in possession).

[76] See Holly's, Inc., 140 B.R. at 689; Schmidt Indus., Inc. v. Schreiber (In re Schreiber), 14 B.R. 1013, 1014 (Bankr. S.D. Fla. 1981) (holding that failure to file a plan as required by the Bankruptcy Code is bad faith).

[77] See In re Forest ridge, II, Ltd. Partnership, 116 B.R. 937, 946 (Bankr. W.D.N.C. 1990) (holding that "the property is not being presently mismanaged so as to constitute cause"); Homestead Sav. & Loan, Assoc. v. Associated Investors Joint Venture (In re Associated Investors Joint Venture), 91 B.R. 555, 556-57 (Bankr. C.D. Cal. 1988) (ruling for the debtor only on the alleged postpetition mismanagement); In re Sea Queen Kontaratos Lines, Ltd., 10 B.R. 609 (Bankr. D. Me. 1981).

[78] See Goya Foods v. Ulpiano Unanue-Casal (In re Ulpiano Unanue-Casal), 159 B.R. 90, 101 (Bankr. D. P.R. 1993), cf. Wilson v. Unioil (In re Unioil), 54 B.R. 192, 195 (Bankr. D. Colo. 1990) (stating that bare allegations are insufficient to satisfy the debtor's burden of proof); In re Highcrest Management Co., 30 B.R. 776, 778 (Bankr. S.D.N.Y. 1983) (holding that ample evidence in the record supposed lifting a stay).

[79] See Parent Creditors' Comm. V. LTV Corp. (In re Chateauguay Corp.), 120 B.R. 707, 711 (Bankr. S.D.N.Y. 1990) (holding that the bankruptcy court's failure to issue a final order prevents its decision from being appealed).

the debtor is generally not paying its debts when they become due. The petitioning creditor or creditors must have valid unsecured debts totaling at least $5,000.[80] The debtor must file an answer within twenty days. Then, the court will hold a hearing within ten days of the answer's due date to determine whether it should enter the order for relief.[81]

[4] Exclusive Period: Developing the Plan of Reorganization

[a] Term of Exclusive Period

During the first 120 days following the voluntary filing of a petition, the debtor has the exclusive right to develop and to file a reorganization plan and a disclosure statement disclosing all of the facts that are relevant to creditors and describing all assumptions that the debtor used in the plan.[82] If the court grants an order for relief in an involuntary filing, the 120-day period commences from the date of the order.[83] If the debtor files a plan within the 120-day period, the debtor is granted an additional sixty days to obtain confirmation of the plan.[84] During this period debtors and creditors ordinarily stake out the value of the collateral and the type and amount of the creditors' complaints concerning the tendency of bankruptcy courts to almost routinely grant debtor's extensions of the plan exclusivity period, the 1994 Reform Act allows a creditor to appeal as of right to the district court any order that increases or decreases the debtor's exclusivity period.[85]

[b] Proof of Claim

By the claim bar date, creditors must file a proof of claim that describes the amounts due and summarizes the collateral.[86] The proof of claim describes the status of the loan as of the petition filing date. Often, counsel may recommend distinguishing accrued interest at the contract rate from interest that is charged at the default rate. Default interest and other reasonable charges that are provided in the loan documents, including prepayment charges, will only be allowed

[80] 11 USC §303(b) (1994).
[81] *Id*. §303(d), (e) (1993).
[82] *Id.* §1121(b) (1993). Section 1121(d) provides that the court, for cause, may increase or decrease the length of the exclusivity period by motion of any party in interest. See, e.g., In re Don & Lin Trucking Co., 110 B.R. 562 (Bankr. N.D. Ala. 1990) (extending the exclusivity period on debtor's motion).
[83] 11 USC §1121(c)(2) (1994).
[84] *Id*. §1121(c)(3).
[85] Section 102 of the 1994 Reform Act, although not directly amending §1121 of the Bankruptcy Code, effectively amends 28 USC §158 to provide that parties may appeal, as a matter of right (rather than with leave of the district court) any orders and decrees that increase or reduce the time periods provided by §1121.
[86] 11 USC §501 (1994); Fed. R. Bankr. P. 3001, 3002.

postpetition to the extent that the secured creditor has a claim that is oversecured at the time of that filing.[87]

[c] Separation of Debt into Secured and Unsecured Claims

The bankruptcy process treats undersecured creditors differently from secured creditors. Under the Bankruptcy Code, an undersecured creditor, a creditor whose debt exceeds the value of the collateral, has two claims against the debtor's estate: (1) a secured claim in an amount equal to the value of the collateral, and (2) an unsecured recourse claim for the remainder of the debt.[88] Undersecured creditors have both of these claims under the Bankruptcy Code even if the loan is nonrecourse.[89] The valuation of the collateral determines the relative size of these two claims and is often disputed by the debtor, who may take varying positions on value throughout the case. Early in the case, the debtor has a minor interest in having a high value on the collateral to stop relief from stay motions by arguing that the secured creditor is adequately protected.[90] Later in the case, however, the debtor has a major interest in having a low value for the collateral for purposes of the Chapter 11 plan and payment of the secured claim because the debtor will want to argue that the debt must be crammed down.[91]

[d] Classification of Claims

For claims-payment purposes, debtors use their own valuations of collateral to classify creditors as being secured or undersecured. Often debtors will attempt to create additional claims-voting classes by classifying trade and contingent liabilities separately from other unsecured debt, based on a number of the debt's characteristics.[92] Creating numerous voting classes increases the likelihood that at least one voting class will support the debtor's plan of reorganization. The debtor needs at least one impaired noninsider class to vote in favor of the Chapter 11 plan to have the plan confirmed and crammed down on a dissenting class of impaired claims.[93]

[5] Reaching a Consensus for the Plan and Obtaining Confirmation

After the plan and disclosure statement are filed with the court, the judge schedules a hearing on the adequacy of the disclosure statement, usually giving

[87] 11 USC §506(a) (1994).
[88] *Id*. §506(a) (1993).
[89] 11 USC §1111(b)(1)(A).
[90] 11 USC §362(d)(2)(A).
[91] 11 USC §1129(b)(2)(A)(i)(II).
[92] See §24.13[4] "Classification Tactics" *infra*.
[93] 11 USC §1129(a)(10) (1993) (amended 1994); see §24.13 "Voting and Classification" *infra*.

creditors at least twenty-five days advance notice of the hearing.[94] The debtor is responsible for producing a full and complete disclosure statement, and the judge will hear arguments from both sides. The judge can order that certain changes be made to the disclosure statement and approve the disclosure statement concurrently.[95] The judge then schedules a date for a confirmation hearing, again usually providing twenty-five days notice to all creditors.[96] Typically, the debtor will request a postponement of each of these dates. The judge often grants these extensions, even if a creditor objects.

[6] Emerging from Bankruptcy

If the bankruptcy court confirms a plan, all impaired debt is modified in accordance with the confirmed plan.[97] Modifications, if approved by the court, are deemed effective as of the plan confirmation or effective date.[98] Some creditors may be left unimpaired either because they were paid in full or because the contractual terms of their debt will not be modified.[99]

If the bankruptcy court does not confirm a plan, the judge may grant relief from the stay, dismiss the case, convert it to a Chapter 7 liquidation proceeding, or give the debtor the opportunity to submit a revised plan.[100]

§24.07 Secured Creditors' Strategies and Remedies

The Chapter 11 process is a negotiation process involving the judge, the debtor, and the controlling creditor. The judge sometimes manipulates the parties toward a settlement. Chapter 11 powers generally tilt the playing field in favor of the debtor.

The process and strategies of bankruptcy litigation can be used to improve negotiating structure, to upset either the debtor's or secured creditor's leverage in attempting to reach a particular result, or to bind dissenting parties to achieve a certain economic outcome. The following actions illustrate the types of pressures that creditors can put on the debtor to produce consensus or to assure that a consensus is never reached. Many of these tactics use the Bankruptcy Code's ambiguous and often undefined concepts and tools, such as adequate protection,[101] the new value exception to the absolute priority rule,[102] and

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[94] *Id*. §1125 (1993) (amended 1994); Fed R. Bankr. P. 3017.
[95] 11 USC §1125(f).
[96] Fed R. Bankr. P. 2002(b).
[97] 11 USC §1141(a) (1994).
[98] *Id*. §1127 (1993); Fed. R. Bankr. P. 3019. See In re UNR Indus., Inc., 20 F.3d 766 (7th Cir. 1994) (holding that a plan or reorganization, once implemented, should be modified only for compelling reasons).
[99] 11 USC §1124(1).
[100] 11 USC §1112 (1993) (amended 1994).
[101] See §24.03[6] "Debtor's Use of Assets—Adequate Protection" (discussing adequate protection) *supra*.
[102] Except when substantial and necessary new capital in the form of cash is invested into the reorganization, the absolute priority rule prevents interest holders from retaining any ownership interests unless all senior creditor classes receive the full value of their claims or have approved the plan. Judicial controversy exists over whether the new value exception survived the 1978 codification of the

classification of various classes of debt.[103] Some believe that these ambiguities were intentionally placed in the statute to provide the judges with discretion to confirm plans that otherwise should not be confirmed under the Bankruptcy Code.

In real estate Chapter 11 reorganizations, it is important to analyze who the players are and how they will respond to different kinds of pressure or opportunities to negotiate a settlement. Some bankruptcies present opportunities for various creditor alliances. For example, a second mortgage lender might be able to enlist the first mortgage lender on its side. Both the first mortgage lender's counsel and the debtor's counsel will attempt to influence the second mortgage lender because many of the pressure points in the bankruptcy game work best two-on-one. Also, because bankruptcy cases often involve issues in which overwhelming precedent is lacking and because the business issues in bankruptcy involve future projections such as market risks, interest rates, income, and sale potential, issues often have no right answer and good arguments may overcome the judge's philosophical leanings. Practically speaking, however, most judges are influenced favorably when a particular economic course of action is recommended by multiple parties.

With these thoughts in mind, the secured creditor should plan its litigation strategy in advance, taking into account the judge's previous decisions, the judge's clerk, areas of factual ambiguity or distortion, recent case law, and the debtor's basic proclivity toward litigation or settlement.

§24.08 Understanding the Secured Creditor's Options

[1] Asking and Answering Questions

The secured creditor must ask and answer numerous basic questions to obtain the proper position. The most important questions are whether the lender is secured, unsecured, or undersecured, and what is the margin of security or undersecurity. Another important issue is whether the lender took all of the steps necessary to perfect its interest in rents to establish that the rents and receivables are the lender's cash collateral.[104] Furthermore, even if all proper enforcement actions have been taken and the lender or a court-appointed receiver has actually begun collecting rents prepetition, the lender should take further steps to insure that the rents and receivables are the lender's property and not part of the bankruptcy estate. As discussed previously, cash collateral cannot be used by the debtor without a court order requiring the debtor to furnish adequate protection to the lender.[105] The lender's task in this regard has been made easier as the result of the 1994 Reform Act, which

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Bankruptcy Act because the legislature did not include the exception in the Bankruptcy Code. See §24.15(2) "New Value Exception to the Absolute Priority Rule" *infra*.

[103] To confirm a plan that impairs any class of claims, the debtor must, under §1129(a)(10), obtain acceptance of at least one class of impaired claims. However, a debtor may not, as a general rule, gerrymander classes of claims solely to obtain a consenting, impaired class (*e.g.*, by separately classifying the Bankruptcy Code created unsecured deficiency claims from the claims of trade creditors). 11 USC §1129(a)(10) (1994). See §24.13 "Voting and Classification" *infra*.

[104] See §24.06[1][a] "Assignment of Rents and Use of Cash Collateral" *supra*.

[105] *Id*.

provides that a lender's prepetition security interest in rents also applies to postpetition rents and constitutes cash collateral without regard to applicable state law regarding perfection.[106] Other questions that must be asked are:

(1) Who is the debtor? Who are the co-debtors? Are any related entities of the debtor also in bankruptcy?
(2) Is the debtor a single asset or multiple asset entity?
(3) What are the debtor's organizational motivations?
(4) Who are the other secured and unsecured creditors?
(5) Do management insiders have claims?
(6) Does the lender have personal guarantees, letters of credit, or other recourse instruments or collateral?
(7) What is the capability of current management, and does the lender need to, or have the right to, seek the appointment of a trustee or examiner in Chapter 11?
(8) What is the company's need for cash? What are its cash flow projections? When is the next payroll? Has it been paying its income and property taxes, payroll taxes and withholding? How does it intend to make the next payroll?
(9) What is the debtor's likely cash balance as of the petition date?
(10) Have transfers of rents and income from the property been made to the debtor's principals or partners, or affiliated or related entities, after a default on the loan?

These questions and their answers will naturally lead to other questions.

[2] Reviewing Loan Files

The lender should review its loan files carefully to determine whether the loan is properly documented and whether security interests in collateral were properly granted and perfected. The 1994 Reform Act's revisions to the Bankruptcy Code were intended only to render state law inapplicable to the issue of the enforcement or activation of a secured lender's interest in rents.[107] Consequently, the unperfected security interests may still be subject to the trustee's or DIP's avoidance powers.[108] The Uniform Commercial Code Financing Statements should be checked carefully.[109] Creditors should make sure that these statements were filed correctly and were properly continued, insuring that they are still valid.

If the lender has an assignment of rents, the lender should determine whether applicable state law considers this assignment as automatically activated or if the law requires the lender to take additional action to activate the assignment, such as notifying tenants, filing a court action, requesting the appointment of a receiver,

[106] 11 USC §552(b)(2), *as amended by* §214 of the 1994 Reform Act. See §24.06[1][a] "Assignment of Rents and Use of Cash Collateral" *supra*.
[107] See §24.06[1][a] "Assignment of Rents and Use of Cash Collateral" *supra*.
[108] See §24.03[2] "Preferential Transfers and Fraudulent Transfers" *supra*.
[109] Most commercial mortgage lenders obtain, as part of their original collateral package, not only a recorded mortgage and assignment of rents, but also a UCC-1 financing statement to give the lender a perfected lien on personal property and intangible property related to the real property collateral.

actually obtaining a receiver, or taking possession of the property.[110] Prior to the passage of the 1994 Reform Act, it was often too late after the bankruptcy filing date to activate a lender's perfected interest in the rents, although some courts recognized postpetition activation under applicable state law.[111]

The lender must determine whether there had been any preferential transfers or payments to creditors within the ninety-day preference period before the filing of the bankruptcy petition or any fraudulent transfers within the year prior to the filing. Lenders also need to look for preferential transfers or payments to insiders within the one-year (or more, depending on the state) period prior to the filing.[112]

[3] Assessing the Property's Value

[a] Significance of Valuation

The key to all strategies and tactics employed by the lender is assessing the value of the collateral. The reason valuation is so important is because (1) secured creditors have vastly improved rights over unsecured creditors and (2) the lender's debt is divided into a secured claim to the extent of the value of the collateral and an unsecured claim for the remainder,[113] and (3) there are at least fourteen purposes which a court may have for valuing a creditor's security interest.[114] If the secured creditor is overcollateralized, the creditor is probably adequately protected and cannot seek relief from the automatic stay absent special circumstances such as the continued depreciation in the value of the property below the amount of the debt or a bad-faith filing by the debtor.[115] Also, if the

[110] See Chapter 7, §7.09[2] "Effect on Mortgagee of Mortgagor/Landlord's Bankruptcy: Right to Rents" and Appendix 7A "Jurisdictional Laws and Practices Regarding Rights to Possession, Receivers, and Rents," both *supra*.

[111] Although the 1994 Reform Act has made individual state law activation requirements inapplicable, this result may not have been fully accomplished for prepetition rents because of possible deficiencies in the language of the amendment. See footnotes to §7.09[2][d] in Chapter 7. Many courts invoke §546(b), which allows a creditor to perfect a security interest postpetition by giving notice if the applicable state law provides that perfection of that security interest relates to an earlier time. Consequently, by bringing a motion to lift the automatic stay or otherwise giving notice, the creditor can perfect its interest postpetition against prior lien holders. These cases generally confused the issue of perfection with the conception of enforcement or activation of the secured creditors interest in the rents. See Virginia Beach Fed. Sav. & Loan Assoc. v. Wood, 901 F.2d 849 (10th Cir. 1990); Casbeer v. State Fed. Sav. & Loan Assoc. (In re Casbeer), 793 F.2d 1436 (5th Cir. 1986); In re The Mews Assocs., 144 B.R. 867 (Bankr. W.D. Mo. 1992); First Am. Bank v. Harbour Point Ltd. Partnership (In re Harbour Point Ltd. Partnership), 132 B.R. 5091 (Bankr. D.C. 1991); In re Cohartier Const., 126 B.R. 956 (Bankr. E.D. La. 1991): In re Gelwicks, 81 B.R. 445 (Bankr. N.D. Ill. 1987); In re Colter, 46 B.R. 510 (Bankr. D. Colo. 1984). The 1994 Reform Act, as well as the statutes recently enacted in many states, have attempted to clarify that a security interest in rents is perfected at the time the assignment of rents is recorded, thereby effectively eliminating §546(b) as a necessary consideration in most rent assignment situations. See §7.09[2] "Effect on Mortgagee of Mortgagor's Bankruptcy: Right to Rents" *supra*.

[112] See §24.03[2] "Preferential Transfers and Fraudulent Transfers" *supra*.

[113] 11 USC §506(a). See the discussion in §24.03[3][b] "Approaches to Valuation in Bankruptcy" *infra*.

[114] J.F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18, 25 (1987).

[115] 11 USC §§362(d), 506(a) (1994). See §24.11[1] "Grounds for Relief."

debtor's plan does not modify the loan terms in any way, the creditor will not be an impaired class and, therefore, will not have the right to vote for or against a plan.[116] In addition, the debtor may seek to use, sell, or lease a portion of the secured collateral, arguing that the secured creditor is adequately protected by an equity cushion or the availability of other collateral.[117]

If the creditor is undersecured (with a secured claim for the value of the property and an unsecured claim for the balance) the creditor will need valuation information and testimony to prove that the creditor is not adequately protected in order to receive monthly payments to adequately protect the secured portion of the claim.[118] Under a 1988 U.S. Supreme Court ruling, *United States Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*,[119] and cases decided thereafter by other courts, undersecured creditors are not entitled to postpetition payments of interest or lost opportunity costs, although they are entitled to adequate protection against diminution in the value of their collateral.

Opinions concerning the value of collateral are always inherently sensitive. One key issue in determining the treatment of secured creditors under the Bankruptcy code is whether the creditor is less than fully secured or slightly more than fully secured. In many districts, the fully secured creditor is not entitled to adequate protection payments, but the secured claim will accrue interest up to the value of the collateral.[120] The Bankruptcy Code permits an oversecured lender, to the extent that the creditor's claim is oversecured,[121] to collect interest on such claim and any reasonable fees (including attorneys' fees, costs, and charges) that are provided for in the loan documents.[122]

Thus, an oversecured lender should be entitled to include, as part of its claim, interest at the default rate on the debt as well as the amount calculated pursuant to its contractual prepayment premium. However, the bankruptcy courts in various jurisdictions have differed as to whether the lender with an oversecured claim should be entitled to a prepayment premium and whether the charge is reasonable under federal or state law. In *In re Skyler Ridge*,[123] a 1987 bankruptcy court

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[116] 11 USC §1124 (1993).

[117] *Id*. §363(b)(1), (e) (1993). See §24.03[6] "Debtor Use of Assets" *supra*.

[118] See §24.11[1][c] "Adequate Protection of Hard Collateral" *infra*.

[119] United States Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988). If the secured collateral is declining in value, the creditor's interest must be protected by periodic payments, substitute liens covering the decline, or by some other means that provide the "indubitable equivalent" of the creditor's interest in the property. 11 USC §361 (1993). If such adequate protection is not provided, a creditor whose interest in the secured property is declining is entitled to relief from the automatic stay. *Id*. §362(d)(1).

[120] See §24.11[1][c] "Adequate Protection of Hard Collateral" *infra*.

[121] Orix Credit Alliance, Inc. v. Delta Resources, Inc. (In re Delta Resources, Inc.), 54 F.3d 722, 727 (11th Cir. 1995), cert. denied, sub nom., Inc., __ U.S.__, 116 S. Ct. 488, 133 L. Ed. 2d 415 (1995) (recovery of postpetition interest on its oversecured claim pursuant to §506(b) is virtually unqualified).

[122] 11 USC §506(b) (1984).

[123] In re Skyler Ridge, 80 B.R. 500 (Bankr. C.D. Cal. 1987). The decision in *Skyler Ridge* has been criticized as a result-oriented decision in which the court sought to preserve value for junior creditors when the debtor's assets would otherwise have been insufficient to do so. Debra P. Stark, *Prepayment Charges in Jeopardy: The Unhappy and Uncertain Legacy of* In re *Skyler Ridge*, 24 Real Prop. Prob. & Tr. J. 191, 193 (1989); see Debra P. Stark, *New Developments in Enforcing Prepayment Charges After an Acceleration of a Mortgage Loan*, 26 Real Prop. Prob. & Tr. J. 213, 234 (1991) ("[B]oth bankruptcy

decision, the court disallowed a prepayment premium provision as an invalid liquidated damages clause under Kansas law because it was not reasonable. The prepayment premium had not been discounted to present value. However, subsequent bankruptcy court decisions have held that an oversecured lender can collect its actual damages under a prepayment provision when such a provision is enforceable under applicable state law.[124] If the lender is less than fully secured, the lender will be denied payment of interest during the case as well as any payments for lost opportunity costs and will not be entitled to adequate protection payments unless the value of the property is depreciating. The lender should consult its attorney regularly, reporting an up-to-date view of the relationship between the value of the collateral and the amount of the debt.

[b] Approaches to Valuation in Bankruptcy

[i] Prior to the *Rash* Case

In 1997 the Supreme Court decided *Associates Commercial Corp. v. Rash*.[125] The *Rash* case has created uncertainty in valuation when the debtor intends to retain and use the collateral. The case is discussed in the following section after the discussion of the case law prior to *Rash* in this section.

The significance of valuation is discussed above in §24.08[3][a]. In bankruptcy, creditors are typically undersecured. That is, the value of the security is less than the amount of the debt. The under secured creditor has a secured claim equal to the value of the collateral,[126] but the daunting task is to determine the value of the collateral. For example, if the debtor's plan is to retain the collateral, is the value to be determined by the value of the collateral to the debtor or to the creditor? Further, is the value: the replacement cost to the debtor or to the creditor, fair market value that a willing buyer would pay to a willing seller, liquidation value at a public auction after proper advertising, foreclosure under state law (with or without foreclosure costs) foreclosure under state law with the price discounted due to the right of statutory redemption retail value, "fair-market" value, "fair value," wholesale value, going concern value taking into account the value of goodwill, and so forth? Is the valuation the same for purposes of determining adequate protection to prevent lifting the stay,[127] whether the debtor has equity in the

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courts and nonbankruptcy courts have recently repudiated the flawed *Skyler Ridge* analysis, which in essence required a perfect estimate of the lender's damages rather than a reasonable one.").

[124] United Merchants & Mfrs. Inc. v. Equitable Life Assurance Society (In re United merchants & Mfrs., Inc.), 674 F.2d 134, 143-44 (2d Cir. 1982); Financial Ctr. Assocs. v. Funding Corp. (In re Financial Ctr. Assocs.), 140 B.R. 829, 835 (Bankr. E.D.N.Y. 1992); Travelers Ins. Co. v. 100 LaSalle Assoc., No.90-C-4778, 1991 U.S. Dist. LEXIS 1903, at **8-*9** (Bankr. N.D. Ill. Feb. 15, 1991); see Connecticut Gen. Life Ins. Co. v. Schaumburg Hotel Owner Ltd. Partnership (In re Schaumburg Hotel Owner Ltd. Partnership), 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989) (upholding, under Illinois law, a clause allowing the lender to accelerate the debt and collect prepayment charges). But see In re Carr Mill Mall Ltd. Partnership, 201 B.R. 415 (Bankr. M.D.N.C. 1996).

[125] Associates Commercial Corp. v. Rash, __U.S. __, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997).

[126] 11 USC §506(a).

[127] 11 USC §362(d)(1).

property,[128] as it is for confirmation purposes to determine the amount the debtor's plan must provide for secured claims?[129] The linchpin for valuation is §506(a):

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, *is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property*, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property*, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest. (Emphasis added.)

The appropriate standard by which value should be fixed caused considerable controversy during the development of the 1978 Code. The Code makes it clear, in section 506(a), that the standard of valuation will vary with the situation, since value is to be "determined in light of the purpose of the valuation. . . ." Indeed, the legislative history might be reasonably interpreted to indicate that something approaching going concern value should be the appropriate standard in most cases involving the automatic stay, and most courts have tended to adopt this standard. See, for example, *Loper v. Mulcahy (In re Mulcahy)*, 5 B.R. 558 (Bankr. D. Conn. 1980). Not surprisingly, a systematic method for valuing collateral has not evolved, due to Congress' intention that valuations be made on a case by case basis. S. Rep. No. 989, 95th Cong., 2d Sess. 54, U.S. Code Cong. & Admin. News 5787, 5840 (1978) ("Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case").[130]

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[128] 11 USC §362(d)(2)(A).

[129] 11 USC §1129(b)(2)(A)(i)(II).

[130] See D.G. Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 Am. U.L. Rev. 63, 64 (1991) ("Not surprisingly, bankruptcy courts have indeed gratified the wishes of congress by producing an extremely diverse and contradictory set of valuation theories.") This mandate to make new decisions regarding valuations with each case is further complicated when one realizes that the "value" ascribed to collateral is little more than a "shadow," J.F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18 (1987), or an estimated prediction of the price the property would bring at a future auction; D.G. Carlson, *Unsecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b) Second Looks at Judicial Valuations of Collateral*, 6 Bankr. Dev. J. 253, 262 (1989). The latter commentator noted, "[u]nless the collateral is highly fungible and stable in price, valuations are inherently uncertain. . . ." *Id.* For a discussion of valuation questions, see Fortgang, *Valuation in Bankruptcy*, 32 U.C.L.A.L. Rev. 1061-32 (1985). For cases citing the fair market or going concern value, see: In re Automatic Voting Machine Corp., 26 B.R. 970, 972 (Bankr. W.D.N.Y. 1983) ("the appropriate method of valuation to gauge whether [a creditor] is adequately protected in a reorganization case is the 'going concern' or fair market value"); In re QPL Components, Inc., 20 B.R. 342, 344 (Bankr. E.D.N.Y. 1982) ("the value to be accorded collateral which is inventory of an ongoing Chapter 11 debtor, with reasonable prospects that it can continue, is the dollar value realizable from its

[ii] After the *Rash* Case

The Supreme Court in *Associates Commercial Corp. v. Rash*[131] held that where a debtor in a Chapter 13 reorganization plan retains and uses property subject to a lien the debtor's plan must pay the secured creditor the replacement value of the property retained. The facts of the case involve a Chapter 13 debtor's plan to retain and use a commercial truck. However, the significance of the case is much broader because the Court had to interpret valuation of secured claims under 11 USC section 506(a), which also applies to valuation under Chapter 7, 11, and 12.

The specific issue in Rash was a dispute concerning the proper application of §506(a) of the Bankruptcy Code, which defines the value of a secured claim, when a bankrupt debtor has exercised the "cram down" option for which Code §1325(a)(5)(B) provides.[132] Specifically, when a debtor, over a secured creditor's objection, seeks to retain and use the creditor's collateral in a Chapter 13 plan, is the value of the collateral to be determined by (1) what the secured creditor could obtain through foreclosure sale of the property (the "foreclosure-value" standard), (2) what the debtor would have to pay for comparable property (the "replacement-value" standard), or (3) the midpoint

disposition in the ordinary course of business"); In re Shockley Forest Industries, 5 B.R. 160 (Bankr. N.D. Ga. 1980) ("Because Debtor is a going business concern with reasonable prospects for rehabilitation, the proper standard of valuation of the collateral herein is the fair market value."); In re American Kitchen Foods, Inc., 2 B.C.D. 715 (Bankr. D. Me. 1976); In re 203 N. LaSalle Street Partnership, 190 B.R. 567, 587 (Bankr. N.D. Ill. 1995) (there is no reason to suppose that the [secured creditor] would not be able to sell the property for its fair market value, and so the [secured creditor] is entitled to the value rather than a lower value based on a foreclosure or other forced sale). For cases utilizing the liquidation value, see In re Demakes Enterprises, Inc., 145 B.R. 362 (D. Mass. 1992); In re Robbins, 119 B.R. 1 (Bankr. D. Mass. 1990) (in context of relief from stay motion, security interest is worth what it will bring at commercially reasonable foreclosure, and foreclosure costs are proper deductions); In re T.H.B. Corp., 85 B.R. 192 (Bankr. D. Mass. 1988) (in context of use of cash collateral, where no sale of debtor's assets is in prospect, value ascribed to collateral is the liquidation and not going concern value); In re Conquest Offshore International, Inc., 73 B.R. 171 (Bankr. S.D. Miss. 1986) (liquidation value is more appropriate standard than fair market value for collateral for which there exists no normal market).

[131] Associates Commercial Corp. v. Rash, 117 S. Ct. 758, 136 L. Ed. 2d 694, 65 USLW 3499, 65 USLW 3504 (U.S., Jan. 17, 1997) (No. 96-454).

[132] To qualify for confirmation under Chapter 13, the Rashes' plan had to satisfy the requirements set forth in §1325(a) of the Code. The Rashes' treatment of ACC's secured claim, in particular, is governed by subsection (a)(5). Under this provision, a plan's proposed treatment of secured claims can be confirmed if one of three conditions is satisfied: the secured creditor accepts the plan, see 11 USC §1325(a)(5)(A); the debtor surrenders the property securing the claim to the creditor, see §1325(a)(5)(C); or the debtor invokes the so-called "cram down" power, see §1325(a)(5)(B). Under the cram down option, the debtor is permitted to keep the property over the objection of the creditor; the creditor retains the lien securing the claim, see §1325(a)(5)(B)(i), and the debtor is required to provide the creditor with payments, over the life of the plan, that will total the present value of the allowed secured claim, i.e., the present value of the collateral, see §1325(a)(5)(B)(ii). The value of the allowed secured claim is governed by §506(a) of the Code.

between these two measurements? The Court held that §506(a) directs application of the "replacement-value" standard.[133]

In rejecting a finding that valuation should be based on the value of the collateral to the creditor, that is what a creditor would obtain in a foreclosure sale, the Court noted that in §506(a) the first sentence words—"the creditor's interest in the estate's interest in such property" does not expressly reveal how the interest is to be valued.[134] This language is not an instruction to equate a "creditor's interest" with the net value a creditor could realize through a foreclosure sale.[135] It is the second sentence of §506(a) which does speak to the how question. "Such value," the sentence provides, "shall be determined in light of the purpose of the valuation[136] and of the proposed disposition or use of such property."[137] The Court concludes that applying the foreclosure-value standard in a cram down attributes no significance to the different consequences of the debtor's choice to surrender or retain the property.[138] The Court states that: "[B]y replacement value, we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property or like age and condition."[139] Later, the Court concludes as follows: "In sum, under §506(a) the value of property retained because the debtor has exercised the §1325(a)(5)(B) 'cram down' option is the cost the debtor would incur to obtain a like asset for the same 'proposed . . . use.' " "It is at this point that a final footnote 6 is added, the effect of which is to provide more questions than answers.[140]

When the debtor retains the collateral, in addition to rejecting the foreclosure value standard, the Court rejected using the "split the difference"

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[133] Associates Commercial Corp. v. Rash, 117 S. Ct. 1879, 1882 (1997).
[134] 117 S. Ct. 1879, 1884.
[135] *Id.*
[136] For a listing of the purposes of valuation, see James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18, 25 (1987) (lists 14 purposes for valuation of a security interest).
[137] 117 S. Ct. 1879, 1885.
[138] *Id.*
[139] Rash, __ U.S. at __-__ n.2, 117 S. Ct. at 1884 n.2.
[140] At __ U.S. at __-__ n.6, 117 S. Ct. at 1886-87 n.6 is as follows:

> Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram-down cases leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. *Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property*. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. Cf. 90 F.3d, at 1051-1052. Nor should the creditor gain from modifications to the property—e.g., the addition of accessories to a vehicle—to which a creditor's lien would not extend under state law.

(Emphasis added.) For an analysis of the Chapter 13 vehicle cases after *Rash*, see In re Younger, 216 B.R. 649, 653-56 (Bankr. W.D. Okla. 1998) (arbitrarily fixing the average of the retail and wholesale NADA value as the starting point for vehicles retained by Chapter 13 debtors).

value between foreclosure and replacement value[141] and rejected the "rule-less" or case-by-case approach.[142]

Apparently in anticipation of the argument that the creditor will receive a windfall by having the property valued at higher than foreclosure value the Court stated:

> When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds. . . . If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more "adequate protection," 11 USC §361, do not fully offset these risks. See 90 F.3d, at 1066 (Smith, J., dissenting) ("vast majority of reorganizations fail . . . leaving creditors with only a fraction of the compensation due them"; where, as here, "collateral depreciates rapidly, the secured creditor may receive far less in a failed reorganization than in a prompt foreclosure") (internal cross-reference omitted) accord, *In re Taffi*, 96 F.3d, at 1192-93.[143]

The *Rash* case deals with a Chapter 13 debtor's retention of a vehicle, but the case extends beyond this. As previously noted, the impact is broad because the court interpreted §506(a), which also applies to valuations in Chapter 7, 11, and 12.[144] The Supreme court cited two Chapter 11 cases with approval.[145]

[A[Valuation for Confirmation

In view of *Rash*, for confirmation of a plan how should courts value real property retained by the Chapter 11 debtor? The Court in *Rash* cited with approval the Ninth Circuit's *Taffi* case in which a debtor's Chapter 11 plan provided for the continued possession of a house:

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141 *Rash*, 117 S. Ct. at 1886. See In re Hoskins, 102 F.3d 311, 316 (7th Cir. 1996); cf. In re Valenti, 105 F.3d 55, 62 (2d Cir. 1997) (bankruptcy courts have discretion to value at midpoint between replacement value and foreclosure value); In re 203 N. LaSalle Street Partnership, 190 B.R. 567, 578 (Bankr. N.D. Ill. 1995) ("despite its adoption by a number of circuits, this 'second sentence' view of Section 506(a) is not the best reading of the section").

142 *Rash*, 117 S. Ct. at 1886, n.5. Cf. In re Valenti, 105 F.3d 55, 62-63 (2d Cir. 1997) (permissible for bankruptcy courts to determine valuation standard case-by-case).

143 *Rash*, 117 S. Ct. at 1879, 1885.

144 See Mulvania v. U.S. Int. Rev. Ser. (In re Mulvania), 214 B.R. 1, 9 (9th BAP 1997) (citing *Rash* in Chapter 11—IRS secured claim should not be reduced by hypothetical sales costs); In re Goodyear, __ B.R. __, 1998 WL 58528 (Bankr. D. Vt. 1998) (citing *Rash* in Chapter 12—courts must recognize and award secured creditors compensation for risk where debtors retain collateral).

145 *Rash*, 117 S. Ct. at 1183-84; In re Taffi, 96 F.3d 1190, 1191-92 (9th Cir. 1996) (en banc), *cert. denied*, 117 S. Ct. 2478 (1997); In re Winthrop Old Farm Nurseries, Inc., 50 F.3d 72, 74-75 (1st Cir. 1995).

> Rather, our use of the term replacement value is consistent with the Ninth Circuit's understanding of the meaning of fair-market value, we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition.[146]

It is well recognized that the valuation of real property, especially income property, is inherently uncertain.[147] In *In re T-H New Orleans*[148] in a Chapter 11 confirmation hearing the Fifth Circuit upheld the bankruptcy court's determination of "fair value" of a hotel as being consistent with the *Rash* requirement that value be determined "in the light of the purpose of the valuation and of the proposed disposition or use of the property.[149] The bankruptcy court valuation was based on an appraisal report but it is not clear whether the appraisal was based on the price a willing buyer would pay a willing seller.[150] If "fair value" is different from "fair market value" as defined in *Rash* then the *New Orleans* case used the wrong valuation standard. For the distinction, in pre-*Rash* cases, see *In re Stockbridge Properties I, Ltd.*, 141 B.R. 469, 472 (Bankr. N.D. Ga. 1992) where the court, discussing valuation for confirmation, states that: "Fair market value assumes a sale of the property between a willing buyer and seller in which both parties are fully informed, acting reasonably, and unaffected by undue stimulus," but [a] 'fair value' is . . . by definition a duress valuation." *But see In re Monica Road Associates*[151] distinguishing between "fair value" as requiring that expected cash flows be discounted to present value when a current sale is not expected but "market value" does not require the discounting to present value.

Problems created by the *Rash* case are illustrated in *In re Inter-City Beverage Co*.[152] In a Chapter 11, the debtor's plan provided for the sale of vehicles and other assets. The court, citing *Rash*, held that the value of the secured liens on the vehicles was the *replacement value* rather than the liquidating value, even though the debtor was liquidating.[153] There are

[146] *Rash*, 117 S. Ct. at 1879, 1884 n.2.

[147] See Chapter 27D, §27D.07[5] "Appraisal Orthodoxy" *infra*; Leslie Kent Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Appraisal Methods to Value Income-Producing Property*, 66 S. Cal. L. Rev. 2251, 2285-88 (1993); American Institute of Real Estate Appraisers, The Appraisal of Real Estate 487-518 (9th ed. 1987).

[148] Financial Security Assurance, Inc. v. T-H New Orleans Limited Partnership (In re T-H New Orleans Ltd. Part.), 116 F.3d 790, 799 (5th Cir. 1997).

[149] *In re New Orleans* at 799.

[150] *In re New Orleans* at 795 ("The bankruptcy court, . . . found that the appraised value of the Hotel was $12.1 million"). The district court case sheds no light on whether the appraisal was based on a willing buyer and seller approach. 188 B.R. 799 at 802.

[151] First American Bank of Virginia v. Monica Road Associates (In re Monica Road Associates), 147 B.R. 385, 391-92 (Bankr. E.D. Va. 1992) (valuation for lifting the stay, cites cases on the use of different standards of valuation). See also In re 203 North LaSalle Street Partnerships, 190 B.R. 567, 578 (Bankr. N.D. Ill. 1995) ("The court accepts the discounted cash flow method of valuation").

[152] In re Inter-City Beverage Co. 209 B.R. 931 (Bankr. W.D. Mo. 1997). See §24.08[3][b][ii][C] "Valuation for Sale Under §363(f)."

[153] 209 B.R. at 933.

even problems applying *Rash* to the subject matter of *Rash*, that is Chapter 13 bankruptcies where the debtor retains a vehicle.[154]

[B] Valuation for Lifting the Stay

Under §§362(d)(1) and (2) the stay can be lifted for lack of adequate protection or if the debtor does not have equity in the property and the property is not necessary for an effective reorganization. An initial approach is to view *Rash* as not applicable to valuation for purpose of lifting the stay because *Rash* dealt with valuation for purpose of confirmation and §506(a) requires that the "value shall be determined in light of the purpose of the valuation . . . ." However, §506(a) also adds ". . . and of the proposed disposition or use of such property, . . ." and the Court in *Rash* focused on the proposed disposition and use of the property. The Court in *Rash* valued the security interest in view of the *debtor's* use because the debtor's plan provided for the use of the collateral. However, the Court did not specify that the valuation should always be from the debtor's perspective. The second sentence of §506(a) states that the valuation is to be made in view of the "proposed disposition or use," not "debtor's proposed disposition or use."

It is arguable that if the creditor is proposing lifting the stay to dispose of or use the property, the focus should be on the creditor's disposition or use and, for example, this would not necessarily include the debtor's going concern value of the property.[155] In reality, the "proposed disposition or use" should be viewed from both the creditor's and debtor's perspective. If the stay is lifted the creditor will probably liquidate but if the stay is not lifted the debtor will benefit from the use of the property. In litigation over lifting the stay, perhaps the pre-*Rash* Second and Seventh Circuit's "split the difference" valuation makes sense.[156]

So far, there are few cases attempting to apply *Rash* as a standard for valuation for lifting the stay. In a Chapter 13 case, the court recognized that the standard for determining value for a Chapter 13 cram down is not necessarily the same standard for determining adequate protection prior to plan confirmation.[157] Without much of a rationale, the court then cited *Rash* and valued the vehicle based on the replacement value to the

[154] In re Younger, 216 B.R. 649, 653-56 (Bankr. W.D. Okla. 1998).

[155] See James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18, 33 (1987); *Stay Litigation After Rash*, http://www.stinson.inter.net/2cents/rash.htm (1998). Compare, First Trust Union Bank v. Automatic Voting Machine Corp. (In re Automatic Voting Machine Corp.). 26 B.R. 970 (Bankr. W.D.N.Y. 1983) (creditor must produce evidence of going concern value) with In re Robbins, 119 B.R. 1 (Bankr. D. Mass. 1990) (debtor's operation of property does not warrant adopting going concern value of property).

[156] See In re Hoskins, 102 F.3d 311, 316 (7th Cir. 1996); cf. In re Valenti, 105 F.3d 55, 62 (2d Cir. 1997) (for confirmation bankruptcy courts have discretion to value at midpoint between replacement value and foreclosure value).

[157] In re Jenkins, 215 B.R. 689, 690 (Bankr. N.D.Tex. 1997).

debtor.[158] In another Chapter 13 case of lifting the stay the court cited *Rash*, but lifted the stay on other grounds.[159]

The *Rash* case does not shed much light on the ongoing question of the treatment of secured rents and the adequate protection of the security interest in rents.[160]

[C] Valuation for Sale Under §363(f)

After *Rash*, there is a continuing problem regarding valuation when the debtor/trustee wishes to sell property free and clear of liens. Under §363(f)(3) the Trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if "(3) such interest is a lien and the price at which such property to be sold is greater than the aggregate value of all liens on such property."[161]

What is the "value of all liens"? Is it the total amount or face value of all liens or is it the total value of secured liens as determined by §506(a)? For example, if there are liens against the property of $80,000 and $50,000, for a total of $130,000, can the court make a determination under §506(a) that the actual value of the property is only $100,000 and approve a sale of the property for $100,000 free and clear of the liens? There is a split in the cases on this question. The majority of the courts follow *Matter of Stroud*[162] in holding that the liens must be paid off in full because no

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[158] The court did state "In this case, the court applies that value [*Rash*] to the adequate protection analysis of §362. But, when the debtor constructs the Chapter 13 plan, the debtor must provide sufficient payments to the secured creditor over time to assure that the creditor receives the value as of the effective date of the plan." *Jenkins* at 692.

[159] In re Wojcicki, 1997 WL 742513, 8 (Not in B.R.) (Bankr. N.D. Ill. 1997).

[160] For an overview of the "single valuation," "dual valuation" and "continuous valuation" as affected by rents, see In re Addison Properties Ltd. Part., 185 B.R. 766 (Bankr. N.D. Ill. 1995). See also Chapter 7, §7.09[2][e][I] "Adequate Protection Prior to Confirmation" *supra*.

[161] 11 USC §363(f) reads in full as follows:

(f) The Trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if—
  (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
  (2) such entity consents;
  (3) such interest is a lien and the price at which such property to be sold is greater than the aggregate value of all liens on such property;
  (4) such interest is in a bona fide dispute; or
  (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Section 363(f) is phrased in the disjunctive, such that only one of the enumerated conditions must be met in order for the Court to approve the proposed sale. In re Collins, 180 B.R. 447, 450 (Bankr. E.D. Va. 1995).

[162] David G. Epstein, Steve H. Nickles & James J. White, *Bankruptcy* §4-7 (West Practitioner Treatise 1992); Matter of Stroud Wholesale, Inc., 47 B.R. 999 (E.D.N.C.), *aff'd*, 983 F.2d 1057 (4th Cir. 1985) (unpublished disposition) ("While we do not necessarily agree with all that was said in the opinion of the district court . . . we think that the district court reached a correct, proper and equitable result.") See also Matter of Riverside Investment Partnership, 674 F.2d 634, 640 (7th Cir. 1982) ("As a general rule, the bankruptcy court should not order property sold "free and clear of" liens unless the court is satisfied that

creditor can complain about a sale if the proceeds of the sale will fully liquidate the creditor's claim. Under this view, no valuation is necessary under §506(a). The other view is that the court may approve the sale if the proceeds are at least sufficient to pay the value of the property, that is, the value of the secured claims as determined by §506(a) rather than the face amount of the liens.[163]

The first case to apply *Rash* to this question seemed to assume that the court could approve a sale under §363(f)(3) even though the proceeds would be insufficient to pay the total face value of the liens. The court then proceeded to misapply *Rash*. In *In re Inter-City Beverage*,[164] the issue was the valuation of two vehicles which were included in other assets being sold free and clear in a Chapter 13. Based on *Rash* the court held that the value of the vehicles would be the replacement value and this amount, which was less than the total face value of the liens, would be distributed to the creditor. In *Rash* the Court selected the replacement value to the debtor because the debtor was retaining the vehicles, but in *Inter-City* the debtor was disposing of the vehicles.

§24.09 Limiting Debtor's Control over Property

[1] Appointment of Trustee or Examiner[165]

If the lender has adequate proof of fraud, misconduct, gross mismanagement, dishonesty, incompetence, or other just cause that does not include mere mismanagement, the lender should consider seeking the appointment of a trustee or examiner.[166] The lender may also consider the conversion of the case to a Chapter 7 liquidation, which automatically requires the appointment of a trustee.[167]

In a voluntary Chapter 11 case, there is a strong presumption that the debtor should remain in possession. The creditor that is moving for the appointment of a trustee must show something more serious than the debtor's mere management indiscretion because all Chapter 11 debtors may have some degree of management problems.

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the sale proceeds will fully compensate secured lienholders and produce some equity for the benefit of the bankrupt's estate.").

[163] In re Collins, 180 B.R. 447 (Bankr. E.D. Va. 1995); In re Beker Industries Corp., 63 B.R. 474 (Bankr. S.D.N.Y. 1986); In re WPRV-TV, 143 B.R. 315 (D.P.R. 1991), aff'd in part, rev'd in part on other grounds, 983 F.2d 336 (1st Cir. 1993).

[164] In re Inter-City Beverage Co., 209 B.R. 931 (Bankr. W.D. Mo. 1997).

[165] See §24.06[2] "Reorganization by Debtor or Trustee" *supra*.

[166] 11 USC §1104(a)(1).

[167] Id. A bankruptcy court has the power under §1112(b) of the Bankruptcy Code to convert a debtor's Chapter 11 case into a Chapter 7 case, even after the debtor's Chapter 11 case has been confirmed. Smith v. Lee (In re Smith), 1996 U.S. Dist. LEXIS 15239 (Bankr. D. Nev., Oct. 10, 1996). A court need not find that any of the specific causes for appointing a trustee under §1104(a)(1) exists; it is sufficient that the appointment be in the interest of the creditors. Oklahoma Refining Co. v. Balik (In re Oklahoma Refining Co.) 838 F.2d 1133 (10th Cir. 1988).

[2] Involuntary Chapter 7 or 11

Creditor's remedies include filing an involuntary Chapter 7, Chapter 11. Or creditor's motion to convert the voluntary or involuntary Chapter 11 to a Chapter 7 liquidation.[168] An order granting relief under an involuntary Chapter 7 or 11 will, among other benefits, make the DIP's use of its funds subject to the bankruptcy court's supervision, prevent preferential transfers from being affected, and preserve the ability of the estate to set aside voidable transfers.[169] However, creditors should take care in filing an involuntary proceeding. Such proceedings require cooperation among creditors, significant legal expense, and a thorough knowledge of the debtor's business and financial affairs. Further, the filing creates an appreciable risk that the debtor will file a lender liability claim if the debtor is not in fact insolvent or claims a loss of business opportunities as the result of the involuntary filing.[170]

§24.10 Obtaining an Interest in Cash Collateral

[1] Perfection of Assignment of Rents

Rents are cash collateral if the rents arise from property subject to a prepetition security interest.[171] This chapter is heavy-handed concerning the lender's interest in rents because, without cash collateral, a creditor has little leverage in a bankruptcy case, and because the debtor can use the rents to amass capital with which to pay its professional fees and other expenses and cram down the lender. Although the amendments to the Bankruptcy Code contained in the 1994 Reform Act specifically render individual state law determinations of the perfection of a secured interest in

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[168] 11 USC §§303, 1112(b) (1993) (amended 1994).

[169] See In re 801 S. Wells St. Ltd. Partnership, 192 B.R. 718, 725 (Bankr. N.D. Ill. 1996). Involuntary bankruptcies may also encourage greater participation by creditors through the proposal of their own plans of reorganization. See In re Mother Hubbard, 152 B.R. 189, 195 (Bankr. W.D. Mich. 1993). Pursuant to §303(f) of the Bankruptcy Code, unless the court orders otherwise, the debtor who is the subject of an involuntary proceeding, may continue its business and use, acquire, and dispose of its property, including rental income, notwithstanding the restrictions on the use of the debtor'' cash collateral otherwise imposed by §363. During this "gap" period, the debtor is free to continue operating its business and remain in control of its assets. See In re DiLorenzo, 161 B.R. 752, 757 (Bankr. S.D.N.Y. 1993).

[170] See Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47, 51 (3d Cir. 1988) (holding that a lender joining in the filing of an involuntary bankruptcy petition against a borrower may be liable for malicious prosecution, abuse of process, fraud, and intentional interference with a business relationship, even though the borrower subsequently filed a voluntary bankruptcy proceeding); In re K.P. Enter., 135 B.R. 174, 175 (Bankr. D. Me. 1992) (holding that a creditor who files an involuntary petition that is dismissed should expect that the court will award fees and costs to the debtor); In re Better Care, Ltd., 97 B.R. 405, 410 (Bankr. N.D. Ill. 1989) (holding that the debtor did not sufficiently prove that the involuntary petition filed by the mortgage lender and three trade creditors was motivated by bad faith and should be dismissed).

[171] See §24.06[1][a] "Assignment of Rents and Cash Collateral" *supra*.

rents inapplicable,[172] the following analysis is relevant because of the remaining uncertainty about the sufficiency of the amendments for this purpose and the lender's desire to properly perfect under state law if an enforcement proceeding against the debtor is commenced or continued outside of bankruptcy. In addition, if all proper steps have been taken by the lender under state law to enforce and actually collect, as well as perfect, its security interest in the rents prior to the bankruptcy filing, the lender can argue that the debtor no longer has any interest in the rents, that they are the sole property of the lender, and that they do not constitute cash collateral in which the bankruptcy estate has an interest. However, the 1994 Reform Act does not permit a lender to claim that the debtor no longer has any interest in the rents after the bankruptcy filing merely by describing the lender's prepetition interest in the rents as absolute in a mortgage or separate assignment-of-rents document.[173]

The issue of the perfection of rents frequently arises when a mortgage lender with an interest in rents has not foreclosed, exercised its assignment of rents, obtained the appointment of a receiver, or otherwise taken action to possess the rents prior to the petition filing.[174] Judges differ on the requirement of peaceful possession of the property by the mortgage lender to the exclusion of the borrower or the owner.[175] In Massachusetts, bankruptcy judges have different views of what is required to

[172] 11 USC §552(b)(2) (1994).

[173] 1994 Reform Act §214 (*amending* 11 USC §552(b)). Prior to (and even after) the passage of the Reform Act, some jurisdictions upheld the validity of such absolute assignments. In re Jason Realty, L.P., 59 F.3d 423, 428 (3d Cir. 1995); Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 37 (3d Cir. 1993); In re Geary's Bottled Liquors, Inc., 184 B.R. 408, 413 (Bankr. D. Mass. 1995) (holding that an "absolute" assignment of rents, although allowing the mortgagor to collect the rents so long as no default occurred under the loan documents, is still an absolute assignment, and noting that "if this case had been filed after October 20, 1994, both rent assignments might have been validated by 11 USC §552(b)(2), as added by §215(a) of the Bankruptcy Reform Act of 1994 . . . which is effective on that date"); MacArthur Executive Assocs. v. State Farm Life Ins. Co., 190 B.R. 189, 195 (Bankr. D.N.J. 1995); Northern Trust Co. v. VIII South Mich. Assocs. (In re VIII South Mich. Assocs.), 145 B.R. 912 (Bankr. N.D. Ill. 1992); In re 163rd St. Mini Storage, Inc., 113 B.R. 87 (Bankr. S.D. Fla. 1990) (citing Fla. Stat. §697.07 (1987); Homecorp v. Secor Bank, 659 So. 2d 15 (Ala. 1994).

[174] See Chapter 7 at §7.09[2] "Effect on Mortgagee of Mortgagor/Landlord's Bankruptcy: Right to Rents" *supra*.

[175] Wattson Pac. Ventures v. Valley Fed. Sav. & Loan (In re Safeguard Self-Storage Trust), 2 F.3d 967 (9th Cir. 1993). The California legislature enacted a statute specifically applying to assignments of rent. 1996 Cal. Adv. Legis. Secr. 49 (Deering). This statute, which applies only with respect to assignments of rent executed after January 1, 1997, repeals section 2938 of the California Civil Code and provides that regardless of the language used in the assignment of rents document, it creates a "present security interest" in both present and future leases and rents on the property, thus eliminating the unworkable and fictitious distinction between absolute assignments of rent and security assignments. Under the new statute the lender will be able to "enforce" or "activate" its perfected right to the rents by taking any one of a variety of actions, including appointment of a receiver, obtaining possession of the rents, making a written demand on the tenants or making a written demand on the borrower, and will be entitled to apply the rents (less property expenses) to the mortgage debt without violating the "one action" or "security first" rule in California.

establish perfection.[176] Judges differ on the requirement of peaceful possession of the property by the mortgage lender to the exclusion of the borrower or the owner.[177]

A security interest also extends to rents that are acquired by the estate after the petition date, subject to two prerequisites: (1) the security agreement was entered into prior to the petition date and extends to after-acquired property, and (2) the security agreement provides for a security interest in rents.[178]

[2] Value of Cash and Prepetition Hoarding

One of the first issues facing a debtor after the filing is how to continue in operation. Businesses that plan to continue operations during a Chapter 11 reorganization required cash because it is the key to a successful reorganization. Cash is required by creditors, employees, trade suppliers, the tax authorities, and a myriad of other parties whose cooperation is essential for a debtor to continue operations. Also, the administrative expenses of a Chapter 11 bankruptcy, such as attorneys' and accountants' fees, are extensive. The Illinois Bankruptcy Court held that "[i]t is well established that cash collateral may appropriately be used to pay administrative expenses [only] if the interest secured by the collateral is adequately protected [or such expenditures are necessary to preserve or maintain the lender's collateral]."[179]

One of the tests that the debtor must meet under Chapter 11 filing is to prove to the court that all obligations incurred after the Chapter 11 filing can be paid promptly and in cash.[180] The bankruptcy courts recognize the importance of continued support from suppliers, employees, and other groups, and give these groups priority unsecured status for their postpetition claims.

The cash needed by the business during reorganization can be generated internally or it can be borrowed. Only in rare circumstances does a company considering bankruptcy maintain a sufficient war chest to fund the costs of filing and have the remaining cash reserves necessary to continue in operation after the filing. For example, one significant expense for the debtor is the large, up-front retainer required by bankruptcy counsel. In most cases, the debtor who has not been able to hoard prepetition cash will either need to borrow this cash or to arrange for the use of cash collateral.

A prepetition debtor holding unencumbered property is in the enviable position of being able to declare a unilateral moratorium on the payment of its debt. Through the collection of receivables or the sale of property, the debtor is able to hoard cash for use during an attempted out-of-court restructuring or ensuing Chapter 11 case. Ways

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[176] In re Concord Mill Ltd. Partnership, 136 B.R. 896 (Bankr. D. Mass. 1992). See also the cases cited in §24.06[1][a] "Assignment of Rents and Use of Cash Collateral" *supra*.

[177] Under an Illinois statute, effective as of January 1, 1996, perfection is deemed effective for all purposes as of the date of recordation of the document that establishes a security interest in the rents. 765 Ill. Comp. Stat. Ann. 5131.5 (West 1996).

[178] 11 USC §552(b)(2) (1994).

[179] In re Addison Properties Ltd. Partnership, 185 B.R. 766, 769 (Bankr. N.D. Ill. 1995); see also 11 USC §363(e) (1993); In re James Wilson Assocs., 965 F.2d 160, 171 (7th Cir. 1992); In re 680 Fifth Ave. Assocs., 154 B.R. 38, 41 (Bankr. S.D.N.Y. 1993).

[180] 11 USC §§1123(a)(5), 1129(a)(4) (1993) (amended 1994).

to limit the size of this prepetition hoard depend on the lender's actions prior to bankruptcy filing.

In the event that a default exists, or in the event that the borrower acknowledges an imminent default, the lender should negotiate a consensual cash management agreement whereby all cash flow is sent by the tenants directly to the lender or to the lender's designated representative and whereby the borrower acknowledges the perfection and enforcement of the lender's interest in the rents. Even though the 1994 Reform Act ostensibly makes state laws regarding the perfection of an interest in postpetition rents inapplicable if a properly recorded prepetition security interest in the rents exists, if bankruptcy is inevitable and the borrower has defaulted, it is still prudent for the lender to move aggressively to perfect or to enforce its security interest in the rents under state law. Moving aggressively in declaring a default and commencing foreclosure to bring on the bankruptcy filing could limit prepetition hoarding by the debtor. In many states, if no default exists, the lender is unable to enforce or to "activate" it interest in rents.[181] If the borrower files for bankruptcy in those states prior to a default, the unused prepetition rents may be an unencumbered stream of cash available for the debtor's use.

If the debtor is a general or limited single asset partnership and has made a cash distribution to its partners prior to filing bankruptcy while real estate taxes due on the property remain unpaid, the secured creditor may be able to assert that such action by the debtor constitutes a fraudulent transfer under state or federal law. The lender can argue that the debtor's failure to pay the taxes constitutes the actionable waste of the debtor's collateral.[182] Waste of collateral by the debtor can create an equitable remedy entitling the lender or the bankruptcy estate to recover the distribution of cash to its partners while real estate taxes were unpaid constituted a fraudulent transfer under the Uniform Fraudulent Conveyance Act that was in effect in New York.[183] State court

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[181] See Chapter 7, Appendix 7A "Jurisdictional Laws and Practices Regarding Rights to Possession, Receivers, and Rents" *supra*.

[182] See generally Chapter 8 "Actions for Waste."

[183] Travelers Ins. Co. v. 633 Third Assocs., 14 F.3d 114 (2d Cir. 1994) *rev'g* 816 F. Supp. 197 (S.D.N.Y. 1993). This landmark decision involved a suit by The Travelers Insurance Company (Travelers) to set aside a $4 million distribution from a single asset partnership borrower to the borrower's partners as a fraudulent conveyance. The distribution was made at the time that a $3.8 million real estate tax bill was due and owing on a forty-one-story office building in New York City, which was the security for Travelers. A $145 million loan was secured by a nonrecourse mortgage on the property. The legal issue was whether Travelers' standing under New York's fraudulent conveyance law permitted it to bring an action against the partnership borrower and the individual partners insofar as such a distribution constituted a waste of its collateral.

Travelers argued that New York law should recognize the failure to pay taxes as waste, which creates a viable substantive cause of action for a nonrecourse secured lender against its borrower. Travelers based its argument on the theory that impairment of the mortgage because of nonpayment of taxes, rather than causing or contributing to physical deterioration of the real estate collateral, constitutes waste remediable by an action in equity. The court ruled that the borrower's failure to pay taxes from available rental income of the property decreased the value of Travelers' secured collateral. The court found that the results of the borrower's actions were akin to the physical injury suffered in a traditional action for waste. The court of appeals further held that Travelers had standing to challenge the prereceivership distribution of cash by the partnership borrower to the borrower's individual partners under New York fraudulent conveyance law.

decisions in Illinois, Florida, Wisconsin, Missouri, Massachusetts, and Minnesota have also held that a mortgagor's failure to pay real estate taxes can constitute actionable waste.[184]

[3] Cash Collateral Motions

The secured creditor should expect the debtor to move for the use of cash collateral.[185] The lender may preempt this move by requesting a hearing on a motion to sequester rents. While the lender usually does not object to the debtor's use of cash collateral to pay reasonable operating expenses of the property, this hearing provides an opportunity for the lender to argue its interest in the cash collateral and to pave the way for court-imposed limits on the debtor's use of the cash collateral.

Sometimes the judge will grant a secured party's requested limitations on the use of the cash collateral by the debtor. The judge usually will recognize an interest in the cash collateral in favor of the lender as a secured party. However, this recognition may depend on the existence of a security agreement including rents as well as the perfection of the lender's security interest in the rents. Additionally, the judge may require that the cash, minus operating expenses, be held in escrow in a segregated account subject to a later determination by the court as to the disposition of the net rental proceeds. The lender should be prepared to present operating histories to

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The decision is significant not only for the ruling on the substantive waste issue, but, more important, for the court's decision that a commercial lender, secured by a traditional nonrecourse permanent loan, could maintain an equitable action against a borrower for misapplication of rental proceeds.

[184] Capitol Bankers Life Ins. Co. v. Amalgamated Trust & Sav. Bank, No. 92-C4480, 1993 WL 594103, at *5 (Bankr. N.D. Ill., May 6, 1993), *aff'd*, 16 F.3d 1225 (7th Cir. 1994). Cf. FDIC v. Prince George Corp., 58 F.3d 1041 (4th Cir. 1995) (holding that filing a bankruptcy petition, resisting a foreclosure action, or any other act, omission, or representation of the borrower that reduces or impairs the lender's rights in the mortgaged property could negate the effect of a nonrecourse provision in the loan documents); Jaffee-Spindler Co. v. Genesco, Inc., 747 F.2d 253, 256 (4th Cir. 1984) (holding that, because waste is a tort, a mortgagee's suit for waste was not barred by the mortgage provision stating that the mortgagor shall not be liable to the mortgagee "on the indebtedness secured hereby or upon any of the other terms, covenants or conditions of this instrument"); Micuda v. McDonald (In re Evergreen Ventures), 147 B.R. 751, 755-56 (Bankr. D. Ariz. 1992) (ruling that a mortgagee was permitted to recover monetary damages against a mortgagor for permissive common law waste, based on the mortgagor's inept management of the property and the failure to maintain the property in a safe and reasonable condition); Lanier v. Spring Cypress Invs., No. 01-93-00414-CVm 1995 Tex. App. LEXIS 1934 (Tex. Ct. App. 1995) (ruling that, where a nonrecourse promissory note provided for recourse liability for the failure to pay real estate taxes and assessments on the mortgaged property, the borrower remained personally liable for unpaid taxes even after a full-price foreclosure sale).

[185] See Chapter 7 at §7.09[2] "Effect on Mortgage of Mortgagor/Landlord's Bankruptcy: Right to Rents" *supra*. Cash collateral is defined by the Bankruptcy Code as

> [C]ash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and 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 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 USC §363(a) (1993) (amended 1994).

persuade the judge to cap the use of rents for operating expenses and to persuade the judge to prohibit the use of the rents for the debtor's legal or accounting expenses.

The trustee or DIP is prohibited from using, selling, or leasing generated cash collateral unless each entity with an interest in the collateral consents or unless the court "after notice and a hearing, authorizes such use, sale, or lease."[186]

The debtor must make a motion to use cash collateral. The motion usually includes (1) the amount of cash collateral to be used; (2) the name and address of each entity having an interest in the collateral; (3) the name and address of any entity having control over the collateral; (4) the facts showing the need to use the collateral; and (5) the nature of any adequate protection to be provided vis-à-vis the cash collateral.[187]

If preliminary or emergency use is sought, the motion must include the amount of cash collateral[188] to be used during the interim period pending a final hearing. A hearing on a request to use cash collateral may be a preliminary hearing or may be consolidated with a final hearing.[189] If it is "a preliminary hearing, the court may authorize [the requested] use, sale, or lease [of cash collateral] only if there is a reasonable likelihood that the trustee [or DIP] will prevail at the final hearing."[190]

The hearing is scheduled in accordance with the debtor's needs, and the court must act promptly on any request for authority to use cash collateral. Nevertheless, the court may not commence a final hearing earlier than fifteen days after service of the motion on each entity with an interest in the cash collateral.[191]

If requested, the court may conduct a preliminary hearing before the fifteen-day period expires, but "may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing."[192]

"If no objection is filed, the court may enter an order approving or disapproving the agreement without conducting a hearing. If an objection is filed or if the court determines a hearing is appropriate, the court [will conduct] a hearing on no less than five days' notice to the objector, the movant, [any committee of the twenty largest creditors,] and such other entities as the court may direct."[193]

Unless the trustee or DIP is permitted to use the cash collateral, he or she is required to segregate and account for any cash collateral in his or her possession, custody, or control.[194] The unauthorized use of cash collateral has been held to be an act in contempt of court on the part of both the debtor and debtor's representative.[195]

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[186] 11 USC §363(c)(2) (1994).
[187] Fed R. Bankr. P. 4001(b).
[188] For the definition of "cash collateral" under the Bankruptcy Code, see §363(a) note *supra*. Cash collateral may not be used by the debtor absent the consent of the bankruptcy court or creditors with liens on such cash collateral and is subject to adequate protection requirements of the Bankruptcy Code. 11 USC §363 (1993).
[189] 11 USC §363(c)(3).
[190] *Id*.
[191] Fed R. Bankr. P. 4001(b)(2).
[192] *Id*.
[193] *Id*. 4001(d)(3).
[194] 11 USC §363(c)(4) (1994).
[195] In re Kelvin Publishing, Inc., No. 94-1999, 1995 U.S. App. LEXIS 36993, at *5, 1995 WL 734481 (6th Cir. Dec. 11, 1995) (unpublished disposition); Commercial Banking Co. v. Jones (In re Maxair Aircraft

Deposit or escrow accounts such as loan holdbacks and tax and insurance escrows held by a secured creditor may be the property of the bankruptcy estate and may be considered cash collateral. The debtor may not use the cash in the account, and the lender may not set off against it unless authorized by the court.[196] If the debtor is authorized to use the cash, the lender should ask to be provided with adequate protection, which should be spelled out in the court order authorizing the use of cash.[197] Also, any setoff occurring within the preference period may be subject to recovery by the trustee or the DIP to the extent that the secured creditor improved its position.[198] The creditor should immediately request adequate protection for any collateral that could be used, sold, or leased by the trustee or the debtor or that is subject to turnover. If such adequate protection later proves inadequate, the former holder of the collateral may be entitled to priority over other administrative claims for the diminution in value.[199]

§24.11 Moving for Relief from Automatic Stay

[1] Grounds for Relief

Sections 362(d) of the Bankruptcy Code provides two grounds upon which the court may grant relief from the automatic stay. Relief may be granted for cause.[200]

Corp. of Ga.), 148 B.R. 353 (Bankr. M.D. Ga. 1992); In re Etch-Art, Inc., 48 B.R. 143 (Bankr. D.R.I. 1985); Mercantile Nat'l Bank v. Aerosmith Denton Corp. (In re Aerosmith Denton Corp.), 36 B.R. 116, 119 (Bankr. N.D. Tex. 1983).

[196] 11 USC §363(c)(2)(B) (1988).

[197] *Id*. §363(e) (1993).

[198] *Id*. §553 (1993).

[199] *Id*. §507(a)(1), (b) (1993).

[200] *Id*. §362(d)(1) (1993). Several courts addressed these cases in terms of assessing whether the debtors had filed their petition in "good faith" and whether there existed "cause" under Sections 362(d)(1) and 1112(b) of the Bankruptcy Code to lift the automatic stay or to dismiss or to convert cases, the effect of which would allow the secured creditor to complete foreclosure. See, for example, In re Coastal Cable T.V., Inc., 709 F.2d 762 (1st Cir. 1983); In re Sonnax Ind., Inc., 907 F.2d 1280 (2d Cir. 1990); Carolina Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989); In re Little Creek Dev. Co., 779 F.2d 1068 (5th Cir. 1986); In re Laguna Associates Ltd. Partnership, 30 F.3d 734 (6th Cir. 1995); In re Trident Associates Ltd. Partnership, 52 F.3d 127 (6th Cir. 1995), *cert. denied*, 116 S. Ct. 188 (1995); In re Madison Hotel Associates, 749 F.2d 410 (7th Cir. 1984); In re Wiesler, 934 F.2d 1393 (11th Cir. 1988). See also In re Holly's Inc., 140 B.R. 649, 689 (Bankr. W.D. Mich. 1992) (finding that " ' cause' to appoint a trustee under §1104 and 'cause' to modify the stay for the benefit of a secured creditor are not identical"); Wilmington Sav. Fund Soc'y v. 1025 Assocs., Inc. (In re 1025 Assocs., Inc.), 106 B.R. 805, 808 (Bankr. D. Del. 1989) (finding that although fraud may constitute sufficient cause for relief from the automatic stay, there was insufficient evidence of such fraud in the instant case); Powers Aero Marine Servs., Inc. v. Merrill Stevens Dry Dock Co. (In re Powers Aero Marine Servs., Inc.), 42 B.R. 540, 546 (Bankr. S.D. Tex. 1984) (holding that prepetition mismanagement by debtor was sufficient cause for relief from the stay). Cause is undefined in the Bankruptcy Code, but has been held in court decisions to include lack of adequate protection for a secured creditor's interest in the property. See, e.g., United Servs. Assoc. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.), 793 F.2d 1380, 1406 (5th Cir. 1986) (recognizing that at a hearing for relief from the automatic stay "the only issue will be the claim of the creditor and the lack of adequate protection or existence of other cause. . . .") *aff'd*.

Relief may also be granted when the debtor has no equity in the property and the property is not necessary for effective reorganization.[201]

[a] Relief Due to Cause

The borrower must provide adequate protection for the lesser of the amount of the creditor's claim or the value of the collateral as of the filing date. Collateral can be hard (the property) or soft (cash). Adequate protection may be afforded to both types of collateral if they exist. In *Timbers*,[202] the U.S. Supreme Court held that adequate protection is meant only to assure that a secured creditor does not suffer a decline in the value of its interest in the bankruptcy estate's property. Adequate protection is not meant to compensate the creditor for the delay in the ability to enforce rights in the property. In other words, an unsecured creditor whose collateral is not depreciating is not entitled to adequate protection payments.

Cash and cash equivalents are the most liquid of the DIP's assets and, therefore, the most susceptible to dissipation. Adequate protection of cash assets may consist of (1) cash payments to the lender to the extent of a decrease in the value of the lender" interest in cash collateral; (2) additional or replacement liens to the extent of such a decrease; or (3) other relief that will yield the equivalent of the lender's interest in the cash collateral.[203]

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484 U.S. 365 (1988); First Fed. Sav. & Loan v. Shriver (In re Shriver), 33 B.R. 176, 181 (Bankr. N.D. Ohio 1983) finding lack of adequate protection is illustrative of cause for granting relief.); Martin v. United States (In re Martin), 761 F.2d 472 (8th Cir. 1985) (finding that determination of adequate protection is a question of fact); Crocker Nat'l Bank v. American Mariner Indus. (In re American Mariner Indus., Inc.); 734 F.2d 426, 435 (9th Cir. 1984) (concluding that sections 361 and 362(d) of the Bankruptcy Code were drafted to "insure that the secured creditor receives the benefit of its bargain"); Grieves v. Bank of W. Indiana (In re Grieves), 81 B.R. 912, 963 (N.D. Ind. 1987) ("[A]dequate protection must be afforded by the debtors to the Bank to keep the stay in effect.").

[201] 11 USC §362(d)(2). "Equity" is the difference between the value of the property and the total liens against it, including junior encumbrances. *Id.* §362(d)(2)(B). See First Nat'l Bank v. Dahlquist (In re Dahlquist), 34 B.R. 476, 80-81 (Bankr. D.S.D. 1983) (holding that a creditor is not entitled to relief on the ground that the debtor lacked equity in the property when the debtor can show that the property is necessary for an effective reorganization); 5 Collier on Bankruptcy ¶ 562.07 (15th ed. 1995). A creditor must establish the validity and perfection of its security interest and the amount of the debt and other allowable costs secured by its secured claim and must carry the ultimate burden of proof with respect to equity. 11 USC §362(g)(1) (1993); In re Colonial Center, Inc., 156 B.R. 452, 459 (Bankr. E.D. Pa. 1993). See, e.g., In re Liona Corp., 68 B.R. 761, 766 (Bankr. E.D. Pa. 1987) (finding that the movants possess the burden of proof on the misuse of equity). The debtor has the burden of proof on the remaining issues if the debtor opposes relief from the stay. If the creditor successfully demonstrates that the debtor has no equity in the property, the burden of showing the necessity of the property for a successful reorganization that is in prospect within a reasonable time shifts to the debtor. 11 USC §362(d)(2)(B), (g)(2). See, e.g., Dahlquist, 34 B.R. at 481 (describing the USC §362(g) allocation of the burden of proof); United Cos. Fin. Corp. v. Brantley, 6 B.R. 178, 184 (Bankr. N.D. Fla. 1980) (explaining that a litigant seeking relief carries the burden of proof regarding equity); LaJolla Mortgage Fund v. Rancho El Cajon Assocs., 18 B.R. 283, 287 (Bankr. S.D. Cal. 1982); Pistole v. Mellor (In re Mellor), 734 F.2d 1396, 1400 n.2 (9th Cir. 1984).

[202] *Timbers*, 484 U.S. at 365.

[203] 11 USC §361 (1993).

[i] Valuation of Property in Bankruptcy

[A] Purpose of Adequate Protection

Section 362(d)(1) of the Bankruptcy Code provides that a court is to grant relief from the automatic stay "for cause, including the lack of adequate protection of an interest in property of [a] party in interest." "Adequate protection" of a secured creditor's interest has meant various things to various judges. The legislative history of the concept is to the effect that it is grounded on notions of Fifth Amendment protections and upon the strong public policy that a secured creditor is not to be harmed by the automatic stay. To the extent possible, the secured creditor is not to be deprived of the benefit of its bargain with the debtor, although it is recognized that the creditor might not receive its bargain in kind. H.R. No. 595, 95th Cong., 1st Sess. 338-39 (1997).

[B] Interpretation of Adequate Protection

The secured creditor is entitled to adequate protection of its "interest in (the estate's) property." A secured creditor's interest in the estate's property is measured by the debt secured by that property. The measure of protection is the value of the collateral.[204] Some guidelines must govern the manner in which that value is to be determined before it can be decided whether a creditor has an equity cushion, whether it is overcollateralized but has a very small cushion, or whether the secured creditor is undercollateralized. For valuation questions, see §§24.08[3][b] "Approaches to Valuation in Bankruptcy" and 24.08[3][b][ii] "Valuation for Lifting the Stay" both *supra*.

[b] Adequate Protection of Rents

In the context of an assignment of rents, the determination of the interests of secured creditors, for purposes of adequate protection, is not directly addressed by the Bankruptcy Code and has produced a large number of conflicting judicial opinions.[205] For example, some courts hold that an undersecured creditor with a prepetition perfected security interest in rents whose hard collateral is not depreciating is not entitled to payment of net rents. These courts find that to the extent that such payments have been made to the secured creditor prior to confirmation, they consist of prepayments that reduce the creditor's secured claim.[206] Other courts hold that if a creditor has a perfected prepetition security interest in the rents, the full amount of the rents is entitled to adequate protection

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[204] For the question of valuation for adequate protection of a security interest in the rents, see §7.09[2][e][i] "Adequate Protection."

[205] See §7.09[2][e] "Use of Perfected Rents" *supra*.

[206] In re Mullen, 172 B.R. 473 (Bankr. D. Mass. 1994); In re Barkley 3A Investors, Ltd., 175 B>R. 755 (Bankr. D. Kan. 1994); In re Reddington/ Sunarrow Ltd. Partnership, 119 B.R. 809 (Bankr. D.N.M. 1990).

and such rents result in an increase in the creditor's secured claim during the pendency of the bankruptcy. Payment of any such postpetition rents that are not used to preserve the hard collateral of the creditor would then result in a loss in the amount of the increase resulting from each payment. In turn, the total amount of the creditor's claim is decreased, except for the secured portion of the claim as measure by the value of the real estate.[207] Still other courts hold that such rents should first be expended to preserve the real estate and then be seen as increasing the creditor's secured claim. To the extent that such net rents are paid to the creditor, they decrease the total amount of the creditor's claim but not the secured portion of the claim as measured by the value of the real estate.[208]

[c] Adequate Protection of Hard Collateral

If a debtor can argue that the value of the collateral exceeds the amount of the secured creditor's claim, the debtor will maintain that the secured creditor is adequately protected by the equity cushion,[209] however small it may be, in its

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[207] See In re Flagler-at-First Assocs., Ltd., 114 B.R. 297 (Bankr. S.D. Fla. 1990) (holding that the amount of a secured creditor's claim must increase during the pendency of the case by adding rents to the value of the underlying collateral). In the past several years, many bankruptcy courts, as well as state courts, have held that a perfected assignment of rents creates a security interest separate and apart from the collateral secured by the mortgage. See, e.g., In re Woodmere Inv. Ltd. Partnership, 178 B.R. 346, 361 (Bankr. S.D.N.Y. 1995) (holding that a security interest in the rents constitutes a form of collateral separate and distinct from the mortgage and must be separately considered and valued, and that the rents received increased the secured creditor's allowed secured claim in equal amounts and, by payment, decreased the secured portion of the claim by the same amount); In re Cadwell's Corners Partnership, 174 B.R. 744, 752 n.8 (Bankr. N.D. Ill. 1994) ("Because possession is fundamental to the ability to collect rents, some courts perceive the nature of an assignment of rents differently than the mortgage on the property itself."); In re 499 W. Warren St. Assocs. Ltd. Partnership, 142 B.R. 53, 56 (Bankr. N.D.N.Y. 1992) ("A secured creditor holding both a mortgage securing a debt on a parcel of real property, and a perfected security interest in rents derived from the property, holds two distinct interests. . . . The value of each of these interests must be separately considered."); In re Lawding Assocs., 122 B.R. 288, 296 (Bankr. W.D. Tex. 1990) (stating that "an assignment of rents confers rights [that] have discrete value apart from the underlying deed of trust interest in the real property generating those rents"); Security Trust Co. v. Sloman, 233 N.W. 216, 219 (Mich. 1930) (holding that an assignment of rents is not merely an incident to the right of possession of land, but as a distinct remedy and additional security).

[208] See In Addison Properties Ltd. Partnership, 185 B.R. 766 (Bankr. N.D. Ill. 1995) (holding that the debtor may use postpetition rents for administrative expenses if the underlying property is not declining in value; to the extent that the rents are not so used by the debtor, such rents are added to the value of the underlying property, measured as of the date of confirmation, for purposes of determining the amount of the lender's secured claim); David G. Carlson, *Adequate Protection Payments and the Surrender of Cash Collateral in Chapter 11 Reorganization*, 15 Cardozo L. Rev. 1357 (1994).

[209] Many of the cases interpreting the meaning of adequate protection hold that if a secured creditor is overcollateralized, the "cushion" between the amount of the debt and the value of the collateral may itself constitute adequate protection. See, e.g., In re Rogers Dev. Corp., 2 B.R. 679 (Bankr. E.D. Va. 1980), and In re Tucker, 5 B.R. 180 (Bankr. S.D.N.Y. 1980). Accord Pistole v. Mellor (In re Mellor), 734 F.2d 1396 (9th Cir. 1984). However, in In re Lane, 108 B.R. 6 (Bankr. D. Mass. 1989), the court held that there was no statutory or common sense basis for the cushion theory of adequate protection, that is either that the equity cushion can provide the adequate protection or that the equity cushion itself must be maintained. The court refused to follow those cases which find adequate protection in maintaining a cushion. Instead, the court believed that United States Savings Association of Texas v. Timbers of Inwood Forest Associates Ltd. (In re Timbers of Inwood Forest Associates, Ltd.), 484 U.S. 365 (1987),

collateral. Junior lien claims are not considered when determining whether an equity cushion exists. When the debtor has little or no equity in the collateral, and the value of the lender's collateral is decreasing, the bankruptcy courts generally have held that the collateral itself is not sufficient to adequately protect the interest of the secured creditor. In these situations, courts require the debtor to provide other adequate protection, such as monthly payments to the secured creditor or a security interest in additional collateral.[210] The judge, in some cases, will consider the monthly generation of cash collateral as the source of adequate protection of the lender's security interest. However, the lender will not be entitled to adequate protection payments based solely on lost opportunity costs.[211]

The argument concerning adequate protection for hard collateral includes protection from declining market values;[212] however, the decline in value must occur and be demonstrated during the case. Bankruptcy courts differ as to

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had shifted the focus from disappearance of the cushion to the potential of reorganization. Moreover, the court refused to take seriously the contention that the taking clause of the fifth amendment requires an equity cushion to be protected. See also Orix Credit Alliance v. Delta Resources, Inc. (In re Delta Resources), 54 F.3d 722 (11th Cir. 1995), *cert. denied*, 116 S. Ct. 488 (1995). In *Orix* the creditor was over secured and thus entitled to the accrual of postpetition interest under §506(b). Because of the accrual of interest the creditor's over secured position was eroding, that is the equity cushion was disappearing. Nevertheless, the court held that the creditor was not entitled to maintain the equity cushion but rather the creditor was entitled to adequate protection only to the extent that the value of the collateral at the time of filing exceeded the value of the creditor's original secured claim. *Id*. at 728. See generally Charles Jordan Tabb, *The Law of Bankruptcy* §3.19 (1997); 9A AmJur Bankr. *Equity Cushion*, §§2102-2108 (1991 & 1998 Supp.); Lawrence J. Dash, Note *The Equity Cushion Analysis in Bankruptcy*, 10 Hofstra L. Rev. 1149 (Sum. 1982); Neal Batson, *The Secured Creditor Versus the Debtor in Possession: The Automatic Stay and Adequate Protection*, 545 PLI/Comm 93 (1990).

[210] 11 USC §361. Nothing in the Code prevents the secured creditor and the debtor in possession from agreeing upon a form of adequate protection. The parties may agree upon a "drop dead" date, which will give the secured creditor the right to foreclose unless the real property has been sold or refinanced before that date. In such a situation, Bankruptcy Rule 4001(d) requires that a motion be filed to approve any such stipulation for adequate protection so that other parties in interest will have an opportunity to object to the stipulation if they are so inclined. When a chapter 11 petition has been filed, the well-advised secured creditor should move quickly in filing a motion for relief from the automatic stay. Putting pressure on the debtor in possession may result in early negotiations and possibly agreement with respect to adequate protection. If settlement cannot be reached, the debtor in possession should attempt to show that there is an equity in the property over and above the amount of the secured creditor's lien, and that that equity constitutes adequate protection.

If the case does go to trial, both parties will invariably present appraisal testimony regarding the value of the property, and the court will have to reach its own conclusions as to the real value of the collateral. If the debtor in possession is unable to demonstrate an equity in the property, it may be able to fall back upon the cases holding that adequate protection is nothing more than a demonstration that the property is not declining in value. If neither of these showings can be made, foreclosure may follow unless funds for periodic payments can be found, perhaps through the device of loans made by the debtor's partners. The failure of the debtor in possession to demonstrate to the satisfaction of the court that the secured creditor is adequately protected will result in an order of the bankruptcy court permitting the secured creditor to proceed with or commence its foreclosure.

[211] *Timbers*, 484 U.S. at 365. See also In re Antell, 155 B.R. 921 (Bankr.. E.D. Pa. 1992) (holding that a debtor may provide adequate protection to a creditor in several ways, including: (1) the existence of an equity cushion; (2) a replacement lien on other unencumbered property; (3) cash payments to the secured creditor; and (4) a viable plan of reorganization that meets the debtor's statutory obligations to the secured creditor).

[212] [Reserved.]

whether, for purposes of adequate protection, the secured creditor's claim is fixed at the date of filing, is entitled to continuous valuation, or is subject to revaluation only on the confirmation date.[213]

One way to argue the lack of adequate protection is to show loss of value during the case, using appraisal testimony at a preliminary hearing on a motion for relief. More appraisal testimony can be presented to show a decline in value since the last appraisal at a later opportunity, such as the debtor's motion to extend the exclusive period.[214] In cases where market rents have declined dramatically and above-market leases are expiring, the property will decline in value as a result of the expiration of the above-market leases.

Claims against the debtor for unmatured interest on totally unsecured debt are not allowed after the filing of the bankruptcy petition. Unsecured creditors are not entitled to adequate protection.[215] The oversecured lender is entitled to interest on its claim and any reasonable fees, costs, or charges provided for by the terms of the agreement under which the lender's claim arose. An oversecured lender is entitled to continue to accrue interest and to pass through attorneys' fees and all other charges that are not penalties as long as they are provided for under the agreement after the filing of the bankruptcy petition.[216]

To rectify the apparent injustice in cases in which the debtor may use collateral even when there is little equity, early bankruptcy courts allowed secured lenders adequate protection on the basis of lost opportunity costs. Drawing on the indubitable equivalent language, these courts construed the concept of adequate protection as entitling the secured creditor to receive monthly payments approximating the amount that the lender originally bargained for or approximately what the lender would earn if allowed to foreclose, sell the collateral, and reinvest the proceeds. However, this line or reasoning was overruled by the Supreme court's decision in *Timbers*.[217] The Supreme Court held that an undersecured lender was not entitled to adequate protection for lost opportunity costs, basing its ruling on a section of the Bankruptcy Code that generally prohibits the payment of postpetition interest to unsecured creditors.[218] The Supreme Court was not persuaded by any of the arguments in favor of lost opportunity costs. *Timbers* reduced the level of adequate protection to which an undersecured lender is entitled and has made it easier for a debtor to avoid modification of the stay. On the other hand, the *Timbers* case may have made it somewhat easier to modify the automatic stay because the debtor has the burden to establish that the collateral is necessary to an effective reorganization. In *Timbers*, the Court listed numerous instances where the automatic stay had been lifted within one year after the filing of a bankruptcy petition and expressly noted that the automatic stay should be modified when there is no realistic prospect of

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[213] *Addison Properties*, 185 B.R. at 766.

[214] This will be true only if the bankruptcy court permits continuous valuation during the course of the bankruptcy prior to confirmation.

[215] 11 USC §502(b)(5) (1993).

[216] 11 USC §506(b) (1993).

[217] *Timbers*, 484 U.S. at 365.

[218] *Id*. at 375.

an effective reorganization, even if the debtor's exclusive period to file a plan of reorganization has not yet expired.[219]

[d] Relief Due to No Equity, and the Property Is Unnecessary for a Reorganization

Even if the secured creditor cannot establish cause as a ground for relief from the automatic stay, the stay will be terminated or modified if the mortgage lender can show that the debtor has no equity, and that the property is not necessary for a reorganization.[220]

The secured creditor has the burden of proving that the debtor has no equity in the property.[221] The creditor may prove this with an appraisal, testimony of an appraiser, or by introducing the debtor's own financial information from the filing of claims and liabilities. The court considers not only the debt of the individual secured creditor, but also all secured claims against the collateral as of the date of the bankruptcy case.[222]

The debtor has the burden of proving that the property is necessary for an effective reorganization and that the debtor can propose a feasible and confirmable plan of reorganization.[223] Courts have held property unnecessary for reorganization when there is no reasonable possibility of a successful reorganization within a reasonable period of time.[224] In single asset real estate cases, the debtor has little hope of rehabilitation, even though the property appears to be indispensable to the debtor's survival.

To rebut this appearance, the creditor must establish that the debtor cannot effectively reorganize due to market conditions. The deteriorating condition of the property, the property's inability to generate sufficient cash flow, or other reasons pertinent to the debtor's business operations may also be evidence that the debtor cannot reorganize. One way to argue this, at least where the bankruptcy is truly a two-party dispute, is to state that no prospect of settlement exists, that the parties' interests are in conflict, and that considerable efforts to work out the loan have failed. When the lender is undersecured, the lender may also argue that the cash flow is not likely to recover soon, nor is the value of the property.

Again, the determination of these issues may depend on a particular court's interpretation of the pertinent Bankruptcy Code provisions. In the *Timbers* decision, the Supreme Court took the position that the debtor need only prove that a reorganization plan is likely in the near future or that it is in prospect.[225] Another

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[219] *Id*. at 376.
[220] *Id*.
[221] 11 USC §362(d)(2)(A) (1993).
[222] See La Jolla Mortgage Fund, 18 B.R. at 287 (stating that equity is "the value . . . that can be realized from the sale of the property for the benefit of the unsecured creditors").
[223] *Id*.; see also Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305 (1st Cir. 1993) (noting that when considering whether property is necessary for an effective reorganization under a Chapter 11 case, the court should consider whether the proposed plan violates any of the §1129 requirements for confirmation of a Chapter 11 plan).
[224] *Timbers*, 484 U.S. at 376.
[225] *Id*.

court decision in a single asset case used the test of whether a debtor is able to come up with a plan that is not objectively futile.[226]

[2] Moving for Dismissal or Conversion to Chapter 7

[a] Case Filed in Bad Faith

Subsequent to the *Timbers* decision, a number of courts have recognized the burdens imposed upon the secured creditor in a single asset case. Some courts are responsive to motions to dismiss single asset cases or to modify the stay on the grounds that the case was filed in bad faith. On the other hand, some bankruptcy judges are hostile to the concept of a bad-faith filing and will seldom dismiss a bankruptcy case on such grounds.[227]

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[226] Carolina Corp. v. Miller, 886 F.2d 693, 700-01 (4th Cir. 1989).

[227] The following are some factors that courts have considered in finding bad faith:

(1) That the debtor has few or no unsecured creditors;
(2) that a bankruptcy petition has been filed previously by the debtor or a related entity;
(3) that the prepetition conduct of the debtor has been improper;
(4) that the petition effectively allows the debtor to evade court orders;
(5) that the debtor owes few debts to nonmoving creditors;
(6) that the petition was filed on the eve of foreclosure;
(7) that the foreclosed property is the sole or major asset of the debtor;
(8) that the debtor has no ongoing business or employees;
(9) that there is no possibility of reorganization;
(10) that the debtor's income is not sufficient to operate;
(11) that nonmoving creditors exerted no pressure;
(12) that reorganization would essentially involve the resolution of a two-party dispute;
(13) that a corporate debtor was formed and received title to its major assets immediately before the petition (the new debtor syndrome); and
(14) that the debtor filed solely to receive the protection of the automatic stay.

See, e.g., In re Love, 957 F.2d 1350 (7th Cir. 1992) (stating that the factors that are relevant in determining good faith include (1) the nature of the debt, (2) timing of the petition, and (3) whether the debtor has been forthcoming with the bankruptcy court creditors); James Wilson Assocs., 965 F.2d at 170 (holding that it is not bad faith for the debtor to seek to gain an advantage from declaring bankruptcy, but that "[t]he clearest case of bad faith is where the debtor enters Chapter 11 knowing that there is no chance to reorganize his business and hoping merely to stave off the evil day when the creditors take control of his property"); Barclays-American/Business Credit, Inc. v. Radio WBHP (In re Dixie Broadcasting, Inc.), 871 F.2d 1023 (11th Cir. 1989), *cert. denied*, 493 U.S. 853 (stating that the factors to be considered by the court in permitting relief from the automatic stay include findings by the court that the debtor has filed the petition (1) at an inappropriate time, (2) despite good financial health, (3) strictly to avoid pending litigation, and (4) "solely to reject an unprofitable contract"); In re Phoenix Piccadilly, Ltd., 849 F.2d 1393, 1394-95 (11th Cir. 1988) (setting forth an on exhaustive list of six factors that a court may consider when deciding whether a debtor's bankruptcy has been filed in bad faith); In re Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984) (applying an objective test of inquiry into the terms of the plan itself and whether the plan will "fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code"); In re 203 N. LaSalle St. Ltd. 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) (finding that the debtor's reorganization plan proposal was made in good faith despite the underlying "motivation of avoiding adverse tax consequences"); In re LDN Corp., 191 B.R. 320, 327

However, case law in this area has been less than uniform, and bankruptcy courts often shy away from the concept of bad faith, even if the objective standards are satisfied. Nonetheless, if the court recognizes the filing as having been made in bad faith, it may allow the debtor no more than its 120-day exclusive period in which to propose a plan or reorganization.

The secured creditor should consider moving for dismissal immediately after the debtor files the bankruptcy petition. The creditor's motion for dismissal may be heard simultaneously with the debtor's motion to use cash collateral. This hearing is the creditor's first opportunity to present to the judge the creditor's interests and efforts, or inability, to work out a solution to the case. The creditor might try to persuade the judge that the filing was made in bad faith or that a reorganization is futile. Although it is unlikely that the case will be dismissed at such an early stage, the judge may set a strict time limit for extensions to the exclusivity period and may deny any motions without prejudice.

[b] Unconfirmable Plan or Other Grounds for Dismissal

The creditor's next opportunity to move for dismissal would be when the debtor submits an unconfirmable plan. If the creditor has the good fortune of having the judge rule in the creditor's favor, the debtor will have had its day in court and no more.

In general, even after confirmation, in the event that a Chapter 11 case proves to be unsuccessful for any one of a number of reasons, the court may, upon motion of a party in interest, either dismiss the case or convert it to a Chapter 7 case.

Section 1112(a) provides that the debtor may convert a chapter 11 case to a Chapter 7 case, as a matter of right unless a trustee has been appointed, the case is an involuntary case originally commenced under Chapter 11, or the case was converted to Chapter 11 from Chapter 7 or 13 by one other than the debtor's request. In the event that one of these three things is true, the debtor may still request that the case be converted to Chapter 7, but not as a matter of right, and a conversion can be ordered only after notice and hearing.

Grounds for conversion by a party in interest are set forth in section 1112(b). That subsection provides that upon request of a party in interest, and after a notice and hearing, the court may convert a Chapter 11 case to a case under Chapter 7 or

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(Bankr. E.D. Va. 1996) (granting creditor's motion to dismiss for bad faith filing based on late filing of debtor's plan, failure of debtor to request filing extension and failure to commence interest payments or to pay debt service from operating income in the past); In re Midway Investments, Ltd., 187 B.R. 382, 387 (Bankr. S.D. Fla. 1995) (concluding that "the Bankruptcy Reform Act of 1994 does not limit that Phoenix Piccadilly line of cases"); In re Victoria Ltd. Partnership, 187 B.R. 54, 59 (Bankr. D. Mass. 1995) (discussing the perceived conflict between the good faith filing doctrine and section 1112(b)(1), "which authorizes the court to dismiss the case for continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation," and the addition perceived conflict with §1112(b)(2), which requires dismissal for inability to effectuate a plan); Cadwell's Corners, 174 B.R. at 762; In re Rusty Jones, Inc., 110 B.R. 362, 375 (Bankr. N.D. Ill. 1990) (holding that a reorganization plan was not proposed in good faith when it did not effectively reorganize the business' affairs, prevent job loss, and prevent adverse economic effects); Castleton Assocs., 109 B.R. at 350-51 (stating that the purpose of a reorganization is not to provide a soft landing for a debtor's partners).

may dismiss the case "whichever is in the best interests of creditors and the estate, for cause, including" and there follows a list of the types of causes, which are illustrated by this section. Among these causes are (1) continuing loss to or the diminution of the estate and the absence of a reasonable likelihood of rehabilitation; (2) inability to effectuate a plan; (3) unreasonable delay by the debtor that is prejudicial to creditors; (4) a proposed plan has been denied confirmation; or (5) there has been material default by the debtor with respect to a confirmed plan. If any one of these types of causes exists or if the court finds other causes for dismissal or conversion, the case will either be dismissed, in which case it will be as if the bankruptcy has never occurred, or the case will be converted to Chapter 7, in which situation a liquidation will follow. An independent trustee will be appointed to take control of all of the assets of the debtor and the trustee will administer the estate. If there is no equity in the property of the estate for the benefit of the creditors, over and above the liens of the secured creditors, in most instances a secured creditor will be granted leave to foreclose, either following the filing of a motion by the secured creditor and a court hearing or by stipulation with the trustee. If there is equity in the property for the estate, the court can direct the trustee to sell the property subject to all liens or free and clear of all liens, in which case liens attach to proceeds.[228] In any event, all of the property of the debtor will be liquidated.

§24.12 Chapter 11 Plan

[1] Who Can File a Plan

The primary goal of the Bankruptcy Code, and Chapter 11 in particular, is to implement a plan of reorganization that will allow the debtor to continue operating its business and will bind all secured creditors, unsecured creditors, and equity holders. Chapter 11 also permits a liquidating plan of reorganization.[229]

The Bankruptcy Code gives the debtor the exclusive right to file a plan of reorganization until 120 days after the filing of the bankruptcy petition.[230] However, pay party in interest may file a plan of reorganization if (1) a trustee has been appointed; (2) the debtor has not filed a plan within 120 days after the filing of the petition; or (3) the debtor has not, within 180 days of the petition filing, filed a plan that has been accepted by each class of claims or interest that is impaired under the plan.[231] Additionally, once the debtor's exclusive period to file a plan expires, creditors have the right to file rival plans.

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[228] See §24.08[3][b][ii][C] "Valuation for Sale Under §363(f)."

[229] See, e.g., Jartran, Inc., 886 F.2d at 868 (holding that a debtor whose reorganization plan has failed may file a new liquidating plan rather then converting to Chapter 7 liquidation).

[230] 11 USC §1121(b) (1993).

[231] *Id.* at §1121(c) (1993). Under the procedural rule that governs the time for filing a plan, a party authorized to file a plan under §1121(c) of the Bankruptcy Code "may not file a plan after entry of an order approving a disclosure statement unless confirmation of the plan relating to the disclosure statement has been denied or the court otherwise directs." Fed. R. Bankr. P. 3016(a). See In re landmark

However, when cause is shown, the court may reduce or extend the 120-day period or the 180-day period.[232] Creditors do not commonly submit plans for reorganization because the debtor seldom relinquishes sole authority to propose a plan within the first 120 days. Furthermore, the bankruptcy judge rarely terminates the debtor's exclusivity early enough in the case to permit a creditor to submit a plan. Additionally, a creditor's plan is also very time-consuming and expensive to propose.

[2] Disclosure Statement and Plan

The plan of reorganization must be submitted to creditors and equity holders for approval, along with a disclosure statement. The burden falls on the debtor to prepare an accurate, fair, and complete disclosure statement. The disclosure statement's adequacy will be tested at a hearing.[233] At the hearing, the plan's proponent will introduce the disclosure materials and other evidence necessary to show that the disclosure is accurate, fair, and complete.[234]

The plan of reorganization enumerates the treatment of each class[235] and sets forth the mechanics of ownership and payment of the debtor's amended obligations.[236] The

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Plaza Ltd. Partnership, 167 B.R. 752 (Bankr. D. Conn. 1994) (holding that an unsecured creditor could file a competing plan prior to confirmation when a debtor failed to obtain an extension of its exclusive 120-day period, but eventually filed an amended plan and disclosure statement that was approved by the court).

[232] 11 USC §1121(d) (1993 & Supp. 1996).

[233] Fed. R. Bankr. P. 3017.

[234] The relevant factors in determining the adequacy of disclosure usually include (1) the events which led to the filing of the bankruptcy petition; (2) a description of the available assets and their value; (3) a description of the nature and amount of claims asserted against the estate; (4) the Chapter 11 plan or a summary thereof; (5) the administration of the Chapter 11 case; (6) the anticipated future operations of the company; (7) historical and projected balance sheets, income statements, valuations, and related financial data relevant to the creditors' decision to accept or reject the Chapter 11 plan; (8) the estimated return to creditors under a Chapter 7 liquidation; (9) the future management of the debtor; (10) the estimated administrative expenses, including professional fees; (11) the collectibility of the accounts receivable; (12) the actual or projected realizable value from the recovery of preferential or otherwise voidable transfers; (13) information relevant to the risks posed to creditors under the plan; (14) litigation likely to arise in a nonbankruptcy contest; (15) tax attributes of the debtor; and (16) the relationship of the debtor with affiliates. The determination of the adequacy of a disclosure statement under 11 USC §1125 is a matter for the bankruptcy court's discretion on a case-by-case basis. Texas Extrusion Corp. v. Lockheed Corp. (In re Texas Extrusion Corp.), 844 F.2d 1142, 1156-57 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988); Colorado Mountain Express, Inc. v. Aspen Limousine Serv. (In re Aspen Limousine Factors, Inc.), 193 B.R. 325, 333-34 (Bankr. D. Colo. 1996); In re Cardinal Congregate I., 121 B.R. 760, 764-65 (Bankr. S.D. Ohio 1990); In re Scioto Valley Mortgage Co., 88 B.R. 168, 170 (Bankr. S.D. Ohio 1988); In re Brandon Mill Farms, Ltd., 37 B.R. 190, 192 (Bankr. N.D. Ga. 1984); In re A.C. Williams Co., 25 B.R. 173, 176 (N.D. Ohio 1982).

[235] 11 USC §1123(a) (1993). A plan of reorganization shall (1) designate classes of claims and classes of interests; (2) specify any class of claims or interests that is not impaired under the plan; (3) specify the treatment of any class of claims or interests that is impaired under the plan; (4) provide the same treatment of each claim or interest of a particular class unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest; and (5) provide adequate means for the plan's implementation. *Id.*

[236] The plan of reorganization could include provisions requiring (1) retention by the debtor of all or any part of the property of the estate; (2) transfer of all or any part of the property of the estate to one or more

disclosure statement generally contains a liquidation analysis, to demonstrate that creditors will not be in a worse position upon confirmation of the debtor's plan.

§24.13 Voting and Classification

[1] Classes in General

The classification of claims is the foundation of the reorganization plan. The debtor segregates the creditors' claims into various classes, ordered in priority of repayment or consideration. Each class receives a specified treatment or payment schedule. A debtor may place a claim in a particular class only if the claim is substantially similar to other claims in that class.[237]

[2] Unimpaired Classes and Their Treatment

Unimpaired classes are not allowed to vote for or against the confirmation of a plan.[238] However, treatment of unimpaired claims must comply with one of the following standards: (1) the plan must not alter the legal, equitable, and contractual rights of claims holders in the class; or (2) the plan must cure all prebankruptcy arrearage, reinstate the maturity of the claims, and compensate the claims holders for damages incurred as a result of reasonable reliance on their contractual provisions.[239]

Prior to the passage of the 1994 Reform Act, section 1124(3) of the Bankruptcy Code provided that a class was considered to be unimpaired if, on the effective date of the plan, the class members received cash for the allowed amount of their claims. However, section 213 of the 1994 Reform Act deleted section 1124(3) of the Bankruptcy Code with the intention of forcing debtors to pay interest to unsecured creditors if the creditors' allowed unsecured claims were paid in full. Congress deleted this section to overrule a 1994 bankruptcy decision[240] holding that, under certain circumstances, the claims of unsecured creditors could be considered paid in full and unimpaired, even though no postpetition interest was to be paid on such claims. Unfortunately, the deletion of this provision may make it easier for a single asset debtor to impair unsecured creditors and confirm a plan. Arguably a debtor can

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entities, whether organized before or after the confirmation of the plan; (3) merger or consolidation of the debtor with one of more persons; (4) sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate; (5) amendment of the debtor's charter; (6) issuance of securities of the debtor or the new ownership for cash, property, existing securities, in exchange for claims or interests, or for any other appropriate purpose. These provisions might also prohibit the issuance of nonvoting equity securities in the debtor's charter, distribute voting power among equity securities classes, and address dividends and the election of directors upon the default of dividend payments. 11 USC §1123(a)(5), (6) (1993).

[237] 11 USC §1122(a) (1993).

[238] 11 USC §1126(f), 1129(a)(8) (Collier 1998).

[239] 11 USC §1124 (1993).

[240] In re New Valley Corp., 168 B.R. 73 (Bankr. D.N.J. 1994).

now pay allowed unsecured claims in full upon confirmation of the plan without paying interest and still treat the class as impaired for voting purposes.[241] Prior to deletion of this provision, the debtor avoided paying interest only by paying less than 100 percent of such claims or by paying the impaired unsecured creditors in full within an extended period of time—for example, ninety days after the effective date of the plan—and taking a greater risk that the class would reject the plan.

[3] Voting of Impaired Classes

The debtor must submit its plan to the creditors holding claims in impaired classes. The creditors may vote to accept or reject the plan. Generally, the creditors do not need to explain of defend their reasons for accepting or rejecting the plan. Certain rules govern creditors' individual and class voting rights. For example, an impaired class of claims is deemed to have accepted the plan if the plan is approved by at least two-thirds in amount and more than one-half in number of those creditors casting ballots.[242] Furthermore, if all classes of impaired claims accept the plan, and the debtor satisfies all of the other requirements under the Bankruptcy Code for confirming a plan of reorganization, the bankruptcy court will confirm the plan[243] and make it binding on all creditors.[244] If, however, the plan does not receive confirmation votes from all impaired classes, but at least one impaired class does accept the plan, the plan may be crammed down on the dissenting classes provided that the court believes that the plan is fair and equitable, and that the plan does not unfairly

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[241] See Equitable life Ins. Co. of Iowa v. Atlanta-Stewart Partners (In re Atlanta Stewart Partners), 193 B.R. 79 (Bankr. N.D. Ga. 1996) (an "administrative convenience" class of unsecured creditors is impaired and may vote on a plan where the plan provides for payment in full of the allowed claims of members of the class even though the debtor is insolvent). The case suggests that a single asset real estate debtor may effect a cramdown over the objections of its undersecured mortgagee by obtaining favorable votes of an administrative convenience class of de minimis general unsecured claims notwithstanding §1129 (a)(10). The unintended consequence of a claim being impaired when it is paid in full seems to stem from the prologue to §1124 which states that a claim is impaired unless it meets the specific parameters of 1124, and after Congress deleted §1124(3) in order to be unimpaired the claim had to specifically fit into §1124(1) or (2). See also In re Crosscreek Apartments, Ltd., 213 B.R. 521, 535 (Bankr. E.D. Tenn. 1997); Neil Batson, *Real Estate Problems in the Bankruptcy Court—Selected Issues in Single Asset Real Estate Cases*, 753 PLI/Comm. 401, 408 (Apr. 1997); but see Paul Rubin, *Fleeting Hope For Single Asset Real Estate Debtors?*, 16 Am. Bankr. Inst. J. 1 (Mar. 1997) (critical of Atlanta-Stewart Partners and its progeny); In re Equitable Dev. Corp., 196 B.R. 889, 893 (Bankr. S.D. Ala. 1996) (*Atlanta-Stewart* may be correct but not applicable because debtor attempted to impair a nonvoting priority tax class); In re Seasons Apartments, Ltd. Partnership, 215 B.R. 953 (Bankr. W.D. La. 1997) (attempt to disimpair under secured mortgagee to preclude mortgagee's vote). For a discussion of *New Valley* and the repeal of 1124(3), SEE Barbara J. Houser, Thomas S. Henderson, Richard M. Rosenberg, Shari A. Wilkins & Jenny J. Hyun, *Plan Issues: Classification, Impairment, Subordination Agreements*, SB37 ALI-ABA 327, 359 (May 8, 1997). The intent of Congress in repealing 1124(3) was not to weaken the creditor's 1129(a)(10) classification veto, but rather to reverse the *New Valley* case in which a debtor avoided paying postpetition interest to unsecured creditors by means of disimpairment. See David Gray Carlson, *Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 Bankr. Dev. J. 273, 290 (1997).

[242] 11 USC §1126(c) (1993 & Supp. 1996).

[243] 11 USC §1129(a)(7), (8) (1994).

[244] *Id*. §1141(a) (1993).

discriminate against the dissenting classes.[245] In each impaired class of claims, each holder of an impaired claim must either accept the plan or receive property, valued as of the effective date of the plan, that equals at least the amount that the holder would have received if the debtor were liquidated under Chapter 7 of the Bankruptcy Code.[246]

If an undersecured creditor's claim is planned in two different classes, that creditor may be able to cast two votes. If the value of the secured creditor's collateral is less than its claim, the creditor has a secured claim in an amount equal to the value of the collateral and an unsecured claim for the amount of the debt that exceeds the collateral.[247] An unsecured claim that arises in this manner is known as a deficiency claim.

[4] Classification Tactics

[a] Case Split

The Bankruptcy Code provides that a plan may include a claim in a particular class only if the claim is substantially similar to the other claims in that class.[248] Although the case law is not uniform, recent decisions have not required that all similar claims be grouped into one class, but merely that any class contain similar claims. Accordingly, it appears that similar claims may be segregated into separate classes.[249]

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[245] *Id.*§1129(a)(10), (b)(1). See In re Lettick Typographic Inc., 103 B.R. 32, 38 (Bankr. D. Conn. 1989); Balcor Real Estate Fin. v. Windsor on the River Assocs. (In re Windsor on the River Assocs., Ltd.), 7 F.3d 127, 130-31 (8th Cir. 1993). The debtor as the proponent of the plan, bears the burden of proving that the plan does not unfairly discriminate. In re Graphic Communications, Inc., 200 B.R. 143, 145 (Bankr. E.D. Mich. 1996); In re J.A.B.T.C. Townhouse Ass'n, Inc., 152 B.R. 1005, 1009 (Bankr. M.D. Fla. 1993); In re Montgomery Ct. Apts. Of Inghem County, L&S, 141 B.R. 334, 346 (Bankr. S.D. Ohio 1992). The court in In re *Graphic Communications* employed a four-factor analysis to determine whether the debtor's plan unfairly discriminated against the undersecured creditor. *Graphic*, 200 B.R. at 146-47. But see §24.13[2] "Unimpaired Classes and Their Treatment" (and footnotes thereto) *supra* on the treatment of §1129(a)(10).

[246] 11 USC §1129(a)(7)(A)(ii) (1994). This requirement is commonly known as the best interests of creditors test. See, e.g., In re Woodbrook Assocs., 19 F.3d 312 (7th Cir. 1994) (stating that, in the best interests of the creditors, remedies other than conversion to Chapter 7 do not have to be considered by the court); 5 Collier on Bankruptcy ¶ 1129.02[7], at 1129-39 (15th ed. Supp. 1996).

[247] 11 USC §506(a) (1994).

[248] *Id*. §1122(a) (1993).

[249] In re One Times Square Assocs. Ltd. Partnership, 159 B.R. 695, 703 (Bankr. S.D.N.Y. 1993). See, e.g., Heartland Fed. Sav. & Loan v. Briscoe Enters. II (In re Briscoe Enters. II), 994 F.2d 1160 (5th Cir. 1993) (allowing class separation when there is a good business reason); In re SM 104 Ltd., 160 B.R. 202, 217 (Bankr. S.D. Fla. 1993) (stating that "separate classification for business reasons in uniformly accepted"); ZRM-Oklahoma Partnership, 156 B.R. 67, 78 (Bankr. W.D. Okla. 1993) (stating that the "plain language of the statute [§422(a)] does not alone support any other restriction" than prohibiting the single classification of dissimilar claims); In re Kliegl Bros. Universal Elec. Stage Lighting Co., 149 B.R. 306 (Bankr. E.D.N.Y. 1992) (separating one claim into a secured and an unsecured claim to constitute a consenting class); cf. In re Granaola Wines, Inc., 748 F.2d 42, 46 (1st Cir. 1994) (stating that "[t]he general rule regarding classification is that 'all creditors of equal rank with claims against the same property should be placed in the same class' "); In re Piece Goods Shops Co., 188 B.R. 778, 788 (Bankr.

Usually, the plan proponent attempts to gerrymander classes of claims to create at least one assenting impaired class.[250] This gerrymandering may involve isolating a large deficiency claim of a secured creditor into its own class.[251] If the deficiency claim votes against the plan, another impaired class of unsecured claims could still vote in favor of it.[252] Several courts have strongly disapproved of attempts by debtors to manipulate unsecured claims or classes. Overall, however, the courts are split over whether this is acceptable or is a bad faith classification on the part of the debtor. A majority of courts have denied confirmation of plans that separately classify deficiency claims from other general unsecured claims unless there is a valid reason to do so. Separate classifications are usually deemed invalid when the only apparent purpose of the separate classification is to gerrymander the vote to satisfy the Bankruptcy Code confirmation requirements.[253]

However, the Seventh Circuit, which includes Illinois, Wisconsin, and Indiana, allows the separate classification of deficiency claims. In *In re*

M.D.N.C. 1995) ("[p]lan proponents are to be given considerable discretion in classifying claims according to the facts and circumstances of their cases").

[250] 11 USC §1129(a)(10).

[251] The Second, Third, Fourth, Fifth, Eighth, and Eleventh Circuits do not permit classification of claims for the sole purpose of gerrymandering votes to ensure the existence of at least one consenting impaired class. Mohammad Samih Barakat v. The Life Ins. Co. of Virginia (In re Mohammad Samih Barakat), 99 F.3d 1520, 1523 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1725 (1997); Federal Deposit Ins. Corp. v. Boston Post Rd. Ltd. Partnership (In re Boston Post Rd. Ltd. Partnership), 21 F.3d 477, 481-83 (2d Cir. 1994), *cert. denied*, 115 S. Ct. 897 (1995); John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154, 160 (3d. Cir. 1993); Balcour Real Estate Fin. v. Windsor on the River Assocs. (In re Windsor on the River Assocs.), 7 F.3d 127, 131 (8th Cir. 1993); Travelers Ins. Co. v. Bryson Properties, XVII (In re Bryson Properties, XVII), 961 F.2d 496, 501 (4th Cir. 1992); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 995 F.2d 1274, 1279 (5th Cir. 1991); Olympia & York Fla. Equity Corp. v. Bank of N.Y. (In re Holywell Corp.), 913 F.2d 873 (11th Cir. 1990); Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.), 800 F.2d 581, 586 (6th Cir. 1986).

[252] In cases in which no, or only minimal, unsecured claims exist other than deficiency claims, the courts have construed such circumstances as two-party disputes in which the debtor is attempting to force the lender to renegotiate the loan. Courts have concluded that, in this situation, the debtor's proposed cram down is an abuse of the bankruptcy process. See cases cited §24.13[4] "Classification Tactics."

[253] See Connecticut Gen. Life Ins. Co. v. Hotel Assocs. (In re Hotel Assocs.), 165 B.R. 470, 473 (Bankr. 9th Cir. 1994) (adopting a good faith approach to the impairment of a class); Briscoe Enters., 994 F.2d at 1160; 203 North LaSalle St., 190 B.R. at 567; In re Dunes Hotel Assocs., 188 B.R. 174, 188-89 (Bankr. D.S.C. 1995); In re Barney & Carey Co., 170 B.R. 17 (Bankr. D. Mass. 1994); In re Daly, 167 B.R. 734, 736 (Bankr. D. Mass. 1994); In re Dean, 166 B.R. 949 (Bankr. D.N.M. 1994); In re North Wash. Ctr. Ltd. Partnership, 165 B.R. 805, 809-10 (Bankr. D. Md. 1994); Citibank, N.A. v. 266 Washington Assocs. (In re 266 Washington Assocs.), 141 B.R. 275, 286-87 (Bankr. E.D.N.Y.), *aff'd*, 147 B.R. 827 (E.D.N.Y. 1992); Mutual Life Ins. Co. v. Lumber Exch. Bldg. Ltd. Partnership (In re Lumber Exch. Bldg. Ltd. partnership), 968 F.2d 647 (8th Cir. 1992); Richard F. Casher & Ronald J. Silverman, In re *Dunes Hotel Associates: A Natural Response to Artificial Impairment*, Bankr. Court Decisions (LRP Publications, Feb. 13, 1996), at A5; Bruce A. Markell, *Clueless on Classification: Forward removing Artificial Limits on Chapter 11 Claim Classification*, 11 Bankr. Dev. J. 1 (1995); Scott F. Norberg, *Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification*, 69 Am. Bankr. L.J. 119 (Spring 1995).

Woodbrook Associates,[254] the court held that, at least when the debtor is a partnership comprised of a fully encumbered single asset, the existence of a right by the secured creditor to elect under section 1111(b)(2) of the Bankruptcy Code means that the undersecured creditors; therefore, separate classification is *required*.

Other than a secured lender's deficiency claim, typical gerrymandered classes can be comprised of trade creditors. This is because the nature of trade creditors' debt is allegedly different from other creditors in that trade creditors' debt consists of short-term credit and claims with recourse to the general partner of the debtor. Tenants may be another such class of trade creditors if they are classified as unsecured. This classification might occur by showing that the tenants stand to receive less than they originally bargained for because of the debtor's rejection of their leases.

[b] Bankruptcy Review Commission Proposal

The Bankruptcy Review Commission Report[255] proposes the following amendment regarding classification of all claims in Chapter 11.

2.4.16 Classification of Claims

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can

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[254] In re Woodbrook Assocs., 19 F.3d at 319 (noting that the separate classification of the secured creditor's "§1111(b) claim neither prevents confirmation of Woodbrooks' plan nor serves as conclusive evidence in this case that Woodbrook manipulated the plan to obtain an affirmative vote").

Other courts, as well as some commentators, have argued that courts should not prohibit artificial impairment of claims by a borrower because such a judicially created prohibition lacks support impairment of claims by a borrower because such a judicially created prohibition lacks support under the Bankruptcy Code. See Steelcase Inc. v. Johnston (In re Johnston), 21 F.3d 323, 328 (Bankr. 9th Cir. 1994); In re Aztec Co., 107 B.R. 585, 592 (Bankr. M.D. Tenn. 1989); Te-Two Real Estate Ltd. v. Creekstone Apts. Assocs. (In re Creekstone Apts., Ltd. Partnership), 1995 Bankr. LEXIS 14876 at *1 (Bankr. M.D. Tenn. Sept. 18, 1995); In re Ridgewood Apts. Ltd., 183 B.R. 784 (Bankr. S.D. Ohio 1995); John R. Clemency & John A. Harris, *The Fight Over "Artificial" Impairment Under §1129(a)(10): It's Time to Call it Quits*, Am. Bankr. Inst. J. (1995), at 14. Although the National Bankruptcy Conference suggested the deletion of §1129(a)(10) of the Bankruptcy Code stating that "[i]n practical terms, however, this particular rule [§1129(a)(10)] adds little to the existing statutory protection [of §1129]," Congress declined to adopt this recommendation when it enacted the 1994 Reform Act. Bernard Shapiro, National Bankr. Conf., Reforming the Bankruptcy Code: final Report (May 1, 1994 at 276-77); see also Connecticut Gen. Life Ins. Co. v. Hotel Assocs. (In re Hotel Assocs.), 165 B.R. 470 (Bankr. 9th Cir. 1994); Kawosaki Leasing Int'l, Inc. v. L & J Anaheim Assocs. (In re L & J Anaheim Assocs.), 995 F.2d 940, 943 (9th Cir. 1993) (adopting the strict or literalist interpretation of impairment, that once a class of claims has been impaired under §1124 and the creditor votes to accept, the requirements of §1129(a)(10) should automatically be deemed to have been satisfied); In re Duval Manor Assocs., 191 B.R. 622, 626-29 (Bankr. E.D. Pa. 1996); In re Elmwood, Inc., 182 B.R. 845, 849 (Bankr. D. Nev. 1995); In re Beare Co., 177 B.R. 886, 889 (Bankr. W.D. Tenn. 1994); In re Rivers End Apartments, Ltd., 167 B.R. 470, 479 (Bankr. S.D. Ohio 1994); In re Bjolmes Realty Trust, 134 B.R. 1000, 1003-04 (Bankr. D. Mass. 1991).

[255] *Bankruptcy: The Next Twenty Years*, (Recommend 2.4.16) (National Bankruptcy Review Commission Final Report, Oct. 20, 1997). The Report is available on the Internet at http://www.nbrc.gov.report.

demonstrate that the classification is supported by a "rational business justification."

The Commission takes a middle ground based on the classification cases. The test permits a debtor to classify groups of claims separately for business reasons, but prohibits a debtor from separately classifying claims for the sole purpose of gerrymandering an assenting impaired class to cram down a plan.[256] The Commission rejects the extremes of (1) courts permitting unrestricted separate classification of similar claims, and (2) courts prohibiting separate classification of similar claims.[257] The Commission chose this response rather than proposing the elimination of section 1129(a)(10) which is the source of the conflict.[258] The single asset real estate cases are the predominate cause of the classification debate. The Commission chose to propose a limited amendment to 1112 and have the single asset problems addressed elsewhere, such as in section 363(d)(3).[259]

The Commission recommended to permit classifying similar claims in different classes if there is a "rational business or financial justification" for doing so. The justification for this is (1) to clarify current inconsistent case law, (2) to afford flexibility to a debtor to deal with a supplier or other creditor whose services are critical to reorganization, and (3) to give the debtor more flexibility without permitting the debtor to gerrymander claims to obtain an assenting class for cram down. However, by adding another factual question regarding "rational business or financial justification" the result may well create more litigation. Further, by permitting separate classification of similar claims this overrides state law and also exposes the creditors to potential pressure from the debtor who may try to manipulate the claims. This gives the debtor an alternative to gerrymandering.

[c] Proposed Legislation—H.R. 3150

In proposed legislation, H.R. 3150, the "rational business justification" proposal of the Bankruptcy Review Commission of the preceding section is not incorporated.[260]

[5] Creditors' Committees

Secured and unsecured creditors are not passive participants in the negotiation of any plan of reorganization, regardless of their voting classifications. If the proposed plan is unacceptable, the holder of an impaired claim may not only vote against the plan, but the holder can encourage others to vote against it. Because the seven largest unsecured or partially unsecured creditors are eligible and are generally asked to

[256] Commission Report, at 569.
[257] *Id*. at 572.
[258] *Id*. at 584.
[259] *Id*. at 588.
[260] On February 3, 1998, Congressman George Gekas (R-Pa.), Jim Moran (D-Va.), Rick Boucher (D-Va.), and Bill McCollum (R-Fla.) introduced H.R. 3150. The Bill is available on Lexis, Legis, Bltext ("Bankruptcy Reform Act of 1998").

become members of a creditors' committee, a secured creditor with an unsecured claim should consider whether or not to participate as a member.[261] Because certain fiduciary obligations arise from membership on a committee, a secured creditor should consult counsel to determine whether the benefits outweigh the burdens.[262]

§24.14 Confirmation

[1] Requirements for Confirmation

If all impaired classes vote in favor of the plan of reorganization, the plan will be confirmed under section 1129(a) of the Bankruptcy Code, provided that it is feasible and meets all of the tests. Section 1129(b) allows for confirmation of a plan, notwithstanding the objection of an impaired class, if it is feasible, "fair and equitable," and "does not discriminate unfairly" against the dissenting class.[263] Under Section 1129(b) a plan is fair and equitable to secured creditors if: (1) each secured creditor retains a lien to the extent of the claim, although the property may be transferred to a third party;[264] (2) each secured creditor receives deferred cash payments that total at least the amount of the secured creditor's claim; and (3) the deferred cash payments have a present value equal to at least the value of the creditor's interest in the collateral.[265] Generally, the only real question here is the discount rate used.

A plan is fair and equitable to unsecured creditors if (1) each creditor receives property with a present value equal to the allowed amount of its claim, or (2) no junior class, including equity holders, (i.e., any class junior to the dissenting class) retains property or receives payment of any kind.[266]

[2] Effect of Confirmation

[a] In General and Discharge

The confirmation of a plan of reorganization has a number of effects upon parties in interest. First, section 1141(a) of the Code provides that the provisions of the confirmed plan "bind the debtor, any entity issuing securities under the

[261] 11 USC §1102(b) (1993).

[262] See Collier, Handbook for Creditors' Committees, chs. 2-5 (Matthew Bender); Peter C. Blain & Diane H. O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 Marq. L. Rev. 581 (1990).

[263] See §24.15 "Cramdown Plans, Variations, and Alternatives" *infra*.

[264] 11 USC §1129(b)(2)(A)(i)(I).

[265] 11 USC §1129(b)(2)(A)(i)(II).

[266] Section 1129(b) of the Bankruptcy Code states that the debtor, equity holders, or junior claimants may not retain any claim or property interest pursuant to a plan over the objection of a class of claimant unless all creditors who are senior to the interests receive full satisfaction of their allowed claims. 11 USC §1129(b) (1996). This is known as the "absolute priority rule." See cases cited *infra* §24.15[2] "New Value Exception to Absolute Priority Rule."

plan, any entity acquiring property under the plan, and any creditor or equity security holder of, or general partner in, the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether such holder, equity security holder, or general partner has accepted the plan." This means that if the requisite majority of a class has voted in favor of a plan, the provisions of the plan, when confirmed, are binding on the dissenting members of the class. Protections for the dissenting members are built into the confirmation standards discussed in the preceding section.

The confirmation of a plan also discharges the debtor from any debt that arose before the date of confirmation, except as otherwise provided in the plan or in the order confirming the plan. The only obligations of the reorganized debtor going forward are those which are specifically set out in the plan and in the order of confirmation.

However, there are some exceptions to the discharge. If the plan contemplates the liquidation of all or substantially all of the property of the estate, then there is no discharge.[267]

[b] Effect of Confirmation on Liens

[ii] Liens Pass Through Bankruptcy Unaffected

Under particular circumstances, liens can be avoided under the avoiding powers of the trustee or debtor in possession.[268] Otherwise, as a general rule, a secured creditor can bypass the debtor's bankruptcy proceeding and enforce the lien in the usual way, which would normally be by bringing a foreclosure action in a state court.[269] This is the principle that liens pass through bankruptcy unaffected.[270] If the creditor follows this route, the discharge in bankruptcy will not impair the lien.[271] Alternatively, the creditor may decide to collect the debt in the bankruptcy proceeding, and to this end may file a proof of claim in that proceeding.[272] The creditor will do this if the creditor is undersecured, for in that case merely enforcing the lien would not enable the creditor to collect the entire debt owed. The creditor's only chance of recovering any part of the amount by which the debt exceeds the value of the

[267] Section 1141(d)(1)(A) discharges the "debtor" which in a Chapter 11 can include corporations and partnerships, see §109(d) ("person eligible"), and §101(41) ("person" includes corporation and partnership). Under 11 USC §1141(d)(3), the §727(a)(1) restriction of discharge to individual debtors is applied in a liquidating Chapter 11. Charles Jordan Tabb, *The Law of Bankruptcy* §10.36 (Foundation 1997).

[268] See Chapter 25 "Bankruptcy—Trustee's Avoiding Powers."

[269] This statement is subject to the provision that if the creditor is forced into the bankruptcy or the bankruptcy court or the trustee has possession of the collateral the automatic stay of section 362 will be in effect.

[270] Long v. Bullard, 117 U.S. 617, 620-21 (1886); Dewsnup v. Timm, 502 U.S. 410 (1992); In re James Wilson Associates, 965 F.2d 160, 167 (7th Cir. 1992).

[271] Dewsnup v. Timm, *supra*, 112 S. Ct. at 778; In re Tarnow, 479 F.2d 464 (7th Cir. 1984).

[272] 11 USC §501(a).

lien would be to share in the distribution of the debtor's estate to the unsecured creditors.[273]

[ii] Forcing Creditor to Participate in Bankruptcy

A secured creditor may be dragged into the bankruptcy involuntarily because the trustee or debtor (if there is no trustee) or someone who might be liable to the secured creditor and therefore has an interest in maximizing the creditor's recovery, may file a claim on the creditor's behalf.[274] The creditor may participate in the bankruptcy in order to try to get the automatic stay[275] lifted to the extent of allowing the creditor to enforce his lien; for the stay applies to the enforcement of liens. The creditor may want to participate in the bankruptcy proceeding (and so may decide to file a claim) simply because the creditor wants to make sure that the debtor's estate is not administered in a way that will diminish the value, as distinct from threatening the existence, of the lien.[276]

[iii] Due Process and Lack of Notice

A creditor's lien may be affected in bankruptcy,[277] but not without due process. Lack of due process may invalidate actions taken to alter the secured status of a creditor where the creditor has received insufficient notice.[278] Due process within the Bankruptcy Code is determined initially by reference to the rules of construction within the Code. Section 102 sets forth the requirement of notice and a hearing as follows: (1) "after notice and a hearing," or a similar phrase—(A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but (B) authorizes an act without actual hearing if such notice is given properly and if—(i) such a hearing is not requested timely by a party in interest; or (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.[279]

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[273] 11 USC §506(a); In re Penrod, 50 F.3d 459 (7th Cir. 1995); In re Tarnow, *supra*, 749 F.2d at 465.
[274] 11 USC §501(b), (c); In re Lindsey, 823 F.2d 189, 191 (7th Cir. 1987).
[275] 11 USC §362(d).
[276] In re CMC Heartland Partners, 966 F.2d 1143, 1147 (7th Cir. 1992).
[277] See chapter 24C "Bankruptcy—Cram Down in Chapter 11."
[278] See, e.g., Southtrust Bank of Alabama v. Thomas (In re Thomas), 883 F.2d 991 (11th Cir. 1989), *cert. denied*, 497 U.S. 1007 (1990).
[279] 11 USC §102(1). The phrase "notice and a hearing" is a flexible concept within the Code, and requires only "such notice as is appropriate in the particular circumstances. . . ." 11 USC §102(1); Matter of Pence, 905 F.2d 1107, 1109 (7th Cir. 1990) ("Due process does not always require formal, written notice of court proceedings; informal actual notice will suffice."). The issue, the court in In re Basham, 167 B.R. 903 (Bankr. W.D. Mo. 1994), stated is that the contents of adequate notice must be "reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Id.* at 907, citing Mullane v. Central Hanover Bank & Trust, 339 U.S. 306, 70 S. Ct. 652, 94 L. Ed. 865 (1950). The court in Basham went on to state: Looking to the contents of the notice to determine if the notice is reasonable calculated, under the

The general rule regarding notice takes into account the notion that "unless action is taken to avoid a lien, it passes through a bankruptcy proceeding."[280]

Due process also restricts the ability of a court to modify a secured claim. The Eleventh Circuit discussed due process and the modification of a creditor's claim in the cases of *Foremost Financial Services Corp. v. White*[281] and *Green Tree Acceptance, Inc. v. Calvert*.[282] In *White*, the court held that the bankruptcy court could not review a proof of claim *sua sponte* where no party sought determination of the creditor's secured status, and the creditor was not provided with notice of the court's actions. In *Calvert*, the court held that a notice of confirmation hearing which stated that the court "may" hear evidence on claim valuation did not constitute adequate notice tot he creditor that its rights may be altered.

[iv]Res Judicata Effect of Confirmation

As discussed in the previous section, the effect of confirmation is to bind all parties unless an exception is applicable. The res judicata effect of an order confirming a plan of reorganization is contained in both common law notions of res judicata and the Bankruptcy Code at 11 USC §1141(a). Section 1141(a) of the Bankruptcy Code provides: (a) Except as provided in subsections (d) (2) and (d) (3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.

The Supreme Court established the res judicata effect of a confirmed plan when it stated:

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circumstances, to apprise interested parties that their rights may be modified, is a flexible approach that encompasses the totality of the circumstances presented in each case. Such approach allows the court to consider a creditor's sophistication, the amount of their involvement in the bankruptcy proceeding, as well as that creditor's reliance on the claims allowance procedures as demonstrated by a proof of claim filed before plan confirmation. Basham at 908.

[280] Matter of Pence, 905 F.2d 1107, 1109 (7th Cir. 1990), citing In re Tarnow, 749 F.2d 464 (7th Cir. 1984). In Pence, the court allowed a confirmed plan to void a security interest in the debtor's residence in exchange for other property. In so doing, the court characterized the rule regarding due process and the terms of a confirmed plan as follows: In the cases where the courts have allowed a lien to survive bankruptcy proceedings despite provisions in a reorganization plan to the contrary, the plan did not allow for any payment of the secured claim—typically where the secured creditor did not file a proof of claim and the plan provided only for the payment of 'allowed secured claims'. [citation omitted]. It is a very different matter where the plan treats the secured claim in a fair and equitable manner, providing for full payment of the debt. *Id*. at 1110.

[281] Foremost Financial Services Corp. v. White (In re White), 908 F.2d 691 (11th Cir.), *rehearing denied*, 916 F.2d 719 (1990).

[282] Green Tree Acceptance, Inc. v. Calvert (In re Calvert), 907 F.2d 1069 (11th Cir.), *rehearing denied*, 917 F.2d 570 (1990).

> Every court in rendering judgment tacitly, if not expressly, determines its jurisdiction over the parties and the subject matter. An erroneous affirmative conclusion as to the jurisdiction does not in any proper sense enlarge the jurisdiction of the court until passed upon by the court of last resort, and even then the jurisdiction becomes enlarged only from the necessity of having a judicial determination of the jurisdiction over the subject matter. When an erroneous judgment, whether from the court of first instance or from the court of final resort, is pleaded in another court or another jurisdiction the question is whether the former judgment is res judicata. After a Federal court has decided the question of the jurisdiction over the parties as a contested issue, the court in which the plea of res judicata is made has not the power to inquire again into that jurisdictional fact. We see no reason why a court in the absence of an allegation of fraud in obtaining the judgment, should examine again the question whether the court making the earlier determination on an actual contest over jurisdiction between the parties, did have jurisdiction of the subject matter of the litigation.[283]

In *Holywell Corp. v. Smith*,[284] the Court stated that while a confirmed plan binds all creditors with preconfirmation claims, a plan could not bind creditors with postconfirmation claims. Therefore, the trustee of the estate was forced to make tax returns as the assignee of the property of the estate in trust despite the fact that the plan was silent about the payment of estate income tax. The binding effect of a plan has accordingly been limited to reconfirmation claims.

[v] Res Judicata Effect of Plan Provisions Contrary to Applicable Law

The binding effect of a confirmed plan of reorganization is such that res judicata applies even when the plan contains provisions which are arguably contrary to applicable law. Consequently, challenges to a confirmed plan of reorganization which allege that the plan is contrary to applicable law, either bankruptcy or otherwise, are bound to be unsuccessful.[285] Therefore, the contents of a plan of reorganization may not be challenged on the grounds that the plan's provisions are contrary to applicable law absent an appeal.[286]

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[283] Stoll v. Gottlieb, 305 U.S. 165, 171-72, 59 S. Ct. 134, 83 L. Ed. 104, 137-38 (1938).

[284] Holywell Corp. v. Smith, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196 (1992) on remand to In re Holywell Corp., 965 F.2d 994 (11th Cir. 1992).

[285] In re Bowen, Jr., 174 B.R. 840, 847 (Bankr. S.D. Ga. 1994); Republic Supply Co. v. Shoaf, 815 F.2d 1046 (5th Cir. 1987) (Questions of the propriety or legality of the bankruptcy court confirmation order are properly addressable on direct appeal.).

[286] Laing v. Johnson (In re Laing), 31 F.3d 1050 (10th Cir. 1994) (stipulation of nondischargeability of debt made in a confirmed Chapter 11 plan could not be relitigated upon conversion of case to Chapter 7); Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.), 898 F.2d 1544 (11th Cir.), *cert. denied*, 498 U.S. 959, 111 S. Ct. 387, 112 L. Ed. 398 (1990) (order confirming a plan of reorganization is entitled to preclusive effect on all claims or issues which were raised or could have been raised in the confirmation proceedings); Howe v. Vaughn (In re Howe), 913 F.2d 1138 (5th Cir. 1990) (debtors could have brought

Accordingly, both applicable provisions of the Bankruptcy Code and Rules, and case law precedent provide that orders confirming plans or reorganization are binding on all claims which were, or could have been, raised at the confirmation hearing.

The grounds by which a confirmed plan may be attacked other than by direct appeal are provided for in the Code and Rules. Under section 1144 of the Bankruptcy Code, orders confirming a plan of reorganization can only be revoked if the order was procured by fraud. Pursuant to Fed. R. Bankr. P. 9024, Rule 60 of the Federal Rules of Civil Procedure applies to cases under Title 11. Under Rule 60(b) relief from an order can be obtained for (1) mistake; (2) newly discovered evidence; (3) fraud; (4) the judgment is void; (5) the judgment has been satisfied, precedent reversed, or equities prevent prospective application; and (6) any other reason justifying relief from judgment. Rule 60(b) gives the bankruptcy court authority to review an order of confirmation under those grounds.[287]

[vi]Lien Must Be Provided for in Plan

Section 1141(c) provides with immaterial exceptions that "except as provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor." However, where a creditor has failed to file a claim, and where the debtor also fails to provide for the claim in the plan of reorganization, due process will prohibit the vesting of the property in the debtor free and clear of the creditor's interest.[288] A long line of cases allows a creditor with a loan

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lender liability claims in a previous bankruptcy case which concluded in a confirmed plan, so res judicata applied to bar claims after confirmation); North Alabama Anesthesiology Group, P.C. v. Zickler (In re North Alabama Anesthesiology Group, P.C.), 154 B.R. 752 (N.D. Ala. 1993) (plan releasing nondebtor guarantors was binding on creditors as res judicata); Martin v. United States (In re Martin), 150 B.R. 43 (Bankr. S.D. Cal. 1993), *appeal dismissed*, United States v. Martin, 172 B.R. 644 (S.D. Cal. 1994) (IRS bound by debt collection procedures of plan even though debt was nondischargeable); In re Moussa, 95 B.R. 449 (Bankr. N.D. Tex. 1989) (provisions of plan preempts time limits of Fed. R. Bankr. P. 4004(a); Wayne H. Coloney Co. v. United States (In re Wayne H. Coloney Co.), 89 B.R. 924 (Bankr. N.D. Fla. 1988) (although debtor cannot normally sever and assume part of a contract and reject the remainder, if the confirmed plan so provides, res judicata precludes challenge); City National Bank of Miami v. General Coffee Corp. (In re General Coffee Corp.), 85 B.R. 905 (Bankr. S.D. Fla. 1988) (questions of court's authority to enter confirmation order is res judicata); In re 12th & N Joint Venture, 63 B.R. 36 (Bankr. D.D.C. 1986) (jurisdictional provisions of a plan preempts termination of the automatic stay); In re St. Louis Freight Lines, Inc., 45 B.R. 546 (Bankr. E.D. Mich. 1984) (plan is binding on creditors receiving less under the plan than legally entitled to). But see Union Carbide Corp. v. Newboles, 686 F.2d 593 (7th Cir. 1982) (court did not have authority to discharge guarantors of obligations despite provision in plan; res judicata was not discussed in the opinion); In re Davis Broadcasting, Inc., No. 94-42-COL, slip op. At 2 (M.D. Ga. Aug. 1, 1994) (same).

[287] Southmark Properties v. Charles House Corp., 742 F.2d 862 (5th Cir. 1984) (final judgments, even if incorrect, are not open to collateral attack, but relief is available for fraud, mistake, etc.); In re Rankin, 141 B.R. 315 (Bankr. W.D. Tex. 1992); United States v. Poteet Construction Co. (In re Poteet Construction Co.), 122 B.R. 616 (Bankr. S.D. Ga. 1990).

[288] Bowen v. United States (In re Bowen), 174 B.R. 840, 850 (Bankr. S.D. Ga. 1994), citing Southtrust Bank of Alabama v. Thomas (In re Thomas), a chapter 13 case, was the fact that under Alabama law, the

secured by a lien on the assets of a debtor who becomes bankrupt before the loan is repaid to ignore the bankruptcy proceeding and look to the lien for the satisfaction of the debt.[289] Unless the collateral is in the possession of the bankruptcy court or trustee, the secured creditor does not have to file a claim.[290]

[vii] Plan Does Not Expressly Provide for Lien

As noted above if the creditor and the debtor ignore a secured claim and the claim is not brought into the bankruptcy, the lien passes through the bankruptcy unaffected. Liens can be altered in bankruptcy, subject to the restrictions of cram down.[291] A troubling question is the effect on liens if the claim is subject to the bankruptcy, but the plan does not specifically deal with the lien. What happens if the plan provides for the claim, but does not expressly address the status of the lien? That is, the plan is silent on provision for the lien. This raises the conflict between section 1141(c) which provides that except as provided in the plan the property dealt with in the plan is free and clear of all "interests of creditors" and section 506(d) that a lien is not void if the claim is not allowed "due only to the failure of any entity to file a proof of such claim." In other words, does the debtor have the affirmative duty to expressly avoid or alter the lien or else have the lien go through the bankruptcy unaffected?

Some courts have reasoned that liens not mentioned in the plan do not survive confirmation. In *In re Penrod*,[292] hogs were the collateral, the creditor filed proof of claim, the debtor's plan provided for payment of the claim, but was silent as to the lien. During the plan, the hogs were stricken with a disease which prevented them from being used as breeding purposes, but did not prohibit them from being sold as food. The debtor sold the hogs without remitting the proceeds to the creditor, as the security agreement had required. The creditor brought suit in state court to enforce a lien in the proceeds. In holding that the lien did not survive bankruptcy, the Seventh Circuit relied on section 1141(c) and reasoned: "Section 1141(c) provides with immaterial exceptions that 'except as provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.' The term 'interest' is not defined in the Code, but a lien is defined as an interest in property, 11 USC sec. 101(37) and there is no doubt that a security interest is an interest, and it is defined as a

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debtor held only a possessory interest in the property, and the debtor could not improve its position by forcing the release of the lien merely by "passing [their] property through the estate." Thomas at 998, quoting In re Honaker, 4 B.R. 415, 416-17 (Bankr. E.D. Mich. 1980).

[289] In re Tarnow, 749 F.2d 464, 465 (7th Cir. 1984) (citing cases).

[290] *Id.*, Tarnow; Relihan v. Exchange Bank, 69 B.R. 122 (Bankr. S.D. Ga. 1985) (secured creditor who failed to file proof of claim in chapter 11 did not lose its lien, where no party took steps to avoid lien).

[291] See §24.09[2][h] "Altering Secured Claims" and Chapter 24C "Bankruptcy—Cram Down in Chapter 11."

[292] In re Penrod, 50 F.3d 459 (7th Cir. 1995).

'lien created by an agreement.' 11 USC Sec. 101(51) So section 1141(c) must cover liens."[293] The court in *Penrod* noted that the creditor could have protected its lien by appealing from the order confirming the plan or it may have had an equitable defense to the complete extinction of the lien if the creditor had presented such a defense.[294]

Other courts take the contrary position that unless a debtor affirmatively avoids a lien, the lien is unaffected. In *Relihan v. Exchange Bank*,[295] the debtor proposed a plan that altered the secured creditor's claim. The creditor did not file a claim. The bankruptcy court modified the plan to provide for the prepetition lien. The debtor appealed and the district court affirmed the modification. The district court held that section 1141(c) language "free and clear of any claim or interest" does not free the property of liens.[296] The court distinguished between "claim" and "lien." "Interest" is not defined in the Code. The court cited section 506(d)(2) for the proposition that a lien is not void if it is not an allowed secured claim due only to the failure of an entity to file a claim and held that since no party took steps to avoid the lien, it must stand.[297] In accord with *Relihan* is *In re Electronics & Metals Id., Inc*.[298] in which the debtor's schedules made no mention of the creditor's lien and the creditor did not file a claim.[299]

[viii] Altering Secured Claims

[A] In General

The secured creditor does not, by participating in the bankruptcy proceeding through filing a claim, surrender the creditor's lien; but this is not to say that the lien is sure to escape unscathed from the bankruptcy. The automatic stay itself has an effect on the secured creditor. If the secured creditor's claim is challenged in the bankruptcy proceeding and the court denies the claim, the creditor will lose the lien by operation of the doctrine of collateral estoppel.[300] The creditor may be forced in the plan of reorganization to swap the lien for an interest that is an "indubitable equivalent" of the lien.[301] In some circumstances the creditor

[293] *Id*. at 462-63.
[294] Penrod, Westlaw at p. 4.
[295] Relihan v. Exchange Bank, 69 B.R. 122 (D.S.D. Ga. 1985).
[296] *Id*. at 127.
[297] *Id*.
[298] In re Electronics & Metals Ind., Inc., 153 B.R. 36 (Bankr. W.D. Tex. 1992).
[299] The court stated: It is black letter law that a claim is not impaired by a plan unless it is classified and treated in a manner inconsistent with its prepetition rights. Here, since the Plan neither classifies nor treats the FDIC's claim, it is unimpaired. Since it is left unimpaired by the Plan, there is no justification for interpreting §1141(c) to "void" its lien. To the contrary, §506(d)(2) seems to fit with this situation "hand in glove" since the only reasons the FDIC does not have an allowed secured claim is that it did not file a claim and the Debtor scheduled its claim as disputed. Since the FDIC's secured claim is unimpaired under the Plan, it must retain its secured status postconfirmation. *Id. Electronics*, at 38.
[300] 11 USC §506(d); In re Tarnow, 749 F.2d 464, 465-66 (7th Cir. 1984).
[301] 11 USC §1129(b)(2)(A)(iii); In James Wilson Associates, 965 F.2d 160, 172 (7th Cir. 1992).

may even be compelled to surrender the lien without receiving anything in return. See 11 USC sections 1126(d), 1129(a), (10), (b)(1). Further, the creditor may accept the plan and consent to discharge of the lien.[302]

[B] Lien Stripping

1. Bifurcation Under §506

Section 506 of the Bankruptcy Code provides the statutory authority for reduction of a creditor's lien commensurate with the value of the property and the bankruptcy estate's interest in the property. Such a procedure has been dubbed "lien stripping" or "strip down" by courts addressing the effect of section 506.

Section 506(a) states that to the extent that a creditor's secured claim is of an amount greater than the value of the property, the creditor's claim is divided into two claims: a secured claim to the extent of the estate's interest in the property, and an unsecured claim for the remainder.[303] Section 506(d) states that to the extent that a lien secures a claim which is not deemed secured by operation of the Code, that lien is void. Lien stripping comes about when a creditor's claim is bifurcated pursuant to section 506(a) into secured and unsecured portions, and the lien securing the claim voided pursuant to section 506(d) to the extent that the lien is in excess of that amount of the claim which is deemed secured.

2. Dewsnup v. Timm

Lien stripping in Chapter 11 cases is not universally accepted, with the argument against lien stripping based on Supreme court precedent. The Supreme court in a Chapter 7 case, *Dewsnup v. Timm*,[304] addressed the issue of whether a debtor may " 'strip down' a creditor's lien on real property to the value of the collateral, as judicially determined, when that value is less than the amount of the claim secured by the lien."[305] The Court began with the premise that because the parties disagreed about the meaning of section 506, the statute was

[302] 11 USC §1126. In re Penrod, 50 F.3d 459 (7th Cir. 1995).
[303] Relevant portions of section 506 are as follows: (a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set off is less than the amount of such allowed claim. . . . (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title. 11 USC §506(a) and (d).
[304] Dewsnup v. Timm, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903 (1992).
[305] *Id*. at __, 112 S. Ct. at 775.

ambiguous.[306] The Court reasoned that the term "allowed secured claim" as it is used in section 506(d) need not be defined in accordance with section 506(a).[307] The Court identified the pre-Code rule that a "creditor's lien stays with the real property until the foreclosure."[308] According to the majority opinion, "[a]part from reorganization proceedings [citation omitted] no provision of the pre-Code statute permitted involuntary reduction of the amount of a creditor's lien for any reason other than payment of the debt."[309] The Court went on to state that since Congress made no explicit statement that it intended to revise pre-Code law, the Court would interpret section 506 in light of such previous law.[310] The Court concluded that debtors in a Chapter 7 liquidation case cannot strip down a creditor's lien pursuant to section 506 of the Code.

3. Applicability of *Dewsnup* to Prevent Lien Stripping in Chapter 11

It is important to note that *Dewsnup v. Timm* was a Chapter 7 case. The Court limited its holding and, arguably, its rationale, to the application of section 506 to those cases under Chapter 7.[311] The methodology and analytical premises which lead to the Court's conclusion have been questioned and thoroughly analyzed in the dissenting opinion filed by Justice Scalia as well as by subsequent courts interpreting the seemingly unambiguous statutory language of section 506.[312]

Courts have split in the wake of *Dewsnup v. Timm* on the issue of whether lien stripping is permissible in a case under Chapter 11. The split is largely the result of the apparent willingness of some courts to accept the Supreme Court's invitation to limit *Dewsnup* to cases under Chapter 7.[313] Several courts have refused the invitation.[314] After all, section 506 applies equally to all chapters of the Bankruptcy Code.[315]

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[306] *Id*. at __, 112 S. Ct. at 775-78.
[307] *Id*. at __, 112 S. Ct. at 778.
[308] *Id*. at __, 112 S. Ct. at 778.
[309] *Id*. at __, 112 S. Ct. at 779.
[310] *Id*. at __, 112 S. Ct. at 779.
[311] The Court stated: "Hypothetical applications that come to mind and those advanced at oral arguments illustrate the difficulty of interpreting the statute [section 506] in a single opinion that would apply to all possible fact situations. We therefore focus upon the case before us and allow other facts to await their legal resolution on another day." *Id*. at __, 112 S. Ct. at 778.
[312] See Dewsnup v. Timm, __ U.S. at __, 112 S. Ct. at 779 (Scalia, J., dissenting); Bowen v. United States (In re Bowen), 174 B.R. 840, 853 (Bankr. S.D. Ga. 1994); Dever v. Internal Revenue Service (In re Dever), 164 B.R. 132 (Bankr. C.D. Cal. 1994); Taffi v. United States (In re Taffi), 144 B.R. 105 (Bankr. C.D. Cal. 1992), *rev'd on other grounds*, Taffi v. United States (In re Taffi), 72 A.F.T.R.2d 93-6607, 1993 WL 558844 (C.D. Cal. 1993).
[313] *Id*., Dewsnup at __, 112 S. Ct. at 777-78.
[314] See Taffi, *supra* 144 B.R. at 113; In re Blue Pacific Car Wash, 150 B.R. 434 (W.D. Wis. 1993).
[315] 11 USC §103(a).

Other courts, accepting the Supreme Court's invitation, have opted to discount the majority's rationale in favor of identifying the Court's concerns over lien stripping in liquidation cases, and distinguishing them from reorganization cases. The court in *Dever v. Internal Revenue Service*[316] addresses the applicability of *Dewsnup v. Timm* with respect to the provisions of Bankruptcy Code under reorganization cases. The *Dever* court distinguished *Dewsnup* based on the result the Supreme Court was trying to avoid in *Dewsnup*.[317]

The court concluded that without lien stripping both congressional intent and existing portions of the Code would be sacrificed. Of particular note is the fact that Congress has provided the mechanism in Chapter 11 in the form of 11 USC section 1111(b) for undersecured creditors to opt out of the bifurcation of its claims under section 506(a). By making an 1111(b) election, a creditor may be treated as fully secured to the extent of its allowed claim. As the court in *In re 680 Fifth Avenue Assoc.*,[318] explained:

> [t]he fact that the §1111(b) election exists at all presumes that debtors possess the authority under the Code to limit secured claims to the value of the collateral. The election allows an undersecured creditor to opt out of the lien-stripping found in §1129 in exchange for relinquishing its deficiency claim, retaining its lien for the full amount of its claim, and receiving payments totaling the entire allowed

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[316] Dever v. Internal Revenue Service (In re Dever), 164 B.R. 132 (Bankr. C.D. Cal. 1994).

[317] The *Dever* court analyzed the *Dewsnup* problem as follows: This holding appears to have been driven by two factors: (1) as a voluntary lien, the bargained-for result under state law would have been that, if the debtor failed to repay the loan, the lender was entitled to foreclose; and (2) there was no benefit whatever realized for the estate or other creditors from this postabandonment voiding of the lien. Under the circumstances, the Supreme Court considered unfair an outcome that appeared to place all the risk of a decline in property value on a mortgage lender, and none on the debtor, who would retain the upside potential *if* the property later appreciates in value. A "windfall," the Court called such a result.. . . If an undersecured creditor forecloses, one of two things happens: either the creditor is paid in cash the fair market value of the property by a third party purchaser, which in theory should be the equivalent of the collateral value determined by the bankruptcy court; or the creditor buys the property itself by credit-bid if other bids at the sale are not sufficiently attractive to the creditor. The creditor thus has the choice of whether to forego the immediate cash in favor of betting on the property's future appreciation. What disturbed the Court in *Dewsnup* was the debtor's attempt to create a third alternative in which the creditor neither received the cash value of the property nor the appreciation potential of ownership. The true effect of lien-stripping in Chapter 7 cases is to allow debtors to redeem their property at a discounted value by installment payments over a protracted period—without giving the creditor any choice whatsoever in the matter. The issue, therefore, is not really how much of the claim is protected by the line, but rather who has the right to ownership of the asset when it leaves bankruptcy. Under what conditions does the undersecured creditor have the right to bid for ownership of the property? Framed in this manner, the unfairness of Chapter 7 lien stripping lies in its failure to require that the creditor receive the cash value of its collateral as the price for being deprived of its opportunity to credit-bid at a foreclosure sale. But this is not a Section 506 failing. Other provisions of the Code are responsible for providing the checks and balances on lien-stripping. Dever at 135.

[318] In re 680 Fifth Avenue Assoc., 156 B.R. 726 (Bankr. S.D.N.Y. 1993), *aff'd*, In re 680 Fifth Ave. Associates, 29 F.3d 95 (2d Cir. 1994).

> claim and having a present value equal to the secured amount . . . [citation omitted]. If on the contrary, the undersecured creditor's lien were preserved under section 1129(b) to the extent the underlying claim were allowed, there would be no reason to offer the undersecured creditor the 1111(b) election. The lien would endure regardless of the creditor's decision, and no "election" would be held at all. *Id*. at 731, n. 7.

Stated simply, to say that there is no lien stripping in Chapter 11 is to ignore the existence of section 1111(b).

Further, in the Bankruptcy Reform Act of 1994,[319] Congress proscribed lien splitting of home mortgages in Chapter 11.[320] The clear implication is that, other than as restricted, lien splitting is permitted in Chapter 11.

The *Dewsnup* case stands for the proposition that there can be no lien stripping without payment of the debt which is secured by the lien. The *Dewsnup* problem was that the debtor attempted to strip the creditor's lien without either making payments on the debt or allowing the creditor to purchase the property by credit bid and enjoy the appreciation.[321]

In reorganization cases, the lien stripping is coupled with payments under a plan. In reorganization cases, ownership of the property will vest in the debtor. There is no right to credit-bid which is lost to a lender. Unlike the creditor in *Dewsnup*, creditors in reorganization cases receive something in exchange for the voiding of their liens: payment obligations under a plan of reorganization. If a creditor receives the value of its interest in the property under a plan of reorganization, the principles of *Dewsnup* are not violated and the lien may be stripped.[322]

4. Proscription of Lien Stripping of Home Mortgages

Section 1123(b)(5) added by the Bankruptcy Reform Act of 1994,[323] conforms the treatment of residential mortgages in Chapter 11 to that in Chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor's principal residence.[324] Since it is intended to apply only to home mortgages, it applies only when the debtor is an individual. It does not apply to a commercial property, or to any transaction in which the

[319] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, §206, 108 Stat. 4106 (1994).
[320] See §24.14[2][b][viii][B]4. "Proscription of Lien Stripping of Home Mortgages" *infra*.
[321] Dewsnup at __, 112 S. Ct. at 777-78; Dever at 135.
[322] Bowen v. United States (In re Bowen), 174 B.R. 840, 855 (Bankr. S.D. Ga. 1994) (debtor could strip IRS lien based on value of property securing federal tax claim and extent of state's interest).
[323] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, §206, 108 Stat. 4106 (1994).
[324] See §24A.22[5] "Home Mortgages."

creditor acquired a lien on property other than real property used as the debtor's residence.[325]

§24.15 Cram Down Plans, Variations, and Alternatives

[1] The Cram Down

If all of the legal requirements of a reorganization plan are met, with the exception of a successful confirmation vote by creditors, the plan may still be confirmed over the objection of a dissenting class. If the plan does not discriminate unfairly and if fair and equitable to the dissenting class, it can be crammed down on the impaired class that votes against the plan.[326] In a cram down, the debtor may (1) reduce the principal amount of the secured claim to the value of the collateral; (2) reduce the interest rate; (3) extend the maturity date; or (4) alter the repayment schedule.[327] The debtor may also make a minimal payment on the unsecured claim. Under the Bankruptcy Code a cram down is permissible when the plan provides a dissenting secured class with consideration equal to the amount of its claim or when no class below the dissenting unsecured class participates under the plan.[328]

A cram down is the single biggest workout and bankruptcy threat to a lender. However, the confirmation and other requirements that a debtor must satisfy in order to cram down both a secured and an unsecured claim, particularly in the case of a single asset real estate bankruptcy, impose such burdens on a debtor that few Chapter 11 debtors who propose cram down plans successfully achieve reorganization by cramming down the lender. Although a mortgagee may be entitled to retain all of its rights under the mortgage, the mortgagee will not necessarily receive an obligation with level periodic payments. Also, the present value requirement necessitates the use of an interest rate. This rate varies in each jurisdiction and can be either the contract rate or a market rate based on treasury bill rates plus a court determined upward adjustment for risk factors.[329] The debtor's plan may also propose negative

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[325] H. Rep. 835, 103d Cong., 2d Sess. 46, §206 (1994).

[326] 11 USC §1129(b)(1) (1996). See Chapter 24D "Bankruptcy—Cram Down in Chapter 11"; In re Woodbrook Assocs., 19 F.3d 312, 317-20 (7th Cir. 1994) (finding that a plan that provided a 5 percent distribution to the mortgagee's unsecured deficiency claim while paying debtor insiders in full constituted unfair discrimination); In re Creekside Landing, 140 B.R. 713, 716 (Bankr. M.D. Tenn. 1990) (finding that extreme disproportionality between payments to insiders and to the mortgagee's deficiency claim contributed to finding of unfair discrimination); cf. In re 203 North LaSalle, 190 B.R. at 586 (finding that the debtor's plan did not discriminate unfairly because it was "narrowly tailored to meet the requirements of the best interests test"); In re Aztec Co., 102 B.R. 585, 588-89 (Bankr. M.D. Tenn. 1989) (holding that the language of "[s]ection 1129(b)(1)__ prohibits only unfair discrimination, not all discrimination, and, therefore, some discrimination between classes of unsecured claims must be permissible).

[327] 11 USC §§506(a), 1123(a)(5)(f), (h) (1993).

[328] 11 USC §1129(a) (1994).

[329] See United States v. Doud, 869 F.2d 1144 (8th Cir. 1989); 203 N. LaSalle St., 190 B.R. at 579-81 (Bankr. N.D. Ill. 1995); In re Woodmere Investors, 178 B.R. at 362; see, *e.g.*, In re Roso, 76 F.3d 179, 180 (8th Cir. 1996) (holding that a subsidized rate of interest, based on the interest rate charged by FmHA, was not a market rate of interest); In re 203 N. LaSalle St. Partnership, 190 B.R. 567, 579-81

amortization of the lender's secured claim. Negative amortization occurs when part or all of the interest on the claim is deferred, allowed to accrue, and added to the principal periodically to be paid at a later date when the income from the property has increased or its value has appreciated. Bankruptcy courts have held that negative amortization is not per se impermissible, but courts will closely scrutinize plans proposing this form payment on a case-by-case basis.[330]

A class of secured creditors can also be crammed down if each secured creditor receives the indubitable equivalent of the claim.[331] A secured creditor receives the indubitable equivalent of the claim when the secured creditor receives a return of part of its collateral while the remainder of its secured claim continues to be secured by

(Bankr. N.D. Ill. 1995), *aff'd*, 195 B.R. 692 (N.D. Ill. 1996) (holding that debtor had provided appropriate market rate of interest in cram down plan where compensation to creditor consisted of loan origination fee, "fixed best interest (at 3.5 percent over the rate earned by Treasury obligations maturity 7 years from the effective date of the plan), and a 50 percent participation fee that net proceeds of any sale or refinancing"); In re Overland Park Merchandise Mart Partnership, P.P., 167 B.R. 647, 659 (Bankr. D. Kan. 1994) (approving an interest rate of 9.5 percent, which "is approximately 250 basis points above the comparable term treasury instrument"); In re Bloomingdale Partners, 155 B.R. 961, 984-85 (Bankr. N.D. Ill. 1993) (employing the band of investment technique to determine the appropriate cram down interest rate); In re Oak Partners, Ltd., 135 B.R. 440 (Bankr. N.D. Ga. 1991) (ruling that the cram down interest rate should be determined by the time value of money approach, which takes a relatively risk free rate and adjusts the rate upward to account for risks associated with the debtor, the security, and the plan).

[330] Great Western Bank v. Sierra Woods Group, 953 F.2d 1174, 1177 (9th Cir. 1992); In re Consolidated Properties Ltd. Partnership, 170 B.R. 93, 98-99 (Bankr. D. Md. 1994); In re Carlton, 186 B.R. 644, 648-49 (Bankr. E.D. Va. 1994); In re Calvenes, 169 B.R. 104, 111-13 (Bankr. E.D. Pa. 1994); In re 8305 Fourth Ave. Corp., 172 B.R. 725, 733-37 (Bankr. E.D.N.Y. 1994); In re Wynnefield Manor Assocs., Ltd. Partnership 163 B.R. 53, 58-60 (Bankr. E.D. Pa. 1993); In re Associates, Ltd., 140 B.R. 619, 637-32 (Bankr. E.D. Pa. 1992); In re Buoy, Halland Howard & Assocs., 141 B.R. 784, 790-91 (Bankr. S.D. Ga. 1992).

[331] 11 USC §1129(b)(2)(A)(iii) (1993). The indubitable equivalent concept is derived from In re Murel Holding Corp., 75 F.2d 941 (1935), in which the court stated that the treatment proposed for a secured creditor (under the former Bankruptcy Act) should provide the secured creditor with "a substitute of the most indubitable equivalence" of its secured claim. 75 F.2d at 942. While the term "indubitable equivalent" is not defined in the Bankruptcy Code, the legislative history of §1129(b) describes this standard as a flexible approach for the satisfaction of secured claims. 124 Cong. Rec. H. 11, 103 (Sept. 28, 1978). Generally, a plan that requires an undersecured creditor to accept only a portion of its collateral in full satisfaction of its secured claim will not satisfy the indubitable equivalence standard. See Arnold & Baker Farms v. United States (In re Arnold & Baker Farms), 85 F.3d 1415, 1422-23 (holding that debtor's "dirt for debt" plan, which required creditor to accept part of the mortgagee's property in full satisfaction of its secured claim, depended entirely on the court's valuation of the collateral and did not provide the creditor with the indubitable equivalent of its secured claim); In re Keller, 157 B.R. 680, 683-87 (Bankr. E.D. Wash. 1993) (stating that "to the extent a debtor seeks to alter the collateral securing a creditor's loan, providing that 'indubitable equivalent' requires that the substitute collateral not increase the creditors risk exposure"); In re Sparks, 171 B.R. 860, 866-68 (Bankr. N.D. Ill. 1994) (denying confirmation of the debtor's plan proposing to convert one-half of the debtor's secured collateral, consisting of an apartment complex, to condominiums and to repay the secured claim from anticipated net proceeds of unit sales and net operating income from remaining apartment units; the court found that the evidence demonstrated that the secured creditor was exposed to a significantly higher risk on default); cf. In re Sandy Ridge Dev. Corp., 881 F.2d 1346, 1350 (5th Cir. 1989) (holding that §1129(b)(2)(A)(iii) does not require that a creditor receive the indubitable equivalent of its entire claim, but only of its secured claim; the court approved the debtor's "dirt for debt" plan providing for a transfer of all of the secured creditor's collateral); In re Sun country Development, 764 F.2d 406, 409 (5th Cir. 1985) (approving plan providing for promissory notes from debtor to secured creditor secured by real estate, which notes were worth twice the amount of the secured creditor's claim).

the remaining collateral, and when the debtor proposes to pay the present value of the remaining secured claim over a period of time.

[2] New Value Exception to the Absolute Priority Rule

A plan can be crammed down on a class of dissenting, unsecured claimants if the plan provides for distributions of property that are equal in value to the allowed amount of their claims. This rarely occurs. Under the Bankruptcy Code, the fail and equitable standard mandates that the debtor cannot confirm a plan of reorganization over the objection of a class of unsecured claimants unless each claimant receives property having a present value equal to the allowed amount of such claim. Alternatively, the holder of any junior claim or interest will not receive or retain any property under the plan.[332] Under the absolute priority rule, in a cram down plan the shareholders of a debtor corporation, the partners of a debtor partnership, or other holders of equity interests cannot retain their equity ownership interests in the debtor unless all senior creditor classes are paid in full.[333]

An exception to this rule, called the new value exception, was set forth in dicta in a 1939 U.S. Supreme Court case, *Case v. Los Angeles Lumber Products Co*.[334] This

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[332] *Id*. §1129(b)(2)(B)(ii). See, e.g., Norwest Bank v. Ahlers, 485 U.S. 197, 208 (1988) (stating that "while the Code itself does not define what 'property' means as the term is used in §1129(b), the relevant legislative history suggests that Congress' meaning was quite broad. '[P]roperty' includes both tangible and intangible property.") (quoting H.R. Rep. No. 95-595, at 413 (1978)).

[333] See Justice v. Carter, 972 F.2d 951, 954 (8th Cir. 1992) (defining the absolute priority rule as barring any junior equity interest "until the unsecured creditors are paid in full under the reorganization plan"). The absolute priority rule was a judicial creation developed as the result of alleged fraudulent transfers and collusive actions in connection with equity receiverships and railroad reorganizations. Kham & Nate's Shoes No. 2, 908 F.2d at 1359 (describing the absolute priority rule as requiring that "every cent of each class comes ahead of the first dollar of any junior class); In re Wabash Valley Power Ass'n, 72 F.3d 1305, 1314 (7th Cir. 1995). See, e.g., Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913) (finding that an arrangement in which subordinated rights and interests of stockholders are secured in lieu of those of prior creditors comes within judicial discretion); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Survey Am. Law 0; Douglas G. Baird, *Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738 (1988); Clifford S. Harris, Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 Mich. L. Rev. 2301 (1993); Charles R. Sternback, *Absolute Priority and the New Value Exception: A Practitioner's Primer*, 99 Com. L.J. 176 (1994).

[334] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 119 (1939). It is not clear whether the new value exception, as set forth in this decision survived the adoption of the Bankruptcy Code. See 5 Collier on Bankruptcy (15th ed.). ¶ 1129.03[4][e], 1129-89 to 1129-102 (1996); John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 Mich. L. Rev. 963, 969-73 (1989) (calling the new value exception a "wild-card uncertainty" circumventing the absolute priority rule); Salvatore G. Gangemi & Stephen Bordanaro, *The New Value Exception: Square Peg in a Round Hole*, 1 Am. Bankr. Inst. L. Rev. 173, 187 (1993) (discussing the division in the courts as to whether the new value exception is viable after the adoption of 11 USC §1129(b) and finding it inappropriate to apply the exception to single asset reorganizations); Lawrence B. Gutcho, *The Elimination of the New Value Cram Downs in One Asset Real Estate Bankruptcies*, 10 Cal. Real Prop. J. 4-1 (1992) (discussing the continued existence of the new value exception in single asset cases); Mark E. MacDonald et al., *Confirmation by Cram Down Through the New Value Exception in Single Asset Cases*, 1 Am. Bankr. Inst. L. Rev. 65, 78-80 (1993) (noting that "the new value exception emerged to temper [the] strict application of the absolute priority rule"); J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification,"* SB37 ALI-ABA 595, 603, 677-99 (1997) (collecting more than

exception allows equity holders to keep their ownership interests even though unsecured creditors do not receive full payment of their claims, provided that equity holders contribute new capital to the reorganized debtor in an amount reasonably equivalent to their retained interest in the debtor.[335] The new value exception requires that the equity holders' infusion of capital be (1) substantial, (2) new, (3) reasonable equivalent to the interest being retained, (4) in the form of money or money's worth that constitutes more than a promise by the equity holders to make future payments,[336] and (5) necessary to a reorganization.[337] The court must determine whether the equity holders' contribution is sufficient to permit them to retain their interests, particularly while senior claims are not being paid in full. Generally, the court determines whether the contribution is reasonably equivalent to the value of the retained equity interests, whether the junior impaired classes are better off with the new value, and whether the new value makes the plan feasible. This inquiry depends on the circumstances of the case, and no precise mathematical relationship or calculation can define when a cash infusion is substantial.[338]

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100 published post- *Ahlers* decisions discussing whether a new value exception exists, and noting that "the viability of new value plans under the code has been hotly debated by courts and commentators").

[335] It is, however, clear that neither sweat equity nor a promise to pay future income constitutes money's worth or new value. See Norwest Bank v. Ahlers, 485 U.S. 197 (1988) (holding that the promise of future labor does not constitute new value); In re Graphic Communications, Inc., 200 B.R. 143, 146 (Bankr. E.D. Mich. 1996) (denying); In re Woodmere Inv. Ltd. Partnership, 178 B.R. 346, 363 (holding that rental income obtained from a debtor's asset that is security for a creditor's lien is not new value); In re 8315 Fourth Ave. Corp., 172 B.R. 725, 738 (Bankr. E.D.N.Y. 1994) (holding that a promise to pay future income is not new value); In re Eitemiller, 149 B.R. 626 (Bankr. D. Idaho 1993) (holding that a promise to use future earnings to make plan payments did not constitute new value); Seattle Mortgage v. Boyd, No. 92-36568, 1993 WL 53347 at *1 (9th Cir. Dec. 23, 1993) (holding that rental income obtained from the same asset the debtor is attempting to retain over the secured creditor's objection is not new value); In re Custer, No. 91-14576S, 1993 Bankr. LEXIS 20 at *19 (Bankr. E.D. Pa. Jan. 7, 1993) (holding that sweat equity in the form of a debtor's managerial skills does not constitute new value); In re Hendrix, 131 B.R. 751 (Bankr. M.D. Fla. 1991) (finding that a promise to pay future income does not constitute new value); In re Ambanc La Mesa Limited Partnership, 115 F.3d 650, 654-56 (9th Cir. 1997) (holding that the new value exception to the absolute priority rule should, in the context of a cram down plan, take into account as new value only money contributed as of the effective date of the plan, and not a promised future stream of payments to be contributed by insiders).

[336] *Supra* cases §24.15[2] "New Value Exception to Absolute Priority Rule."

[337] In re Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992).

[338] Woodbrook Assocs., 19 F.3d at 320 (holding that a 3.8 percent contribution was not substantial and that the proposed contribution "must be real and necessary to the successful implementation of a feasible plan"; Snyder, 967 F.2d at 1131 (holding that the contribution of 2.7 percent of total unsecured claims was not substantial); In re Wynnefield Manor Assocs., Ltd. Partnership, 163 B.R. 53, 57 (Bankr. E.D. Pa. 1993) (holding that the substantiality requirement was not met when the contribution amounted to only 6.08 percent of the creditor's unsecured claims); 203 N. LaSalle St., 190 B.R. at 588 (holding that the proposed new value contribution of 10.7 percent of the bank's unsecured claim, which was the only claim being primed by the partners' retention of equity, was substantial and sufficient to warrant the confirmation of the plan); In re Capital Ctr. Equities, 144 B.R. 262, 269-70 (Bankr. E.D. Pa. 1992) (requiring a contribution by the debtor of 30 percent of the amount of the unsecured claims to satisfy substantiality requirement); In re Pullman Constr. Indus., Inc., 107 B.R. 909, 949-50 (Bankr. N.D. Ill. 1989) (finding that contributions of 2 percent and 4 percent were insubstantial. Some bankruptcy courts and commentators have suggested that an auction of the debtor's equity interest is the best method of determining whether existing equity holders are purchasing their equity interests on account of their original position as equity holders or for a sufficient contribution of new capital. In re Homestead Partners, Ltd., 197 B.R. 706 (Bankr. N.D. Ga. 1996) (citing articles); In re Trevarrow Lanes, Inc., 183

[3] Survival of the New Value Exception

[a] Case Law

The U.S. Supreme Court has not decided whether a new value exception to the absolute priority rule still exists. In 1993, the Ninth Circuit Court of Appeals, in *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co.*,[339] held that "the new value exception survived the enactment of the Bankruptcy Code."[340] Because of the conflict among the federal courts of appeals concerning this issue, the Supreme Court agreed to hear an appeal of the *Bonner Mall* decision in 1994. Unfortunately, the bankruptcy community did not receive clarification from the Supreme Court on the issue because the parties in *Bonner Mall* reached a voluntary settlement, and the case was removed from the Supreme court's calendar. In *Phoenix Mutual Life Insurance Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*[341] the Fifth Circuit Court of Appeals overturned

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B.R. 475 (Bankr. E.D. Mich. 1995); In re Overland Park Merchandise Mart Partnership, 167 B.R. 647, 661-62 (Bankr. D. Kan. 1994); In re SM 104 Ltd., 160 B.R. 202, 226-30 (Bankr. S.D. Fla. 1993); In re Ropt Ltd. Partnership, 152 B.R. 406 (Bankr. D. Mass. 1993); In re Bjolmes Realty Trust, 134 B.R. 1000, 1010-12 (Bankr. D. Mass. 1991); Edwards S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and Its New Value Exception*, 1993 Det. C.L. Rev. 1445, 1486 (competing bids are necessary to establish proper valuation); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 72-73 (1991) (the prospect of competitive bidders at an auction benefits all creditors).

[339] Bonner Mall Partnership v. U.S. Bancorp Mortgage Co., (In re Bonner Mall Partnership), 2 F.3d 899 (9th Cir. 1993), *cert. dismissed*, 115 S. Ct. 386 (1994). This case was an especially attractive test case to resolve the question of whether the new value exception survived the enactment of the Bankruptcy Code because the parties stipulated that this was the sole legal issue before the court. The Ninth Circuit Court of Appeals, in dicta, stated its belief that "the [new value exception] doctrine is not actually an exception to the absolute priority rule but is rather a corollary principle, or, more simply a description of the limitations of the rule itself" and further stated that the doctrine should more appropriately be referred to as the "new capital-infusion doctrine." *Id.* at 906-07. The court also noted that while the courts were divided as to the survival of the new value exception, "the majority of courts that have considered the question have held that the new value exception is alive and well." *Id.* at 907. See Wabash Valley Power Ass'n, 72 F.3d at 1315 (leaving open the issue of the existence of the new value exception, but noting that confirmation based on the recognition of the new value corollary makes economic sense because it maximizes the value available to meet creditor claims); David R. Kuney & Timothy R. Epp, *Aftermath of Bonner Mall: Evolution or Regression in the Notion of 'New Value'?,"* 5 J. Bankr. L. & Prac. 211 (1996); Brian A. Basil, *The New Value Exception to the Absolute Priority Rule in Bankruptcy*, 101 Com. L.J. 290 (1996); Michelle Craig, Note & Comment, *The New Value Exception: A Plea for Modification or Elimination*, 11 Bankr. Dev. J. 781 (1995); Julie L. Friedberg, Comment, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*," 66 Temple L. Rev. 393 (1993).

[340] Bonner Mall Partnership, 2 F.3d at 1.

[341] Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 948 F.2d 134 (5th Cir.), *as amended following reh'g en banc*, 995 F.2d 1274 (5th Cir. 1991) (per curiam), *cert. denied*, 506 U.S. 821. In *Greystone*, the secured creditor's claim totaled $9.3 million, but was divided into a secured claim of $5.8 million (the value of the property) and a nonrecourse deficiency claim of approximately $3.5 million. The only other creditors were trade creditors and tenants with claims totaling $10,000. The secured creditor argued that the debtor had improperly classified the deficiency claim by placing it in a class separate from other unsecured creditors, and that, by so doing, the debtor had

the bankruptcy court and district court rulings that confirmed an egregious cram down of the lender, but later withdrew the portion of its original ruling which held that the new value exception did not survive the enactment of the 1978 Bankruptcy Code.

In the past few years, courts all over the country have been lining up on one side or the argument or the other. *Case v. Los Angeles Lumber Products Co.*,[342] the 1939 Supreme Court case that established the new value exception, was decided before the enactment of the present Bankruptcy Code. Courts are divided over whether the new value exception survived codification of the absolute priority rule. In *Travelers Insurance Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*[343] the Fourth Circuit Court of Appeals rejected the debtor's argument that the lender's unsecured deficiency claim could be separately classified from the unsecured claims of other unsecured creditors. The court held that the debtor's plan could not be confirmed even if the new value exception to the absolute priority rule survived enactment of the Bankruptcy Code. The plan was not fair and equitable because only the lender's claim was truly impaired and because the other unsecured claims were to be paid in full by the debtor outside of bankruptcy.

In *In re 203 N. LaSalle Street Partnership*,[344] a three-judge panel of the Seventh Circuit Court of Appeals affirmed the debtor's cram down plan and upheld the validity of the new value exception to the absolute priority rule. The panel majority, while acknowledging the split of authority among the circuits, as well as in academic commentary, held that the debtor, by contributing substantial new capital, was thereby allowed to participate in the reorganized debtor. The panel majority also found that although Congress did not expressly codify the new value exception, or corollary, as part of the Bankruptcy Code, congress (despite the opportunity to do so) never declared that it intended to eliminate such a valuable tool; therefore, it must have been aware of the exception but decided not to abolish it. In a strong dissent, Judge Kanne argued that the statutory language of section 1129(b)(2)(B)(ii) is clear and unambiguous and does not permit, either expressly or implicitly, the existence of a new value exception. Judge Kanne

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manipulated the voting under the plan. The court pointed out that the distinction between Bankruptcy Code-created deficiency claims and other unsecured claims did not warrant separate classification and stated that one clear rule exists which has emerged from the fact-based case law on classification: "[T]hou shall not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." *Id.* at 139.

[342] Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939). The court established the new value exception in dicta. *Id.* at 121.

[343] Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII), 961 F.2d 496 (4th Cir. 1992), *cert. denied*, 506 U.S. 866. The court noted that section 1111(b)(1) of the Bankruptcy Code had the effect of converting the creditor's claim into a recourse claim. The court also noted that the debtor may not classify similar claims separately for the purpose of manipulating voting on a plan and that the distinction between Code-created unsecured deficiency claims and other unsecured claims does not warrant separate classification. *Id.* at 502. The question of whether the new value exception continues to exist under the Bankruptcy Code is still an open issue in the Seventh Circuit. Wabash Valley Power Ass'n, 72 F.3d at 1315 (leaving open the issue of the existence of the new value exception but noting that confirmation based on recognition of the new value corollary makes economic sense); Woodbrook Associates, 19 F.3d at 319-20; Snyder, 967 F.2d at 1130; Kham & Nate's Shoes No. 2, 908 F.2d at 1356.

[344] In re 203 N. LaSalle St. Partnerships, 126 F.3d 955 (1997).

further argued that the bankruptcy law context in which the exception was formulated in 1939 is irrelevant and inapplicable in light of the sweeping changes made by Congress in enacting the Bankruptcy Code, including the elimination of the requirement of unanimous class consent to confirm a plan and the creation of an elaborate definition of the "fair and equitable" test, which would only be operative if unanimous class acceptance did not occur.

In *In re Coltex Loop Central Three Partners, L.P.*,[345] the Second Circuit Court of Appeals held, based on facts similar to those in *203 N. LaSalle Street Partnership*, that a bankruptcy plan that vests in the debtor's partners the exclusive right to retain the equity interests in the reorganized debtor through the contribution of "new value" violates the absolute priority rule. This opinion is especially interesting because it establishes a clear conflict with the ruling of the Seventh Circuit Court of Appeals in *203 N. LaSalle Street Partnership*, and therefore creates a greater likelihood that the U.S. Supreme court will grant certiorari in the *203 North LaSalle* case.

The court in *In re Coltex* explicitly rejected the holding of the panel majority in *203 N. LaSalle Street Partnership*, instead adopting the position of Judge Kanne in his dissenting opinion. In accordance with Judge Kanne's dissent, the court had no problem finding that the debtor's exclusive right to retain its equity interest in the property upon making a capital contribution was itself "property," which was received solely "on account of" the debtor's prior equity position.

The court also found that, even if some limited form of new value exception existed under the Bankruptcy Code, it would not apply to the facts of this case, where the prior equity holders were given the *exclusive* right to contribute new capital and receive and retain an equity interest in the reorganized debtor. The court explained that granting the debtor such a right would permit the debtor's insiders to retain their equity interests in the reorganized debtor at a "bargain" price "untested by market forces," because the creditors of the bankruptcy estate, as well as other interested parties, would be prohibited from investing in the property of the debtor or making competitive bids. The court noted that the debtor had failed to establish that the existing equity holders' proposed infusion of new capital was "necessary," because the debtor had failed to even explore other potential sources of financing a successful reorganization or expose the property to the open market. The court did note, however, that where no other party seeks to file a plan, or where the property is in fact subjected to open market bidding, the debtor may be able to demonstrate that its retention of its equity interest would not violate the absolute priority rule. (As the attorneys for the bank pointed out in their petition for certiorari to the U.S. Supreme Court in *203 N. LaSalle Street Partnership*, the bank did move to file a competing plan of reorganization, but the bankruptcy court denied the request.)

The court also expressly adopted the reasoning of Judge Kanne, in his dissent in *203 N. LaSalle Street Partnership*, that a "plain reading" of section 1129(b)(2)(B)(ii) of the Bankruptcy Code (enunciating the absolute priority rule) requires the conclusion that former equity holders junior in priority to the unsecured creditor class, who seek to receive property under the plan on account

[345] In re Coltex Loop Cent. Three Partners, L.P., 1998 U.S. LEXIS 2661 (2d Cir. Feb. 19, 1998).

of their former interests, have violated the absolute priority rule and that such a plan is not "fair and equitable" under section 1129(b)(1). The court noted that "[w]here the statutory language is clear the Supreme court will reject prior bankruptcy practice, without an expression of intention in the legislative history to reject this practice," and found that "if equity's new interest under the plan results in any significant way from its old status, the plan may not be confirmed."[346] The court further quoted, with approval, the language in Judge Kanne's dissent that argued that as a result of the substantial changes from prior practice effected by the enactment of the Bankruptcy Code in 1978, the new value exception became inapplicable and unnecessary. The court also found that the absolute priority rule strikes a "considered balance" between the interests of debtors and creditors, and that the courts should not upset this balance by "add[ing] to the rights of either side."[347]

[b] Bankruptcy Review Commission Proposals

On October 27, 1997, the Bankruptcy Review Commission submitted its Final Report to Congress,[348] which included various proposals regarding single asset real estate cases, and further recommended that the new value exception be incorporated into the Code.[349] If the property is classified as "single asset real estate" under 11 USC section 101(51B)[350] the recommendation is that to qualify as a new value contribution the debtor must pay down 20 percent of the court-determined fair market value of the property.[351]

[4] Section 1111(b)(2) Election

Section 1111(b) of the Bankruptcy Code enables an undersecured, nonrecourse creditor to avoid being cashed out at the depressed value of the secured collateral and enables the creditor to share in any future appreciation in such value.

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[346] *Id*. at *12.

[347] *Id*. at *16.

[348] *Bankruptcy: The Next Twenty Years* (National Bankruptcy Review Commission Final Report, Oct. 20, 1997). The Report is available on the Internet at http://www.nbrc.gov/report.

[349] In 1994, Congress, as part of the Bankruptcy Reform Act of 1994, established The National Bankruptcy Review Commission to review the bankruptcy system. When Congress established the National Bankruptcy Review Commission, it pronounced itself "generally satisfied with the basic framework established in the current Bankruptcy Code," counseling that the Commission's recommendations "not disturb the fundamental tenets of current law." Final Report of the National Bankruptcy Review Commission, Preface at p. iv. The Commission was charged with reviewing the Code and making recommendations to improve the integrity, accountability and efficacy of the system; to maintain and restore the balance between debtors and creditors; to provide fair treatment for creditors and a fresh start for debtors; and to recommend changes to make the process faster, less expensive and more accountable. The Final Report contains 170 recommendations, and also is a comprehensive survey of American bankruptcy law. See John C. Murray and Judith Greenstone Miller, "*Recent Developments in 'New Value' and Single Asset Real Estate Cases*," 25 Mich. Real Prop. Rev. 23 (Spring 1998).

[350] See Chapter 24D "Bankruptcy—Single Asset Real Estate Cases" *infra*.

[351] Recommendation 2.6.3.

As noted above, the claim of an undersecured creditor is divided into two claims: (1) a secured claim equal to the value of its collateral, and (2) an unsecured deficiency claim for the balance.[352] Under section 1111(b)(2) an undersecured creditor may elect to have the entire claim treated as fully secured.

The following are two important aspects of making the section 1111(b)(2) election: (1) the undersecured creditor loses the right to vote regarding the previously unsecured claim; and (2) the unsecured creditor must make the election before the conclusion of the hearing on the disclosure statement. Often, this second requirement forces the undersecured creditor to elect before adequate disclosure has been made concerning the plan and the proponent's intentions. By making a section 1111(b)(2) election, a creditor may significantly affect whether the amount of deferred cash payments proposed under a plan and the present value of those payments satisfy the cram down confirmation standards of section 1129(b).

For example, assume that a creditor has a $5 million claim secured by collateral worth $3 million. Under section 1129(b)(2)(A)(i)(II) the plan would have to provide the secured creditor with deferred cash payments that total at least #3 million (the amount of the allowed secured claim) and that have a present value of at least $3 million. These cash payments may continue over five years and would total $4.5 million at a 10 percent rate of interest.[353] Expecting the confirmation of a cram down, the debtor would be likely to propose some treatment of the $2 million unsecured deficiency claim. Usually, the debtor proposes to pay the deficiency claim at a fraction of the face amount over a period of time, such as 20 percent over five years.

If, however, the creditor makes the section 1111(b)(2) election, the deferred cash payments for the secured claim must equal $5 million (the allowed amount of the entire claim) and have a present value of $3 million (the value of the collateral). Thus, in this example, if the undersecured creditor makes this election, the creditor is entitled to a total of $2 million of additional deferred cash payments, not just a fraction of this amount. However, this requirement is often met by lengthening the term of the deferred payments. Here, seven years of payments at 10 percent would total $5.1 million and would satisfy section 1111(b)(2).

Under section 1111(b)(2), the creditor will never get less than the full mortgage amount, but also will never get more than the net present value of the collateral on the plan date. On the other hand, a cram down plan could provide a market rate of return on the collateral value plus a potential benefit in the form of a share of the excess cash flow, sharp depreciation upon a subsequent sale or refinancing, or a scheduled payment on the unsecured portion of the claim.

By making the section 1111(b)(2) election, the creditor becomes secured and, therefore, loses the right to vote in the unsecured class. In other words, the creditor loses one opportunity to vote against the plan. By foregoing the unsecured claim, the

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[352] 11 USC §506(a).

[353] The plan must specify the interest rate factor so that the court is able to determine the adequacy of the proposed deferred cash payments. Many courts have concluded that the discount rate should be comparable to the interest rate that a creditor would charge to make a loan to a borrower with similar terms, circumstances, duration, collateral, and risks. Generally, the appropriate interest rate is determined by the facts of each case and by current market conditions. The secured creditor's contract rate will generally not be the appropriate rate of interest unless it reflects current market conditions. See cases cited *supra* §24.15[1] "The Cram Down."

undersecured creditor also foregoes the opportunity to assert any potential classification, unfair discrimination, and fair-an-equitable objections. These objections could prove fatal to the confirmation of the debtor's plan. Thus, the undersecured creditor could be relinquishing major litigation advantages by making the section 1111(b)(2) election.

Nevertheless, a secured creditor should consider making a section 1111(b)(2) election when the deficiency claim is small and unlikely to dominate voting in the secured creditor's class. In this instance, losing a vote as a consequence of making the section 1111(b)(2) election may not be a factor that the creditor needs to consider.[354] The right to make the section 1111(b)(2) election belongs solely to the secured creditor.[355]

[5] Feasibility Requirements of a Cram Down Plan

Before a court confirms a cram down plan, the court must, among other things, determine whether the plan is feasible. In other words, the court must believe that the plan probably will not be followed by an unproposed liquidation or a need for further financial reorganization.[356] According to the U.S. Supreme court, "[h]owever honest in its efforts the debtor may be, and however sincere its motives, the District court is not bound to clog its docket with visionary or impractical schemes for resuscitation."[357] Although the feasibility requirement does not guarantee the success of the reorganized debtor, it does require that the plan enable the reorganized debtor to emerge solvent and with reasonable prospects of financial stability and success.[358] The burden is on the debtor to prove that the plan is feasible.[359]

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[354] An undersecured creditor should compare the risks and benefits of a cram down to the results of a §1111(b)(2) election by assessing the following (1) cash flows; (2) the proposed sale date and the value of the collateral at that date; (3) the voting strategy of other unsecured creditors and the likely outcome; and (4) new value and the possibility that the judge will confirm the plan over dissenting classes or allow gerrymandering of classes. Under a cramdown, the debtor retains all of the benefits of its equity interest, while the secured creditor bears all of the risk. Because an undersecured creditor has both a secured and an unsecured claim, the decision of whether to make the §1111(b)(2) election is complicated further. Creditors will most likely refuse to make the §1111(b)(2) election if they anticipate that their unsecured claims are at least one-third of the amount of the unsecured claims that are voting on the plan, and thus are large enough to control the voting of the classes of the unsecured creditors. If the undersecured creditor then votes against the plan, the debtor must cram down the class of unsecured claims as well as the class of secured claims. The undersecured creditors that fail to make the §1111(b)(2) election are, in effect, gambling the additional deferred cash payments against the hope that they will be able to prevent confirmation of the plan because they control the voting for both secured and unsecured classes of claims. See In re Stanley, 185 B.R. 417, 426-28 (Bankr. D. Conn. 1995); 5 *Collier on Bankruptcy* ¶ 1111.02 at 1111-21 to –23 (15th ed. 1995).

[355] Coventry Commons Assocs., 155 B.R. at 453 (finding that the plan's unilateral attempt to make the §1111(b)(2) election on behalf of creditors was inconsistent with the statutory provision, rendering the plan nonconfirmable).

[356] 11 USC §1129(a)(11) (1994). This provision is commonly referred to as the feasibility test. See 5 *Collier on Bankruptcy* ¶1129.02[11] (15th ed. 1995).

[357] Tennessee Publishing Co. v. American Nat'l Bank, 299 U.S. 18, 22 (1936).

[358] Kane v. Johns-Mansville Corp., 843 F.2d 636, 649 (2d. Cir.), *cert. denied*, 488 U.S. 868 (1988). ("[T]he feasibility standard is whether the plan offers a reasonable assurance of success. Success need not be guaranteed."); 203 N. LaSalle St. Ltd., 190 B.R. at 567, *aff'd*, 195 B.R. 692 (Bankr. N.D. Ill. 1996)

Generally, the factors that the court considers in determining feasibility include: (1) the earning power of the business; (2) the sufficiency of the capital structure; (3) the condition of the collateral and any deterioration that may have occurred throughout the bankruptcy process; (4) economic conditions; (5) management efficiency; (6) the availability of credit, if needed; and (7) the debtor's ability to meet capital expenditures.[360] The court is obligated to evaluate past earnings to determine if they are a reliable criterion of future performance and, if not, to make an estimate of future performance by inquiring into foreseeable factors that may affect future prospects. To enable the court evaluate past earnings and to estimate future earnings, the debtor must present competent, concrete, and reliable evidence.[361]

Therefore, although debtors may propose to restructure their debts, debtors have a significant burden to establish that they will be able to satisfy the payments proposed in their plans. In a single asset real estate case, the court will deny confirmation if the debtor cannot demonstrate the plan's feasibility based upon realistic and verifiable projections establishing the existence of adequate cash flow.

[6] Purchasing Claims to Block Confirmation and Avoid Cram Down

Section 1126(e) of the Bankruptcy Code permits a court to disqualify the votes of any entity whose acceptance or rejection of a plan was not incurred in good faith. The Bankruptcy Code does not, however, contain a definition of good faith. Bankruptcy Rule 3001(e) restricts the bankruptcy court's role to the adjudication of disputes regarding the transfers of claims. For the most part, if the transferor does not object, then the transfer is automatically approved without a court order.[362] Rule 3001(e) is not intended either to encourage or to discourage postpetition transfers of claims or to affect any remedies that are otherwise available to a transferor or transferee under nonbankruptcy law, such as the remedy for misrepresentation in connection with the transfer of a claim.

In general, purchasing claims is permitted if full and proper disclosure is made and if the purpose of the purchase is not to increase the creditor's recovery at the expenses of the other creditors. The disclosure requirement may pose a problem unless the creditor pays 100 percent of the claims purchased.[363] A creditor who has

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(holding that feasibility standard is met when "the plan offers a reasonable assurance of success"); Mutual Life Ins. Co. v. Patrician St. Joseph Partners (In re Patrician St. Joseph Partners Ltd. Partnership), 169 B.R. 669, 674 (Bankr. D. Ariz. 1994) (holding that a plan meets the feasibility standard if it offers a reasonable prospect of success and is workable; the mere potential for failure of the plan is insufficient to disprove feasibility).

[359] See, e.g., In re 8th St. Village Ltd. Partnership, 88 B.R. 853 (Bankr. N.D. Ill. 1988) (holding that the debtor has the burden of proving the feasibility of the plan).

[360] See, e.g., 203 N. LaSalle St., 190 B.R. at 567.

[361] *Id.*

[362] Fed. R. Bankr. P. 3001(e)(2)-(4).

[363] See Official, Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1314 (1st Cir. 1993) (approving the purchase of claims by a creditor absent fraud); Insinger Mach. Co. v. Federal Support Co. (In re Federal Support Co.), 859 F.2d 17, 19 (4th Cir. 1988) (staging that good faith "does not require of the creditor a selfless disinterest." Rather, "[e]ach creditor is expected to cast his vote in accordance with this perception of his own self-interest, but he may not act with an ulterior or coercive

purchased claims from creditors who are accepting or rejecting the plan will not be permitted to subsequently change the ballots.[364]

Under current case law, a bankruptcy court may "disallow or limit an assigned claim [if] the assignment . . . involve[d] a breach of fiduciary duty, fraud, misrepresentation or overreaching . . . [that] enabled the assignee to acquire the claim for inadequate consideration."[365]

As noted earlier, for a debtor's bankruptcy plan to be crammed down over the objections of a secured creditor with a deficiency claim, at least one impaired class of creditors must vote to accept the plan. For impaired class to accept the plan, section

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purpose"); In re Dune Deck Owners Corp., 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995) (holding that the designation of a creditor's vote for bad faith acceptance or rejection of a plan is the exception rather than the rule, and that a creditor is free to vote the creditor's own self-interest regarding the claim); In re Pleasant Hill Partners, Ltd. Partnership, 163 B.R. 388, 395 (Bankr. N.D. Ga. 1994) (holding that a mortgagee's acquisition of 95 percent of the unsecured claims and the rejection of the debtor's Chapter 11 cramdown plan were not in bad faith when the mortgagee paid 100 percent to the unsecured creditors, attempted to buy all of the unsecured claims, and did not seek to gain a competitive advantage over the debtor or other creditors by purchasing the claims); In re 500 Fifth Ave. Assoc., 148 B.R. 1010, 1020 (Bankr. S.D.N.Y. 1993) (stating that "there is nothing in the Bankruptcy code which renders a creditor a fiduciary in the voting of his claim; he is free to vote his self-interest"); In re Marin Town Ctr., 142 B.R. 374 (Bankr. N.D. Cal. 1992) (holding that "[t]he mere purchase of claims to block confirmation [of a plan] does not constitute bad faith); In re Mall Building Joint Venture, No. 91-1232F (Bankr. E.D. Pa. 1991) (unpublished decision) (ruling that a mortgagee's conduct in purchasing claims was intended to maximize the mortgagee's return on the secured claim and was not otherwise improper); In re Gilbert, 104 B.R. 206, 216 (Bankr. W.D. Mo. 1989) (allowing a creditor to purchase additional claims against a debtor for the purpose of protecting or enhancing the value of an existing claim against the debtor and ruling that this practice does not constitute bad faith).

[364] In re Kellogg Square Partnership, 160 B.R. 332, 334-35 (Bankr. D. Minn. 1993) ("Where an entity acquires a creditor's claim *after* the creditor has already cast a vote on a plan of reorganization, the assignor-creditor's evidenced commitment to that specific participation in the case is a permanent, binding limitation on the transferred claim.").

[365] See Young v. Beugen (In re Beugen), 99 B.R. 961, 965 (Bankr. 9th Cir. 1989) (ruling that the purchase of claims for the purpose of objecting to the debtor's Chapter 7 discharge, "in order to inflict further punishment and discomfort upon the debtor, was improper and actionable); In re Applegate Property, Ltd., 133 B.R. 827 (Bankr. W.D. Tex. 1991) (expressing the broad disapproval of claims acquisition as a vehicle for blocking an opponent's plan and promoting a competing plan); In re Allegheny Int'l, Inc., 118 B.R. 282, 289 (Bankr. W.D. Pa. 1990) (finding that the creditor "did not purchase significant claims until the voting period on the debtor's plan," and subsequently holding that the creditor's votes should be disqualified for bad faith); In re Executive Office Ctrs., Inc., 96 B.R. 642, 649 (Bankr. E.D. La. 1988) (stating the factors to be considered by bankruptcy courts when determining disallowances or limitations of assigned claims and reviewing and providing extensive citations to pre-Bankruptcy Code cases when the courts limited assigned claims); In re MacLeod Co., 63 B.R. 654, 656 (Bankr. S.D. Ohio 1986) (ruling that the dissenting creditors' votes for rejection should be disqualified because they were not made in good faith, "but rather [were] for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business with which the named individuals were associated, could be furthered""; In re Three Flint Hill Ltd. Partnership, 213 B.R. 292, 301 (Bankr. D. Md. (1997) (holding that where a business associate of the debtor's general partner acts as an "insider" in connection with the "friendly" purchase of claims prepetition, the vote by the holder of such claims to accept the debtor's plan was not motivated by "independent business judgment" and would not be counted); In re Federal Support Co., 859 F.2d 17, 19 (4th Cir. 1988) (stating that a creditor does not act in good faith where it casts its vote "with a purpose of coercing payment . . . of more than he might reasonable perceive as his fair share of the debtor's estate," or where the creditor casts his vote for an "ulterior purpose" such as "pure malice, 'strikes,' and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business").

1126(c) of the Bankruptcy Code requires that creditors holding at least two-thirds of the amount of the allowed claims in the class, including more than one-half of the actual number of the allowed claims that vote, must vote for acceptance. If the secured creditor's claim is not large enough—at least one-third of the total amount of the claims in the class—to control the class vote, or if the secured creditor's deficiency claim has been classified separately from the other unsecured claims, the creditor may seek to purchase sufficient claims from other class members to force a negative vote by the class or to control one-third of the amount of *each* noninsider impaired class in order to block confirmation.

Purchasing sufficient claims to confirm a competing plan filed by the creditor is more difficult because the creditor must purchase enough claims to control two-thirds in amount and one-half in number of each nonimpaired creditor class. The creditor seeking to purchase claims should also be aware that a court could take the position that an entity that buys multiple claims is then treated as having only one claim for voting purposes. This treatment may prevent the creditor from casting more than 50 percent of all possible class votes unless the creditor purchases all of the claims in the class. A creditor may also seek to purchase claims in a noninsider impaired class even if the purchase will not enable the creditor to control that class or force a blocking vote. The purchase would require the debtor to comply with the best interests of creditors test under section 1129(a)(7) of the Bankruptcy Code.[366]

Because the bankruptcy court may disallow claims purchased by a creditor not acting in good faith, the question arises as to whether purchasing claims for the purpose of preventing confirmation constitutes bad faith. The emerging test is whether the creditor acted pursuant to an ulterior motive unrelated to the protection of the secured creditor's claims in the case, such as malice, blackmail, intent to destroy the debtor's business in order to advance the interests of a competing business, intent to profit from the purchase or from information obtained thereby, intent to obtain control of the debtor, or intent to obtain an unfair advantage.

In *In re Allegheny International, Inc.*,[367] the bankruptcy court disallowed, on the grounds of bad faith, the vote of a creditor who had purchased blocking claims. However, in *In re Marin Town Center*,[368] a subsequent bankruptcy decision in California, the court held that the purchase of a blocking claim by a creditor was not acquired in bad faith and that the creditor would be permitted to vote the claim. The court noted that creditors are entitled to cast their votes in accordance with their own perception of self-interest. However, the court distinguished its decision from *Allegheny International* based on factual differences, namely that the claim in *Marin Town Center* was purchased before the debtor circulated a plan and the purchasing creditor was not proposing a competing plan.[369]

[366] The best interests of the creditors test requires that every holder of a claim of each impaired class must have either accepted the plan or received property of a value at least equal to what such holder would receive in a Chapter 7 liquidation. See §24.13[3] "Voting of Impaired Classes." *supra*.

[367] In re Allegheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).

[368] In re Marin Town Ctr., 142 B.R. 374 (Bankr. N.D. Cal. 1992).

[369] *Id*.

In re Kovalchik,[370] s subsequent unreported bankruptcy court decision in Pennsylvania, upheld the purchase of blocking claims by a subsidiary created by the secured lender for the purpose of blocking confirmation. The court ruled that the purchase of the claims was permissible and that the claims could be voted because (1) all impaired noninsider claims in the class were offered the same opportunity to sell; (2) the price offered was 100 percent of each claim with immediate payment in full; (3) the purchasing entity identified itself as the secured creditor; (4) there was no duplicity in dealing with the creditors; and (5) the offer of purchase treated the unsecured creditors equally and fairly.[371] The court stated that no formal solicitation process was required because no discount was requested by the purchasing creditor and noted that a creditor's self-interest in purchasing claims was not bad faith.[372] The issue of whether purchasing blocking claims constitutes bad faith is still unsettled, and the issue may well depend on the facts in each case and the jurisdiction in which the case has been filed.[373]

The equitable subordination doctrine contained in section 510(c) of the Code has also been utilized to address inequitable conduct by insiders in trading in a bankruptcy debtor's claims. In *In re Papercraft Corp.*,[374] the bankruptcy court stated that "insider transactions are subjected to rigorous scrutiny and when challenged, the burden is on the insider not only to prove the good faith of a transaction, but also to show the inherent unfairness from the viewpoint of the corporation and those with interests therein."[375] The court found that a director of the debtor who purchased bankruptcy claims against the debtor at a discount without full disclosure breached its fiduciary duty to the debtor, as well as to the creditors of the debtor upon the insolvency of the debtor. The court also held that a fiduciary is "not entitled to any profits resulting from the purchase of claims against the insolvent debtor" and that the claims so purchased should "at a minimum be limited to the amount paid for such claims to eliminate any potential profits."[376]

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[370] In re Kovalchik, 175 B.R. 863 (Bankr. E.D. Pa. 1994). But see Dune Deck Owners Corp., 175 B.R. at 845 (holding that while a creditor who purchases claims to block confirmation of a bankruptcy plan may not have to explain the reasons for such purchase, if the record shows that the creditor's purpose was to achieve a benefit or goal inconsistent with the interests of the estate or its creditors, the court must conduct an evidentiary hearing to determine whether to designate the votes so purchased).

[371] In re Kovalchik, 175 B.R. at 863.

[372] *Id*. at 875. See also In re 255 Park Plaza, 100 F.3d 1214, 1217-19 (6th Cir. 1996) (holding that a creditor's purchase and voting of the claims of smaller creditors for the purpose of preventing confirmation of the debtor's plan does not demonstrate a lack of good faith); In re Figter Limited, 118 F.3d 635, 639-40 (9th Cir.), *cert. denied*, 118 S. Ct. 561 (1997) (ruling that the purchase of claims by a creditor in an effort to protect its own claim, which claim had been placed by the debtor in a separate class from the claims purchased by the creditor, was justified because the creditor had acted in good faith to protect its own valid interest, rather than for ulterior motives).

[373] Lawrence B. Gutcho, David A Fidler, *Purchasing Claims to Block Bankruptcy "Cram Down" Plans: A New Weapon for Creditors*, 115 Banking L.J. 4 (1998) (discussing In re Fighter, 118 F.3d 685 (9th Cir. 1997); Robert L. Ordin, *Purchase of Claims: Review and Overview*, 753 PLI/Comm. 945 (Apr. 1997).

[374] In re Papercraft Corp., 211 B.R. 813 (Bankr. W.D. Pa. 1997).

[375] *Id*. at 822, (citing Pepper v. Litton, 308 U.S. 295, 306, 60 S. Ct. 238 (1939)).

[376] *Id*. at 826. See also In re Pinetree Partners, Ltd., 87 B.R. 481, 488 (Bankr. N.D. Ohio 1988) (holding that claims should be subordinated only to the extent necessary to offset the harm the debtor and its creditors actually suffered); In re Westgate-California Corp., 642 F.2d 1174, 1177-78 (9th Cir. 1981) (ruling that the doctrine of equitable subordination should not be used punitively to take away anything to which a

[7] Final Words on Cram Down

The provisions regarding confirmation and cram down are among the most complicated in the Bankruptcy Code. Although the potential exists for a debtor to restructure debts over the opposition of creditors, the debtor must satisfy numerous interrelated requirements in order to achieve a restructuring.[377] Considering the number of attempts, the number of successful cram downs are relatively few.[378] All debtors must overcome, among other things, the feasibility requirement. Additionally, if an undersecured creditor does not make the section 1111(b)(2) election, the debtor, at least in the majority of jurisdictions, may not isolate the deficiency claim and treat it differently from other unsecured claims unless there is a valid reason to do so. Generally a valid reason does not exist for classifying similar claims differently solely to gerrymander an affirmative vote on a reorganization plan.[379] In practice, it is often difficult for a debtor to satisfy all of the necessary requirements in order to effect a cram down.

[8] An Alternative: Prepackaged Plans

A prepackaged bankruptcy plan is a relatively risk-free way to avoid the hazards and expenses of litigation that could result from an unsuccessful workout attempt.[380] It also provides protection down the road for the lender if the borrower fails to perform and title is transferred to the lender. A prepackaged bankruptcy plan is negotiated by the lender with the borrower and key creditors before, and submitted to the bankruptcy court simultaneously with, a voluntary Chapter 11 filing by the debtor.[381] It is often used in large workouts when there are few significant creditors other than the lender, for example, when only current trade debt exists, and the claims of the other creditors are to be paid substantially or in full as part of the plan. A

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creditor is justly entitled as a result of liquidation of the debtor's assets and bestow a benefit upon others who have no right to it); In re Cumberland Farms, Inc., 181 B.R. 678, 681 (Bankr. D. Mass. 1995) (holding that a fiduciary who purchases claims of an insolvent debtor at a discount without providing the debtor an opportunity to make purchases for the benefit of all the creditors and such conduct clearly supports a finding of inequitable conduct); In re UVAS Financing Corp., 91 B.R. 575, 579 (same).

[377] For an analysis of cram down cases, see Chapter 24C "Bankruptcy—Cram Down in Chapter 11" *infra*.

[378] One author has suggested the reason for the few number of cramdowns as follows: However, a search through the reported cases decided under the Code reveals fewer cases than one might expect that have actually involved use of the cram down power. A detailed analysis of the structure of chapter 11 reveals the reason for the paucity of cases during the four years the Code has been in effect: chapter 11 is biased toward settlement by the parties in interest in the case. As this article will demonstrate, the risks of failure to reach a settlement are so great, and the possible negative impact of the imposition of the cram down powers so significant, that the cram down power is used more as a threat than as a club actually employed in confirming a plan of reorganization.

[379] See *supra* §24.13[4] (discussing classification of claims).

[380] Another reason to avoid the contested bankruptcy is the perception that "vast majority of reorganizations fail . . . leaving creditors with only a fraction of the compensation due them." Associates Commercial Corp. v. Rash, 117 S. Ct. 1879, 1885 (1997).

[381] For a form, see 10 Norton Bankr. L. & Prac. 2d §1123:3 (1998 supp.).

prepackaged plan eliminates the risks, costs, and delays of contested bankruptcy proceedings and assures a court-approved and court-supervised plan as well as an orderly transfer of title.

A basic prepackaged plan might have the following features and components:

(1) The borrower releases the lender from all lender liability claims.[382]
(2) All cash flow is handled in a manner acceptable to the lender and the borrower. Prior to plan confirmation, the lender should obtain acknowledgment of a perfected and presently enforceable rents assignment through a cash collateral agreement. During the implementation of the plan, perfection should continue. The cash management program must not risk loss of perfection or enforcement status for the lender.
(3) Under the Chapter 11 plan that is agreed to by the borrower and the lender before the bankruptcy is filed, the borrower has a set period of time to market and sell the property or to obtain refinancing for a minimum price; the proceeds would be divided according to a set formula.
(4) If no sale or refinancing has occurred at the expiration of the stipulated time period, the lender would have the option to conduct a Bankruptcy Code sale or be granted immediate relief from the automatic stay and proceed with an uncontested foreclosure sale.
(5) Alternatively, the borrower agrees to transfer the property to the lender at the end of the plan if the lender has not been paid, pursuant to a deed and other transfer documents placed in escrow at the time of plan confirmation.[383]
(6) The borrower agrees not to enjoin or otherwise delay any subsequent foreclosure proceedings conducted by the lender.
(7) A liquidated-damages indemnification agreement, or springing guarantee, executed by a solvent third party or parties is delivered to the lender as part of the plan and becomes effective if any attempt is made to prevent, hinder, delay, or obstruct the lender from obtaining title on the final date.
(8) Some or all of the legal costs are normally borne by the lender, such as the costs of drafting the plan, court costs, schedules, solicitation materials, and distribution. The lender also may agree to the payment of all or part of the debtor's costs and attorneys' fees from property income, although these fees are often capped on a negotiated basis.

In short, the lender's normal remedies are safeguarded from future defenses and delays brought by the borrower, including another adversarial bankruptcy. Having secured concessions from the lender, the borrower gets another chance to perform.

Historically, a prepackaged plan, referred to as an out-of-court restructuring proposal made by a financially distressed debtor, would qualify as a plan of reorganization in a Chapter 11 case. This stipulation would be signed as an order by

[382] See Chapter 4B "Liability of Lender for Controlling Debtor and for Other Acts" *supra*.

[383] The principles of res judicata and collateral estoppel should apply with respect to any attempt by the debtor to void the agreed-to consensual transfer of the property by filing a subsequent bankruptcy proceeding. See In re Howe, 913 F.2d 1138, 1149 (5th Cir. 1990); 203 N. LaSalle, 195 B.R. at 594; In re Eubanks, 1990 WL 128208 (E.D. La. 1990).

the bankruptcy judge and would, therefore, have the force of law. Such bankruptcy stipulations have been judicially upheld as binding on the parties.[384]

The prepackaged plan avoids the adverse effects of dissension that often accompany a bankruptcy filing, especially if all of the impaired parties in interest accept the plan. If the prepackaged plan is not overwhelmingly accepted, but is accepted by a majority of each impaired class that would bind that class in a Chapter 11 case, then the prepackaged plan is filed with the Chapter 11 petition. Depending on factors such as the court's calendar, the plan can be confirmed in as little as thirty to forty-five days after the commencement of the case.[385]

The following are prerequisites to the confirmation of a prepackaged plan under Chapter 11:

(1) The terms of the prepackaged plan and the terms of the plan for which Chapter 11 confirmation is sought must be identical; otherwise, the court is likely to require the proponent of the prepackaged plan to re-solicit the votes of creditors when their treatment under the plan has been changed.[386]
(2) The creditors and interest holders who are solicited prior to the commencement of the case must be clearly notified and must agree that the debtor will use these acceptances in a Chapter 11 case.[387]
(3) The prepackaged plan must meet all of the confirmation standards set forth in the Bankruptcy Code, including the requirement that classification of claims and interests not discriminate unfairly.[388]

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[384] In re Pengo Indus., Inc., 962 F.2d 543, 549 (5th Cir. 1992) ("Bankruptcy policy strongly favors the 'speedy, inexpensive, negotiated' adjustment of creditor-company relations afforded by out-of-court [workouts and settlements]."). See also Chateaugay, 961 F.2d at 382 (citing In re Colonial Ford, 24 B.R. 1014, 1015 (Bankr. D. Utah 1982); In re Crowthers McCall Pattern, Inc., 114 B.R. 877, 881 (Bankr. S.D.N.Y. 1990) (approving plan of reorganization or allowing debtor to merge with another entity); In re Citadel Properties, Inc., 86 B.R. 275 (Bankr. M.D. Fla. 1988) (holding that a petition that is filed late is in bad faith); In re International Supply Corp., 72 B.R. 510 (Bankr. M.D. Fla. 1987) (holding that a creditor is entitled to relief from the automatic stay); Philadelphia Athletic Club, Inc. v. Trustees of Central States (In re Philadelphia Athletic Club, Inc.), 20 B.R. 323, 327 (Bankr. E.D. Pa. 1982) (approving a stipulation between a first mortgagee and a trustee); Marc S. Kirschner, et al., *Prepackaged Bankruptcy Plans: The Deleveraging Tool of the '90s in the Wake of OID and Tax Concerns*, 21 Seton Hall L. Rev. 643, 645-50 (1991) (discussing the effect of the In re Chateaugay Corp. decision). But see Citibank v. Transamerica Commercial Fin. Corp. (In re Sun Runner Marine, Inc.), 116 B.R. 712, 717-19 (Bankr. 9th Cir. 1990) (noting that §365(c)(2) of the Bankruptcy Code does not expressly provide for an exception to the rule of nonassumption even if the lender consents to the proposed assumption); In re TS Indus., Inc., 117 B.R. 682, 687 (Bankr. D. Utah 1990) (ruling that when an agreement is entered into in anticipation of a bankruptcy filing, Bankruptcy Code §365(c)(2), which prohibits the assumption or assignment of an executory contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor," does not apply).

[385] Fed. Rul. Bankr. P. 2002(b).

[386] Fed. R. Bankr. P. 3018(b). See In re City of Colorado Springs Creek, 177 B.R. 684, 691 (Bankr. D. Colo. 1995) ("At the confirmation stage of a prepackaged bankruptcy, the court evaluates the process of solicitation in determining whether the acceptances obtained are valid.").

[387] Fed. R. Bankr. P. 3018(b); 11 USC §1126(b); see In re Sunshine Precious Metals, Inc., 142 B.R. 918, 920 (Bankr. D. Idaho 1992) (finding that the record did not justify the conclusion that the proposed prepackaged plan was not confirmable because of the improper solicitation of acceptances).

[388] 11 USC §1129(b)(1) (1994).

(4) The court must specifically approve the plan, full disclosure must be made, and adequate information must be approved retroactively by the court. Otherwise, the plan must be refiled and acceptances resolicited. Disclosure will be deemed adequate under the Bankruptcy Code if the acceptances or rejections that were obtained prior to the commencement of the case were in compliance with applicable nonbankruptcy law. However, if there is no such applicable state law, solicitation must be preceded by adequate information as that term is defined in the Bankruptcy Code.[389]

(5) The court must find that the prepetition plan was transmitted to substantially all of the impaired creditors and impaired security holders and that reasonable time was allowed for acceptance or rejection of the plan; otherwise, the Bankruptcy Rules prevent validation of prepetition acceptances or rejections.[390]

One advantage of any Chapter 11 plan in states that have high conveyance taxes, such as Florida, Pennsylvania, and New York, is the applicability of section 1146(c) of the Bankruptcy Code. This section exempts transfers pursuant to a bankruptcy plan from state conveyance taxes provided the sole purpose of the plan is not tax avoidance.[391]

Borrowers generally cannot legally be prevented from filing serial bankruptcies. However, a lender can use a previous filing as an argument supporting a motion to dismiss the subsequent bankruptcy case for bad faith even if the previous filing was in conjunction with a consensual plan.[392]

§24.16 Debtor-in-Possession (DIP) Financing

The authority to continue in business includes the right to obtain credit and incur unsecured debt to fund ordinary operating expenses.[393] To induce creditors to extend any

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[389] *Id.* §1125(a)(1) (1993). See In re City of Colorado Springs Creek General Improvement District, 177 B.R. at 691 ("A proponent of a prepackaged plan takes a substantial risk that, at the confirmation stage of the case, the Court may determine that the proposed disclosure statement or process of solicitation are inadequate.").

[390] Fed. R. Bankr. P. 3016-18.

[391] 11 USC §1146(c) (1993).

[392] See In re King, 126 B.R. 777, 781 (Bankr. N.D. Ill. 1991) (holding that the "[s]trategic use of serial filings, particularly when coupled with failure to carry out debtor's duties in bankruptcy, shows lack of good faith justifying dismissal"); Smith v. First Fed. Sav. & Loan Ass'n (In re Smith), 58 B.R. 603, 605 (Bankr. W.D. Pa. 1986) (ruling that multiple filings and filings immediately prior to sheriffs' sales create an inference of abuse of the bankruptcy process); In re AT of Maine, Inc., 56 B.R. 55, 56-67 (Bankr. D. Me. 1986) (holding that modifications of confirmed plans are not permissible after the plans have been substantially consummated); In re Northhampton Corp., 39 B.R. 955, 956 (Bankr. E.D. Pa. 1984) (declining to permit a serial Chapter 11 filing when the debtor sought to submit a new reorganization plan).

[393] See generally George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 Vand. L. Rev. 901 (1993).

necessary postpetition credit, such credit is allowable as an expense of administration.[394] This provides the credit priority over other claims against the estate.[395]

Two tests should be applied to determine whether a new credit transaction is in the ordinary course of a debtor's business, and, therefore, allowed protection through administrative status. The first test, called the horizontal dimension test, compares the debtor's business to other like businesses. The test is whether the creditor transaction in question is similar to those in which comparable businesses engage in their day-to-day operations.[396] The second test is the vertical dimension test, also called the creditor's expectation test. This test analyzes the credit transaction from the vantage point of a hypothetical creditor and inquires whether the transaction subjects a creditor to atypical risks.[397]

If the trustee or the DIP cannot obtain this unsecured credit as an administrative allowance, the court may authorize the trustee or the DIP to obtain credit or incur debt that has priority over all administrative expenses. The court can also authorize debt that is secured by a lien on property of the estate that is not otherwise subject to a lien or is secured by a junior lien on property of the estate that is subject to a lien.[398] Furthermore, the court can authorize debt secured by a senior lien on property of the estate, but only if the trustee or the DIP is unable to obtain such credit otherwise and the existing lienholders' interests are adequately protected.[399]

The burden of proof for both standards is placed upon the trustee or the DIP. Under the prior Bankruptcy Act, a trustee or a DIP could issue certificates of indebtedness supercharging existing liens to secure loans for operating expenses only if there was a high degree of likelihood that there would be a successful reorganization within a reasonable time. This standard has been replaced by the adequate protection standard.[400] Accordingly, the trustee or DIP must convince the court (1) that there is sufficient value in the property to satisfy the interest of the primed lender notwithstanding the granting of

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[394] A debtor makes an administrative claim for the allowance of administrative expenses incurred in the administration of the case, including the actual and necessary costs and expenses of preserving the estate, such as wages, salaries, or commissions for services. The Bankruptcy Code gives first priority to allowed administrative expenses under §503(b). Numerous other items may be allowed as administrative claims, and there are a series of layers of claims and priority. Section 507(b) provides that, to the extent adequate protection of the interest of a creditor proves to be inadequate, the creditor is given a first priority administrative claim for the amount of the shortfall.

[395] 11 USC §§364(c)(1)-(e), 503(b)(3)(D) (1993). See Rosen v. Nations Title Insurance Co., 56 Cal. App. 4th 1489, 1490, 66 Cal. Rptr. 2d 714, 715 (1997) ("[s]uch priming loans gain court-ordered priority over any existing encumbrances and are authorized by 11 USC §364(d)").

[396] Burlington N.R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell, Inc.), 853 F.2d 700 (9th Cir. 1988); Mortino v. First Nat'l Bank (In re Garofalo's Finer Foods, Inc.), 186 B.R. 414, 428 (Bankr. N.D. Ill. 1995); Committee of Asbestos Related Litigants and/or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.), 60 B.R. 612, 618 (Bankr. S.D.N.Y. 1986), *rev'd on other grounds*, 801 F.2d 60 (2d Cir. 1986); Waterfront Cos. v. First St. Cos. (In re Waterfront Cos.), 56 B.R. 31, 34 (Bankr. D. Minn. 1985).

[397] See, e.g., In re Garofalo's Finer Foods, Inc., 186 B.R. 414, 424 (N.D. Ill. 1995); Streetman v. United States, 187 B.R. 287, 292 (Bankr. W.D. Ark. 1995); In re Foundation Group Sys., 141 B.R. 196, 200 (Bankr. E.D. Cal. 1992); Armstrong Wood Indus., Inc. v. James A. Phillips Inc. (In re James A. Phillips, Inc.), 29 B.R. 391, 394 (S.D.N.Y. 1983) (defining ordinances).

[398] 11 USC §364(b)-(c) (1994).

[399] *Id*. §364(b)-(c) (1994).

[400] *Id*.

the new lien;[401] (2) that there is an equity cushion sufficient to adequately protect the prior secured lender; or (3) that the increase in value of the collateral due to capital improvements made as a result of the DIP's financing constitutes adequate protection.[402]

Entities that loan money to debtors without notice and a hearing or a court order act at their own peril. Several courts have held that a creditor who lends money to a DIP without prior court approval is not even entitled to assert a general unsecured claim.[403] On the other hand, a lender has no obligation to continue to extend financing under a prepetition lending agreement subsequent to the petition date. The prepetition lender may also enforce its lending agreement regarding termination or modification upon the commencement of a bankruptcy case.[404]

Because most postpetition lenders are generally prepetition creditors as well, the trustee or the DIP may seek to obtain postpetition financing from such lenders that is secured not only by a postpetition lien, but that also grants additional liens to secure the existing prepetition indebtedness. Bankruptcy courts generally disfavor such cross-collateralization and require the trustee or DIP to demonstrate (1) that absent the proposed financing, the debtor's business operations will not survive; (2) that the debtor is unable to obtain alternative financing on acceptable terms; (3) that the proposed lender will not agree to less favorable terms; and (4) that the proposed financing is in the best interests of all the creditors.[405]

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[401] In re Phoenix Steel Corp., 39 B.R. 218, 234 (D. Del. 1984).

[402] In re Timber Prod., Inc. 125 B.R. 433, 436 (Bankr. W.D. Pa. 1990). See §24.03[6] "Debtor Use of Assets" *supra* (discussing adequate protection).

[403] See, e.g., General Elec. Capital Corp. v. Hoerner (In re Grand Valley Sport & Marine, Inc.), 143 B.R. 840, 849 (Bankr. W.D. Mich. 1992) (finding that the creditor was not entitled to nunc pro tunc approval of the lending agreement); In re Ames Dep't Stores, Inc., 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990) (refusing a credit transaction of the debtor); Bezanson v. Indian Head Nat'l Bank (In re J.L. Graphics, Inc.), 62 B.R. 750, 755 (Bankr. D.N.H. 1986) (denying a nunc pro tunc order).

[404] 11 USC §365(c)(2), (e)(2) (1993); see also In re RLR Celestial Homes, 108 B.R. 36, 45 (Bankr. S.D.N.Y. 1989) (finding that a contract was not terminated simply because the debtor defaulted on or breached the contract); In re Pacid Oil Co., 72 B.R. 135, 139 (Bankr. N.D. Tex. 1987) (treating the nondebtor party as if the party had a prepetition claim); Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms, Co.), 49 B.R. 440, 443 (Bankr. N.D. Iowa 1985) (holding that a debtor has a contractual right in a bonding agreement); In re Murtishi, 55 B.R. 564, 568 (Bankr. N.D. Ill. 1985) (holding that the effect of a rejection of an executory contract is to breach the contract and make the nondebtor party into a creditor); Government Nat'l Mortgage Corp. v. Adana Mortgage Bankers Inc. (In re Adana Mortgage Bankers, Inc.), 12 B.R. 977, 987 (Bankr. N.D. Ga. 1980) (holding that guaranty agreements are executory contracts). The provisions of §365 do not, however, apply to postpetition financing that is extended to the debtor. Tully Constr. Co. v. Cannonsburg Envtl. Assocs. (In re Cannonsburg Envtl. Assocs., Ltd.), 72 F.3d 1260, 1265-66 (6th Cir. 1995) ("Although §365 does not specifically state that it does not apply to postpetition loans, this interpretation is clearly supported by the purpose of section 365(c)(2) and its relationship with section 364."); 1 Collier Bankruptcy Manual ¶365.02[2], at 14-15 (3d ed. 1995).

[405] Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992). The court in *Saybrook* noted that the issue of whether the Bankruptcy Code authorizes cross-collateralization constituted an issue of first impression before any circuit court of appeals and held that cross-collateralization involving the securing of prepetition debt with pre and postpetition collateral as part of a postpetition financing arrangement is an impermissible means of obtaining such postpetition financing, because cross-collateralization is not authorized as a method of postpetition financing under the Bankruptcy Code provision on obtaining credit or incurring debt. The court also held that allowing cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code, *i.e.*, that creditors within a

§24.17 Conclusion

The lender must formulate a coherent and effective course of action when faced with a borrower who has filed a Chapter 11 proceeding prohibit or delay the exercise of the lender's remedies in connection with a defaulted mortgage loan. To do so, the lender must be aware of and anticipate the tactics likely to be employed by the borrower during the pendency of the case. In furtherance of this goad, the lender and its counsel must be familiar with background and purpose of the Bankruptcy Code provisions, as amended by the 1994 Reform act, the Federal Rules of Bankruptcy Procedure that apply to Chapter 11 proceedings, the relevant court decisions interpreting and applying such statutes and rules, and the process of reorganization in general.

The lender and its counsel must also be thoroughly aware of a strategy utilizing the powers and alternatives available to the lender in a Chapter 11 proceeding and analyzed in this Chapter including (1) the purchase of other unsecured claims; (2) the use of cash collateral orders and other rent-perfection and rent-enforcement devices; (3) motions for relief from the automatic stay; (4) motions for dismissal, or for conversion; (5) valuation and feasibility hearings; (6) the section 1111(b) election; (7) the filing of a creditor's plan of reorganization or liquidation; and (8) prepackaged plans.

Certain issues, such as the borrower's ability to gerrymander claims to create a class of assenting creditors in furtherance of a cram down plan and the continuing validity of the new value exception to the absolute priority rule, remain subject to conflicting judicial interpretations and may ultimately require final determination by the U.S. Supreme Court. Lenders and their counsel must closely monitor the continually evolving case law regarding these and other issues affecting Chapter 11 bankruptcy filings by and against single asset real estate entities.

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given class are to be treated equally. The court acknowledged, however, that another form of cross-collateralization, involving only the securing of postpetition debt with prepetition collateral, would be acceptable if the other conditions for such financing were met. But see In re FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985) (finding that a secured creditor's postpetition loan agreement providing for cross-collateralization of prepetition indebtedness was reasonable when the creditor's petition claim was secured by all of the debtor's assets and when the value of such assets, on a going concern basis, exceeded the creditor's claims).

Time Line for Hypothetical Chapter 11 Case

Petition Filing 1	Motion for Use of Cash Collateral 2	Hearing re: Motion to Use Cash Collateral 3	Final Hearing—Motion to Use Cash Collateral 4	Schedule Filing re: Assets & Liabilities 5
Creditors' Committee Selection by U.S. Trustee 6	Section 341 Meeting 7	Proof of Claim Filing 8	Motion to Lift Stay 9	Hearing re: Motion to Lift Stay 10
Debtor's Motion to Extend Exclusive Period 11	Motion to Appoint Trustee & Hearing 12	Filing of Objections to Claims & Hearings re: Objections 13	Filing by Debtor of Avoidance Actions 14	Filing of Disclosure Statement and Plan of Reorganization 15
Hearing re: Disclosure Statement 16	Disclosure Statement and Ballot Mailing 17	Objections to Plan/Ballot Submission 18	Confirmation Hearing 19	Plan Approval 20

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