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# Secured Lender Successfully Invokes Seldom Used Tool to Protect Collateral in Bankruptcy

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The commercial real estate market continues to struggle. Beyond poor market conditions, financing difficulties and other well known issues of late, many mortgage holders, realizing that their properties are worth significantly less than their mortgage balance, are walking away from the properties or otherwise looking for a way to reduce their mortgage obligation to the property's current depressed market value, including through a chapter 11 bankruptcy process. Ultimately, the question in that situation becomes: who will take the loss on their balance sheet—the lender or the borrower? Often, the loss falls on the lender.

On January 19, 2012, however, the United States Court of Appeals for the Seventh Circuit issued an opinion, authored by Judge Richard A. Posner, representing a significant victory for undersecured lenders holding distressed real estate collateral. In that case, ***In re River East Plaza, LLC*, No. 11-3263, --- F.3d ----, 2012 U.S. App. LEXIS 1048** (7th Cir. Jan. 19, 2012), the subject property was the River East Art Center located near Navy Pier in downtown Chicago. Neal, Gerber & Eisenberg LLP ("NGE") was lead counsel to the property owner's senior secured lender, LNV Corp., an affiliate of Beal Bank.

The facts are straightforward: When the building's owner and mortgagor, River East Plaza, LLC ("River East" or the "Debtor"), defaulted on its mortgage, LNV successfully pursued difficult foreclosure proceedings in state court and obtained a foreclosure sale order in February 2011, nearly two years after River East defaulted on its mortgage. Then, just 11 hours before the scheduled foreclosure sale, River East filed for chapter 11 bankruptcy protection, automatically halting the foreclosure sale.

Because this was a single asset real estate ("SARE")[1] case, River East was subject to special Bankruptcy Code rules designed to put pressure on SARE debtors to move their cases quickly.

Once a Debtor files for bankruptcy, an estate is created and the Debtor is protected by an automatic stay that prohibits creditors of the Debtor from taking certain actions to collect debts, enforce remedies or complete litigation without obtaining relief from the automatic stay from the Bankruptcy Judge. Among other things, in a SARE case, a Debtor has only 90 days to start making monthly mortgage payments to its lender or to file a plan of reorganization "that has a reasonable possibility of being confirmed within a reasonable time". If one of these conditions isn't satisfied, then the Bankruptcy Judge must modify the automatic stay and may allow the lender to pursue its state court remedies (i.e. complete its foreclosure). 11 U.S.C. § 362(d)(3).

In this case, however, the Debtor did not make any mortgage payments to the lender within 90 days after the bankruptcy filing. Therefore, the sole issue was whether this Debtor had timely filed a plan of reorganization that had a "reasonable possibility of being confirmed within a reasonable time." Id. The Debtor filed a plan that, in effect, proposed to cash out the lender at a very distressed price, well below LNV's $38.3 million claim. While it was undisputed that the value of the real estate had fallen precipitously in the current real estate recession and that the property was "underwater," the Debtor valued the property at what LNV viewed as an artificially low $15 million (and also valued LNV's claim, after accounting for taxes and mechanics liens, at $13.5 million). Because LNV was unwilling to accept a lowball cash out, it objected to the Debtor's plan and also made the strategic decision to make what is called a "section 1111(b) election" – a provision that has been in the Bankruptcy Code for over 30 years, but is seldom invoked.

The statute is awkwardly worded, confusing and hard to interpret, which may explain why it is seldom invoked, but the key takeaway is that section 1111(b):

1. Allows a secured creditor to "elect" to have its entire claim treated as secured (even if the lender is undersecured (i.e. claim is worth $38.3 million and debtor (borrower) believes the lender's secured interest in the collateral is worth only $13.5 million));
2. Allows the secured lender to retain its lien on the property until that secured claim is paid in full;
3. Is appropriate when the secured creditor believes the property is undervalued and will appreciate, and when the lender believes the reorganized debtor may later default under its confirmed plan; BUT
4. The secured creditor, in making the election, must agree to waive its undersecured deficiency claim (in this case approximately $25 million).

As the Seventh Circuit stated:

> . . . an under-secured creditor who decides, as LNV has decided, to participate in his debtor's bankruptcy proceeding has a secured claim for the value of the collateral at the time of bankruptcy and an unsecured claim for the balance. 11 U.S.C. § 1111(b)(1)(A). But generally he can exchange his two claims for a single secured claim equal to the face amount of the unpaid balance of the mortgage. §§ 1111(b)(1)(B), (2). LNV made this choice, so instead of having a secured claim for $13.5 million and an unsecured claim for $24.8 million it has a secured claim for $38.3 million and no unsecured claim . . .
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> The swap is attractive to a mortgagee who believes both that the property that secures his mortgage is undervalued and that the reorganized firm is likely to default again . . .

*River East Plaza, 2012 U.S. App. LEXIS 1048, at *7-8*.

The Debtor responded to LNV's § 1111(b) election by filing an amended plan that offered LNV the option of receiving (1) a cash out of the secured portion of its claim at the distressed price of approximately $13.5 million, plus a dividend of 4% on LNV's $25 million deficiency claim (meaning an additional $1 million); or (2) approximately $13.5 million in 30-year U.S. Treasury bonds paying approximately 3% interest (which, "through the magic of compound interest", would pay LNV a total of $38.3 million in 30 years).

In so doing, the Debtor proposed to retain the property, to strip LNV's lien from the property and, instead, give LNV a lien on the long-term Treasury Bonds so that the Debtor could obtain construction financing, develop the property, realize the benefit of any appreciation or improvement in the real estate market and, presumably, sell the property for a very tidy profit in a few years. LNV, meanwhile, would be effectively cashed out for $13.5 million on its $38.3 million claim.

Needless to say, LNV vehemently opposed this tactic and immediately filed a motion to terminate the automatic stay on the grounds that the Debtor's amended plan "was not likely to be confirmed in a reasonable time" because the Debtor was proposing to retain the property while stripping LNV's lien in violation of section 1111(b) and other plan-related provisions of the Bankruptcy Code. LNV argued that its § 1111(b) election ensured it the right to retainitslien on the real estate and benefit from any appreciation in the real estate market until its claim was paid in full.

The Debtor argued that it was able to do this because, among other things, giving LNV the lien on Treasury Bonds was giving LNV the "**indubitable equivalent**"[2] of its lien on the real estate, which the Bankruptcy Code allows under certain circumstances when a plan proponent (normally the debtor) attempts to cram a plan down the throat of an objecting secured creditor.[3] LNV countered that even if the Debtor could use the "indubitable equivalent" standard of cram down, a lien on stagnant 30-year Treasury Bonds was not the indubitable equivalent of a lien on real estate that can and does fluctuate wildly in value.

Bankruptcy Judge Wedoff agreed with LNV and lifted the automatic stay to allow the foreclosure to proceed, and he also dismissed the bankruptcy case. River East successfully requested a direct appeal to the Seventh Circuit, which ultimately affirmed Bankruptcy Judge Wedoff's decisions.

In a key ruling for secured creditors, the Seventh Circuit determined that the Debtor had delayed the secured creditor long enough and that Judge Wedoff appropriately lifted the stay and dismissed the bankruptcy case. The Seventh Circuit also determined that the proposed replacement lien on 30-year Treasury Bonds was not the indubitable equivalent of LNV's lien on the property because the risk profiles of the two forms of collateral were not equivalent.

Judge Posner observed that:

> River East argues that the reason LNV chose to convert the entire $38.3 million debt that it was owed to a secured claim is that it wanted to thwart the bankruptcy proceeding. No doubt. LNV wanted to foreclose its mortgage and doubtless expected to be the high bidder at the foreclosure sale and thus become the building's owner and so the sole beneficiary of any appreciation if and when the real estate market recovered. But there is nothing wrong with a secured creditor's wanting the automatic stay lifted so that it can maximize the recovery of the money owed it.
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> Banning substitution of collateral indeed makes good sense when as in the present case the creditor is undersecured . . .

*River East*, 2012 U.S. App. LEXIS 1048, at *12.

The Court also explained that:

> And so it comes as no surprise that the lien on the Treasury bonds proposed by River East would not be equivalent to LNV's retaining its lien on the building. Suppose the building turns out to be worth $40 million five years from now, yet River East, having borrowed heavily in the interim to finance improvements that bring the building's value up to that level, defaults. With its lien intact and the bankruptcy court unlikely in this second round of bankruptcy to stay foreclosure, LNV would be able to foreclose, and so would be paid in full. In contrast, if its lien were transferred to the substituted collateral, it would have to wait another 25 years to recover the $38.3 million owed it.

*Id*. at *14.

Judge Posner summed up the case as follows:

> River East's aim may have been to cash out LNV's lien in a period of economic depression and reap the future appreciation in the building's value when the economy rebounds. Such a cashout is not the indubitable equivalent of a lien on the real estate, and to require it would be inconsistent with section 1111(b) of the Code, which allows the secured creditor to defeat such a <u>tactic</u> by writing up his secured claim to the full amount of the debt, at the price of giving up his unsecured claim to the difference between the current value of the debt and of the security.

*Id*. at *17 (emphasis added).

So, at least in this jurisdiction, secured lenders holding distressed real estate as collateral when a borrower files a SARE chapter 11 case now have another arrow in their quiver that can be used and <u>must</u> be considered. Depending on the facts of your particular case, the §1111(b) election may just be "checkmate" to a debtor that is (i) frustrating a secured lender's remedies on a defaulted mortgage, (ii) stringing out the lender in foreclosure court and then filing a bankruptcy petition on the eve of foreclosure to attempt to retain their property, and (iii) attempting to cash out the secured lender at a historically low price or give it inferior collateral in an effort to cram down a bankruptcy plan that hurts the lender. Such "tactics" will no longer be tolerated in the Seventh Circuit.

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[1] The Bankruptcy Code defines SARE as a nonresidential property, or a residential property containing five or more apartments or other residential units, "on which no substantial business is being conducted by a Debtor other than the business of operating the real property and activities incidental thereto." 11 U.S.C. §101(51B).

[2] The Bankruptcy Code does not define indubitable equivalence.

[3] A complete discussion of the parameters of "cram down," which is technically complicated under the Bankruptcy Code, is beyond the scope of this article.



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