Cramdown and Valuation Issues for Secured Creditors

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Secured creditors need to be aware of recent bankruptcy rulings that affect their rights and interests. These rulings have tested the boundaries of key concepts affecting the ability to "cramdown" and involuntarily restructure a secured creditor's rights and the valuation of collateral. Secured creditors must therefore be mindful of these developments and risks in guiding their negotiating and litigation strategy against a cramdown threat. We discuss developments in three areas: (i) artificial impairment and claim classification; (ii) valuation of collateral; and (iii) the new value exception.

Artificial Impairment and Classification Issues

To effect a cramdown, a debtor's plan must include at least one consenting impaired class of creditors. This is an important protection for an under-secured creditor whose deficiency claim can potentially be used to block the unsecured creditor class from accepting the plan. Some borrowers may attempt to negate a secured creditor's leverage in this respect either by "artificial impairment" (*i.e.*, proscribing for a modest or "artificial" impairment to a creditor to engineer a consenting impaired class, such as delaying full payment for a very brief period) or by separately classifying undersecured deficiency claims from other unsecured claims. Although most bankruptcy courts including those in the Second and Third Circuits have resisted debtors' efforts to artificially impair a consenting creditor class by scrutinizing a debtor's motives and the nature of the impairment, and also take a hard look at efforts to separately classify deficiency claims, the Fifth Circuit Court of Appeals and the Ninth Circuit Bankruptcy Appellate Panel recently adopted a more lenient approach towards such efforts.

In *Western Real Estate Equities, L.L.C. v. Village at Camp Bowie I, L.P. (In re Village at Camp Bowie I, L.P.)*, 710 F.3d 239, 245-46 (5th Cir. 2013), the debtor used artificial impairment to effect a cramdown of a $32 million secured claim. The debtor impaired the unsecured trade creditors totaling $59,000 by proposing to pay them in full without interest over a three month period (despite having adequate cash flow to pay immediately). The Fifth Circuit, while acknowledging a split in authority, ruled that the Bankruptcy Code does not restrict artificial impairment and allows a plan proponent to impair a class of creditors in order to obtain confirmation; a showing of economic justification is not necessary. Instead, a plan proponent's motives are only scrutinized when determining whether the proponent proposed its plan overall in good faith.

In *Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop 76)*, 465 B.R. 525 (9th Cir. B.A.P. 2012), the debtor sought to separately classify an undersecured creditor's deficiency claim from the general unsecured creditors (preventing the secured creditor from having a voting block). The court sustained the cramdown of the secured creditor, finding the separate classification justifiable because the secured creditor could pursue a non-debtor guarantor for payment and thus was not "substantially similar" to the trade creditors for classification purposes.

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Although *Village at Camp Bowie* and *Loop 76* do not necessarily represent the majority view on artificial impairment and classification, they cannot be characterized as outlier decisions and accordingly a secured creditor cannot ignore the risks of artificial impairment and separate classification in evaluating its ability to oppose a cramdown plan.

<u>Valuation of Collateral</u>

The extent to which a secured creditor's collateral is valued at more or less than the debt owing to the creditor can be a crucial determination in a bankruptcy case, as the Bankruptcy Code provides oversecured and undersecured creditors differing treatment and rights. Of particular significance, oversecured creditors are entitled to post-petition interest and payment of reasonable fees and expenses.

The Bankruptcy Code does not prescribe a certain date as to when collateral should be valued. The determination date is often important, since collateral value may fluctuate during a borrower's bankruptcy. Bankruptcy courts have adopted different methods for when to value the collateral. Recently, the Bankruptcy Appellate Panel for the First Circuit decided in *The Prudential Insurance Company of America v. SW Boston Hotel Venture, LLC (In re SW Boston Hotel Venture, LLC)*, 479 B.R. 210, 222-23 (1st Cir. BAP 2012), that it would apply a flexible approach to determine the appropriate time for valuing collateral, considering both the disposition or use of the property and the purpose of the valuation. Notably, and favorable to the interests of secured creditors, the court valued the collateral based on a sale of a substantial portion of the collateral eleven months after the bankruptcy commenced to determine that the secured creditor had been oversecured (and thus, entitled to interest) dating back to the *beginning* of the bankruptcy case.

SW Boston Hotel Venture proved to be favorable to the secured creditor's position in part because the court could look to the value of the collateral garnered by the sale during the bankruptcy. In planning, a secured creditor should consider not only the timing of the valuation, but also other factors that a court will use to determine the value of the collateral. *See, e.g.*, *First S. Nat'l Bank v. Sunnyslope Hous. Ltd.*

P'ship (In re Sunnyslope Hous. Ltd. P'ship), No. 2:11-cv-02579, slip op. at 26-27, 29 (D. Az. Sept. 18, 2012) (affirming in part bankruptcy court's decision that affordable housing project should be valued closer to $2.6 million with public housing restrictions, rather than $7.74 million as highest and best use without public housing restrictions, where debtor was retaining property in cramdown plan).

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New Value Exception

Per the absolute priority rule, absent creditor consent, equity holders cannot normally retain their equity if the creditors are not paid in full. However, bankruptcy courts have recognized a "new value" exception to this absolute priority rule, allowing equity holders to maintain their equity position if they provide necessary new investments into the company. This exception is tempered by the requirement announced by the U.S. Supreme Court in *Bank of America National Trust and Savings Association v. 203 North La Salle Street Partnership*, 119 S. Ct. 1141 (1999), that, assuming the exception exists, any such infusion of "new value" must be subjected to a market test, typically competitive bidding by other parties or a termination of exclusivity, to ensure the best obtainable price for the equity position. In *In re Castleton Plaza, LP*, 707 F.3d 821, 823 (7th Cir. 2013), the debtor's equity holder tried to evade the market test requirement by arranging for new value to be contributed by, and the new equity to go to, his wife, who was not an existing equity holder of the debtor. The Seventh Circuit ruled that an investment by an "insider" (within the meaning of 11 U.S.C. § 101(31)) must be subject to competitive bidding in the same manner required for equity holders. The Seventh Circuit is the first court of appeals to address this issue. This decision insures that an equity holder cannot use related parties to evade the market test requirement. In such a circumstance, a secured creditor will be eligible to participate and bid in the market test and can thereby effectively protect its interests against undervaluation.