The Real Estate Lender's Updated Guide to Single Asset Bankruptcy Reorganizations

Alfred G. Adams Jr.

Jason C. Kirkham

Follow this and additional works at: https://via.library.depaul.edu/bclj

Recommended Citation
Available at: https://via.library.depaul.edu/bclj/vol8/iss1/2

This Article is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Business and Commercial Law Journal by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.
The Real Estate Lender’s Updated Guide to Single Asset Bankruptcy Reorganizations

Alfred G. Adams, Jr. and Jason C. Kirkham*

I. INTRODUCTION

After eighteen years of nearly uninterrupted growth in commercial real estate markets, defaults by commercial real estate borrowers are rising dramatically. In some cases, loans have defaulted because (due to the general downturn in the economy) the property is no longer generating income sufficient to pay the property’s debt service and operating costs. In other cases, the property may currently be able to cover expenses, but the loan has matured with no new financing on the horizon. Regardless of the cause, lenders face a scenario that is becoming all too familiar: The borrower is a special purpose entity that owns a single real estate project. The project was financed by a mortgage loan, which may be either recourse or non-recourse to the borrower and which may (or, may not) be guaranteed (in whole or in part) by the borrower’s principals. With no cure, refinancing or workout in sight, the lender has accelerated its loan and begun the process of foreclosing on the project. But, the borrower, who remains convinced that an economic recovery is just around the corner, insists that if the lender will just renegotiate the loan terms, the project can survive the current crisis, enabling the (eventual) repayment of the debt and the salvaging of the borrower’s equity in the project. To increase the lender’s willingness to agree to terms, the borrower has filed a Chapter 11 bankruptcy petition, threatening a “cramdown” unless the lender agrees (among other concessions) to reinstate the loan and extend its maturity.

What are a lender’s options when a single asset borrower files a Chapter 11 petition? Outside of Chapter 11, the rules are fairly simple: either the mortgage lender gets its loan repaid or it gets its collat-

---

* The authors practice with the firm of Sutherland Asbill & Brennan LLP, in the firm’s Atlanta, Georgia office. Mr. Adams is also an adjunct professor of law at Duke University School of Law. This article is an updated and revised version of a 1993 article written by Mr. Adams, which appeared in 98 Com. L.J. 350 (1993). They gratefully acknowledge the valuable contributions to this article made by their colleagues, Thomas M. Byrne and Justin Lischak Earley.

eral. In Chapter 11, the rules are quite different. The mere filing of a Chapter 11 petition initiates an automatic stay enjoining virtually all acts against the debtor or its property, including foreclosure. Unlike a Chapter 7 liquidation, where a trustee is appointed immediately upon filing, the borrower in a Chapter 11 reorganization remains in control of its assets as a “debtor-in-possession.” Virtually all business entities, including corporations, limited liability companies, partnerships, and sole proprietorships, may seek Chapter 11 relief. Insolvency is not a requirement.

Over twenty-five years ago, in the midst of another severe recession, a bankruptcy court aptly observed that in Chapter 11 “there are seldom any winners, just survivors.” This Article summarizes the key issues that arise in single asset Chapter 11 cases and discusses strategies and tactics mortgage lenders can employ to maximize their chances of survival. In particular, this Article examines two significant changes in the world of commercial real estate finance since the last real estate recession: (1) the impact of the Bankruptcy Abuse and Consumer Protection Act of 2005 (“BAPCPA”) on bankruptcies by single asset real estate entities and (2) the increasingly widespread use of so-called “springing,” “exploding,” and “non-recourse carve-out” guaranties in commercial real estate loans. As discussed below, while these two developments may discourage bankruptcies by single asset entities and limit single asset debtors’ options once a bankruptcy petition has been filed, lenders are likely to face new challenges by debtors who are able to seek bankruptcy protection.

2. Id. §§ 301, 362(a) (2006). The automatic stay applies to all efforts by any creditor to collect the debt it is owed. Attempting to obtain the appointment of a receiver or attempting to use “self-help” measures to collect rents generated by a project are clearly stayed. Once the bankruptcy case is filed, no further steps can be taken regardless of whether the creditor has knowledge of the bankruptcy filing. Sanctions can result from “willful” violations of the automatic stay. See id. § 362(k); In re Atl. Med. Mgt. Servs. Inc., 387 B.R. 654, 661-67 (Bankr. E.D. Pa. 2008).

3. However, banks, insurance companies, thrifts, credit unions and stockbrokers are ineligible for Chapter 11 relief. 11 U.S.C. §§ 109(b), (d) (2006).

4. E.g., In re Capitol Food Corp., 490 F.3d 21, 25 (1st Cir. 2007). There is no statutory requirement that a debtor demonstrate insolvency to be eligible to file a voluntary case. The debtor does not have to show either balance sheet insolvency or that debts cannot be paid as they come due. See id. In an involuntary case, however, the petitioning creditors must be able to demonstrate that the debtor is not paying its debts as they come due if the debtor contests the involuntary petition. See 11 U.S.C. § 303(h) (2006).


II. DEVELOPMENTS SINCE THE RECESSION OF THE EARLY 1990s

A. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

The BAPCPA, while best known for its provisions making it more difficult for consumer debtors to discharge their debts under Chapter 7 of the Bankruptcy Code, also removed the $4 million cap that formerly applied to the Bankruptcy Code's special provisions for single asset real estate entities. With the elimination of the cap and other changes, the requirements applicable to single asset real estate debtors – which initially were made part of the Bankruptcy Code by the Bankruptcy Reform Act of 1994 – have enhanced value to real estate lenders.

1. Relief from the Automatic Stay for Secured Creditors of Single Asset Real Estate Entities

As mentioned above and discussed in more detail below, a principal reason for debtors to seek bankruptcy protection is the automatic stay, which halts all collection efforts against the debtor (including foreclosure of a lender’s mortgage). In recognition of the abuse of bankruptcy by real estate borrowers during the recession of the early 1990s, Congress enacted Section 362(d)(3) of the Bankruptcy Code, which requires the court to grant relief from the automatic stay to a secured creditor of a single asset real estate entity unless, within 90 days after the order for relief or 30 days after the court determines that the debtor is a single asset real estate entity, whichever is later, “(A) the debtor has filed a plan that has a reasonable possibility of being confirmed within a reasonable time; or (B) the debtor has commenced monthly payments that . . . are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor’s interest in the real estate.”

Until the passage of the BAPCPA, a secured creditor could only seek relief from the automatic stay under 11 U.S.C. § 362(d)(3) if the total debt secured by the property did not exceed $4 million, making the provision of little practical use. In addition to removing the $4

---

9. In a voluntary case, the filing of the Chapter 11 petition constitutes an order for relief. Id. § 301(b).
10. Id. § 362(d)(3).
million ceiling, the BAPCPA provides that interest payments must be at the nondefault contract rate of interest.\textsuperscript{11}

Because a debtor has until the later of 90 days after the petition date or 30 days after the date that the bankruptcy court determines that the debtor is a single asset real estate entity, a lender should consider seeking an early determination on that issue. If a lender waits until the 90 day period has expired before seeking the determination, the lender may unintentionally afford the debtor an additional 30 days or more, depending on how soon a court will rule on the lender’s motion, before the debtor will be required to file a plan or start paying debt service.\textsuperscript{12}

Although courts have described the legislative history of Section 362(d)(3) as “meager,”\textsuperscript{13} they have recognized that it was designed to correct the “relative unfairness of lengthy delay” in single asset cases and that “where the case does not early kick forward toward confirmation, a debtor must compensate its mortgagee for the time-value of the mortgagee’s debt-investment, by the payment of interest at the original contractual rate.”\textsuperscript{14} Unfortunately, however, some courts have denied secured creditors’ requests under Section 362(d)(3) even though the debtor failed to comply with the plain requirements of the statute.\textsuperscript{15}

2. Elements for Relief under Section 362(d)(3)

Real estate lenders seeking relief from the automatic stay under Section 362(d)(3) will face a number of issues:

a. Is the Debtor a Single Asset Real Estate Debtor?

The Bankruptcy Code defines “single asset real estate” as:

\textsuperscript{11} See id. Before the BAPCPA’s passage, the interest only had to be at the “current fair market rate,” thereby allowing courts to approve lower interest rates. See, e.g., In re Cambridge Woodbridge Apts., LLC, 292 B.R. 832, 840 (Bankr. N.D. Ohio 2003) (holding that debtor’s adequate protection payments of $19,250 were “in an amount equal to interest at a current fair market rate” even though this amount was less than the debt service required under the mortgage).

\textsuperscript{12} See, e.g., In re Kara Homes, Inc., 363 B.R. 399, 407 (Bankr. D.N.J. 2007) (granting debtors 30 days to file a plan of reorganization or commence making interest payments to their mortgage lenders, since “the initial ninety (90) day period has long since expired”).


\textsuperscript{14} In re Heather Apts. Ltd. P'ship, 366 B.R. 45, 49–50 (Bankr. D. Minn. 2007).

\textsuperscript{15} See In re Windwood Heights, Inc., 385 B.R. 832, 841 (Bankr N.D. W. Va. 2008) (even though debtor’s plan was “patently unconfirmable,” the court nonetheless gave the debtor 30 additional days to file a modified plan because of the secured creditor’s “substantial equity cushion,” notwithstanding the statutory deadlines).
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 who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.\textsuperscript{16} Although there have been some cases discussing under what circumstances multiple properties constitute a "single project,"\textsuperscript{17} most cases have turned on whether the debtor conducts substantial business on the property other than the business of operating the real property and incidental activities, especially when the property in question is operated as a hotel.\textsuperscript{18}

b. Has the Debtor Submitted a Plan with "Reasonable Possibility of Being Confirmed Within a Reasonable Time?"

If the debtor qualifies as a single asset real estate entity, a debtor can still avoid foreclosure if, within 90 days of the date of its bankruptcy petition or 30 days after the bankruptcy court determines the debtor to be a single asset real estate entity, the debtor files a reorganization plan that has a "reasonable possibility of being confirmed within a reasonable time."\textsuperscript{19} In addressing whether a plan filed by a debtor meets that threshold, courts have looked to the case law that has developed since the Supreme Court's decision in United Ass'n of Texas v. Timbers of Inwood Forest Associates., Ltd,\textsuperscript{20} in which the Court announced a very similar standard for deciding whether to grant motions for relief from the stay under Section 362(d)(2), which allows for relief if the debtor does not have equity in the property and the property is not necessary to an effective reorganization.\textsuperscript{21}

\textsuperscript{18} In deciding whether the debtor engaged in substantial business other than the business of operating the real property, courts look to whether the debtor has significant revenue other than "the passive collection of rent from tenants." In re Scotia Pac. Co. LLC, 508 F.3d 214, 221 (5th Cir. 2007) (citing In re Club Golf Partners, L.P., no. 07-40096-BTR-11, 2007 WL 1176010, at *6 (E.D. Tex. April 20, 2007) (holding that actively managed timberlands do not qualify as single asset real estate); see also In re CBJ Dev., Inc., 202 B.R. 467, 472–73 (B.A.P. 9th Cir. 1996) (where debtor's hotel included gift shop, restaurant, and bar, there was "substantial other business"); In re Whispering Pines Estate, Inc., 341 B.R. 134, 136 (Bankr. D.N.H. 2006) (where hotel maintained swimming pool, provided phone and internet service, and served continental breakfast, it was not a single asset real estate debtor, even though it did not operate any bar, restaurant, or gift shop).
\textsuperscript{20} 484 U.S. 365, 382 (1988).
c. Has the Debtor Commenced Payments on the Lender’s Interest in the Real Estate?

If the debtor has not filed a plan as required under Section 362(d)(3), it can still avoid relief from the automatic stay by commencing to pay interest to the lender. While the interest must be at the non-default contract rate, the interest need only be paid on the value of the lender’s interest in the collateral, not the full amount of the debt. Thus, if the lender is undersecured, it will be entitled to less than the interest provided for under the loan. Furthermore, the debtor can (notwithstanding the Bankruptcy Code’s restrictions on the use of cash collateral)22 pay the interest from pre- and post-petition rents without court or lender consent.23

B. Springing, Exploding, and Non-recourse Carve-out Guaranties

Following the recession of the early 1990s, lenders increasingly insisted that loans be structured with the borrower as a single purpose, “bankruptcy remote” entity (“SPEs”), which would own no assets other than the mortgaged property and which would therefore be insulated from economic problems unrelated to that property. Use of SPEs was also driven by the market in commercial mortgage backed securities, as the rating agencies required their use.

Because, by definition, the SPE would have no assets other than the real property (and personal property used in connection with its operation), lenders typically have insisted that a creditworthy person or entity enter into a “non-recourse carve-out guaranty.” That guaranty, which is sometimes referred to as an “exploding” or “springing” guaranty, would make the guarantor liable for certain “bad acts” – most typically intentional acts that would diminish the value of the collateral (e.g., fraud, waste, or misappropriation of insurance proceeds and rents).24 In addition, and most important for the lender facing a potential borrower bankruptcy, the guaranty would typically make the

24. Depending on the negotiations between the lender and borrower, the guarantor might be liable for only actual losses suffered by the lender because of the borrower’s bad acts, or the loan might become fully recourse to the guarantor. Full recourse provisions are a potential minefield for borrowers. See, e.g., Blue Hills Office Park LLC v. JPMorgan Chase Bank, 477 F. Supp. 2d 366, 388-92 (D. Mass. 2007) (holding guarantor liable for the full amount of a $17.5 million loan where borrower had diverted a $2 million condemnation settlement to itself).
guarantor liable for the full amount of the loan if the borrower filed a voluntary bankruptcy petition.\textsuperscript{25}

The threat of full personal liability may deter some borrowers from using bankruptcy to obstruct a lender’s efforts to foreclose on the collateral. Guarantors will certainly, however, challenge enforceability of these guaranties on a number of grounds, both directly (when lender’s attempt to enforce the guaranties) and indirectly (by asking bankruptcy courts to enjoin enforcement of the guaranties). Guarantors are likely to argue that by encouraging the guarantor to put its personal interest ahead of the rest of its partners, these guaranties foster breaches of fiduciary duty and therefore are void as a matter of public policy. In addition, guarantors are likely to ask bankruptcy courts to use their equitable powers to enjoin collection efforts against guarantors.\textsuperscript{26} So far, only two reported cases deal with the enforcement of non-recourse carve-out obligations, and both have upheld the lender’s position.\textsuperscript{27} Given the ubiquity of these guaranties in the last real estate cycle, more cases are certain to arise.

III. The Debtor’s Perspective

A. Breathing Spell

The filing of the Chapter 11 petition halts the foreclosure process and gives the debtor a “breathing spell” within which to attempt to restructure its debts. In a single asset case, for at least 90 days, the debtor is relieved of the responsibility to pay debt service, although a mortgage lender may be entitled to demand “adequate protection” (which may include the payment of debt service) with respect to its collateral, either because it is undersecured or as a condition to al-

\textsuperscript{25} Typically, but not always, the guarantor will directly or indirectly control the borrower. In mezzanine debt structures, however, it is possible that the mezzanine lender could foreclose on its interest in the borrower entity. Once in control of the borrower, the mezzanine lender could then threaten to file a voluntary bankruptcy petition, making the loan fully recourse to the guarantor, even though the guarantor no longer controls the borrower. It goes without saying that borrowers and their counsel need to consider seriously this possibility when negotiating any sort of guaranty triggered by a borrower bankruptcy.

\textsuperscript{26} See infra Part III.F.1.a.

\textsuperscript{27} See FDIC v. Prince George Corp., 58 F.3d 1041 (4th Cir. 1995) (upholding liability of borrower’s general partner in an action, brought after dismissal of borrower’s bankruptcy petition, where loan agreement provided that loan would be non-recourse to borrower, except for certain acts, including borrower’s bankruptcy); First Nationwide Bank v. Brookhaven Realty Assoc., 637 N.Y.S.2d 418 (N.Y. App. Div. 1996) (holding that lender could bring deficiency judgment against borrower’s principals where loan agreement provided that it was non-recourse unless the borrower commenced a bankruptcy proceeding that was not dismissed within ninety days of filing).
lowing the debtor to use cash collateral.\textsuperscript{28} To reorganize successfully, the debtor must propose and confirm a plan of reorganization. But unless and until the mortgage lender is able to obtain either relief from the automatic stay (either because of the single asset provisions or otherwise) or a dismissal of the case, the lender cannot take any action to obtain payment or recover its collateral from the debtor. The stay enjoins commencing or continuing a lawsuit against the debtor, attempting to foreclose on any asset of the debtor, creating or perfecting any lien against the debtor’s property, and even sending dunning or default notices. Acts taken in violation of the stay are void or voidable and may expose the mortgage lender to monetary sanctions.\textsuperscript{29}

B. \textit{Adjustment of Debts}

Chapter 11 provides the owner of a real estate project the opportunity to restructure its mortgage and other debts and to retain ownership of the project by confirming a plan of reorganization. The plan does not have to be consensual. Even without uniform creditor consent, a debtor may “cramdown” a plan over the objections of some creditors, so long as at least one class of impaired creditors votes for it and the plan complies with certain fundamental requirements, although the courts currently do not agree on the interpretation and application of many of these requirements.\textsuperscript{30}

C. \textit{Rejection or Assumption of Contracts and Leases}

The debtor can choose to assume or reject executory contracts and leases.\textsuperscript{31} Court approval must be obtained, but courts generally leave the decision to reject a contract or lease to the debtor’s business judgment.\textsuperscript{32}

\textsuperscript{28} See infra Part IV.B.4.b.i.
\textsuperscript{29} See supra note 2.
\textsuperscript{30} See infra Part VI.
\textsuperscript{31} 11 U.S.C. § 365 (2006). Section 365 does not define “executory contract.” The widely accepted definition is that an executory contract is a contract in which material performance remains due from both sides to the contract as of the date of the bankruptcy filing, such that one party’s failure to perform would give the counterparty a claim for material breach of contract. See \textit{In re} Herbert, 806 F.2d 889, 893 (9th Cir. 1986). Unexpired real property leases are clearly covered by Section 365, and the Section 365 requirements of curing (or in some cases, compensating for) all existing defaults and providing adequate assurance of future performance must be met prior to assumption of any such leases. In a single asset case, this is generally not a difficult requirement because the debtor, as the owner of the real estate, is typically not in default under the unexpired lease.
\textsuperscript{32} The “business judgment test” was first articulated by the Supreme Court in a case decided under the former Bankruptcy Act. Group of Institutional Investors v. Chicago, M., St. P. & P.R.
1. Effect of Rejection

Rejecting an executory contract deprives the other party to the contract of the remedy of specific performance and leaves it with a claim against the debtor's estate. Lessees of real property are accorded special protections from the consequences of rejection by their lessors. Nonresidential leases are deemed to be rejected if not assumed or expressly rejected within 120 days of the order for relief, or before the confirmation of the reorganization plan, whichever is earlier.

2. Assumption

If the debtor instead assumes an executory contract or lease, it must cure all defaults (to the extent possible), compensate the other party for damages, and assure adequate future performance. An assumed contract may be assigned, notwithstanding contractual restrictions on assignment, if the proposed assignee can provide assurance of future performance. Special provisions limit the ability of a tenant-debtor to assume and assign shopping center leases.

---

33. If a lease is rejected, the Bankruptcy Code specifically limits the damages a lessor can claim against the lessee's estate. 11 U.S.C. § 502(g) (2006). Section 502(g) treats a rejection as a breach occurring immediately prior to the filing, thereby entitling the lessor to an unsecured damages claim. The amount of the lessor's unsecured claim is limited to the greater of one year's rent or 15 percent of the remaining term (not to exceed three years) of the lease. Id. § 502(b)(6)(A).

34. 11 U.S.C. § 365(h) (2006). Section 365(h) specifically allows a lessee to remain in possession of the leasehold pursuant to the terms of the lease. This provision allows the lessee to continue paying the rent at the rate specified in the lease for the remaining term of the lease. Id. Section 365(h) prevents a single asset debtor from rejecting below-market leases in an effort to replace those leases with tenants paying higher rents.

35. Id. § 365(d)(4). The bankruptcy court may extend the 120 days to 210 days, but no further absent the lessor's consent.

36. Id. § 365(b)(1)(A).

37. Adequate assurance of future performance is not defined by the Bankruptcy Code and must be decided on a case-by-case basis. The level of adequate assurance that the assignee must provide will vary in direct relation to the financial strength of the assignee. See id. § 365(f).

38. Id. § 365(b)(3). Section 365(b)(3) is designed, in part, to protect the mix of tenants in a shopping center. If a tenant in a shopping center files bankruptcy and seeks to assume and then assign the lease to a new tenant, the new tenant must not affect the existing tenant mix or balance.
3. Lending Agreements are Non-Assumable

Certain types of executory contracts may not be assumed, e.g., personal service contracts and contracts to make a loan or extend financial accommodations. Consequently, a loan commitment cannot be assumed by a Chapter 11 debtor, nor can the bankruptcy court compel a lender to make additional advances to a debtor pursuant to a line of credit or other loan agreement.39

4. State Law Damages Limited

The Bankruptcy Code limits certain kinds of damages that could otherwise be claimed against the debtor under state law. These limited damages include a lessor’s claim for future damages for breach of a lease, an employee’s damages for breach of an employment contract, and claims for unmatured interest on unsecured and undersecured obligations.40

D. Sales and Financings Facilitated

The sale of a real estate project may be “cleaner” from the buyer’s standpoint if accomplished in Chapter 11 with court approval. A potential buyer may be unwilling to buy a project from a financially troubled debtor outside of bankruptcy because of fears of potential claims, including the possibility that the sale may be set aside as a fraudulent or preferential transfer in the event of an ensuing bankruptcy. In Chapter 11, however, a real estate project can be sold free and clear of liens, with the liens attaching to the sale proceeds.41 If

39. Id. § 365(c)(2). The language of Section 365(c)(2) prohibits a debtor from forcing a lender to provide any financial accommodation to a debtor. Since the term “financial accommodation” is not defined, while a single asset debtor clearly could not force a lender to advance additional funds pursuant to an existing loan agreement, it is not clear whether certain services by a mortgage lender (e.g., releasing funds previously escrowed to pay a contractor) are “financial accommodations” governed by Section 365(c)(2). Logic suggests that they should not be. See, e.g., In re Neuhoff Farms, Inc., 258 B.R. 343, 348 (Bankr. E.D.N.C. 2000) (noting that section 365(c)(2) must be narrowly construed).

40. 11 U.S.C. § 502(b). In bankruptcy, an unsecured creditor is not entitled to any post-petition interest. Id. § 502(b)(2). Further, an undersecured secured creditor (i.e., a creditor whose collateral is worth less than its debt) is not entitled to post-petition interest on its claim. United Sav. Ass’n of Texas v. Timbers of Inwood Fire Assocs., 484 U.S. 365, 382 (1988).

41. 11 U.S.C. § 363(f). “Free and clear” sales under Section 363(f) have gained considerable attention, particularly in light of their use in the recent General Motors and Chrysler bankruptcies. See In re General Motors Corp., No. 09-50026, 2009 Bankr. Lexis 1687 (Bankr. S.D.N.Y. July 5, 2009) (approving, over objection of unsecured creditors, sale of substantially all of General Motors’ assets to a government-funded purchaser); In re Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) (approving sale of substantially all of Chrysler’s assets to a government-funded purchaser); cf. Fla. Dep’t of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 2331 n.2 (noting the use of sales under Section 363(b) prior to the confirmation of a plan). To gain ap-
the sale is effected pursuant to a confirmed plan, impediments that would be fatal to the transfer outside of bankruptcy—such as due on sale mortgage provisions or even monetary or non-monetary defaults—can be effectively eliminated by the plan. Chapter 11 also offers an opportunity for the debtor to obtain additional financing to fund its operations or to make improvements to its project. Moreover, if the requirements of Section 364(d)—the financing must be otherwise unobtainable and the mortgage lender's interest in the project must receive "adequate protection"—are satisfied, the new financing can even prime an existing mortgage lien.42

E. Avoidance of Pre-Filing Foreclosures

Any pre-bankruptcy transfers may be set aside in Chapter 11 as a fraudulent conveyance if the property was sold for less than "a reasonably equivalent value" within two years of the bankruptcy filing.43 Foreclosures by mortgage lenders are, however, protected: If the lender complies with all state-law foreclosure requirements, the price received at a foreclosure sale will be deemed "reasonably equivalent value."44

F. Detriments of Chapter 11

Although perilous for the mortgage lender, a Chapter 11 bankruptcy is by no means an unmixed blessing for the borrower. Of course, the borrower is given a stay of execution, but the reprieve is not without its burdens.

42. Id. § 364(d). The mortgage lender's lien can be primed by the new lender only if the debtor is otherwise unable to obtain the new funds (which is invariably true) and the court finds that adequate protection exists with respect to the mortgage lender's interest in the collateral. The latter requirement is more nebulous. See, e.g., In re Strug-Division, LLC, 380 B.R. 505, 513–14 (Bankr. N.D. Ill. 2008).
1. Risk of Liability of Insiders

a. Risk of Liability on Insider’s Springing Guarantees

The automatic stay does not enjoin creditor actions against third parties, such as individual guarantors of the debtor’s obligations. As previously discussed, since the last real estate recession, many lenders have required that a “deep pocket” borrower principal guarantee the full repayment of the loan if, among other triggers, the borrower files a bankruptcy petition. Although discretionary stays are sometimes sought by management guarantors on the ground that warding off collection suits diverts management from the reorganization effort, few such stays are granted.\textsuperscript{45} Insider springing guaranties are probably the largest impediment to borrower bankruptcies.

b. General Partners

If the debtor is a general partnership, actions against general partners, who are liable by operation of law for the debtor’s debts, also are not stayed.\textsuperscript{46}

c. Avoidable Pre-Petition Transfers

Transactions between the debtor and its controlling persons, both before and after the filing, come under scrutiny. The creditors’ committee or, if appointed, a trustee, may seek to recover payments made to insiders as fraudulent transfers or preferences.\textsuperscript{47}

\textsuperscript{45} See, e.g., \textit{In re M.J.H. Leasing}, 328 B.R. 363, 368–69 (D. Mass. 2005) (collecting cases). The court has the authority under Section 105 to issue orders that are necessary and appropriate to carry out the provisions of the Bankruptcy Code. 11 U.S.C. § 105. A debtor can (in some bankruptcy courts) obtain a discretionary stay protecting a third party guarantor if it can demonstrate “unusual circumstances” that justify the injunction. See, e.g., \textit{In re Dow Corning Corp.}, 280 F.3d 648, 658 (6th Cir. 2002) (establishing factor-based test for courts to use in determining “unusual circumstances”); \textit{In re Calpine Corp.}, 365 B.R. 401 (S.D.N.Y. 2007) (affirming bankruptcy court’s section 105(a) injunction staying litigation between creditor and debtor’s surety bond guarantor because such litigation would require a significant time drain on a key debtor employee whose technical knowledge was essential); \textit{In re PTI Holding Corp.}, 346 B.R. 820 (Bankr. D. Nev. 2006) (enjoining civil action by creditor to collect debt from guarantors where guarantors were, “in their own contradicted testimony,” tantamount to being the debtor itself, and such litigation would place a significant drain on the manager-guarantors’ time and resources). But see, e.g., \textit{In re Nat’l Staffing Servs., LLC}, 338 B.R. 35, 38 (Bankr. N.D. Ohio 2005) (“[A] garden-variety surety relationship” does not constitute the sort of “unusual circumstances” sufficient to justify a section 105(a) injunction).

\textsuperscript{46} E.g., \textit{In re Hidden Pointe Properties}, 343 B.R. 372, 374 (Bankr. N.D. Ga. 2005) (“As a general proposition, the automatic stay does not protect general partners.”).

\textsuperscript{47} 11 U.S.C. §§ 544(b), 547 & 548. Payments made by the debtor to creditors in the 90 days prior to filing are subject to avoidance as preferential transfers. \textit{Id.} § 547(b)(4). Debt service payments made or mortgages granted during the 90-day period can be set aside as preferences. However, payments made in the ordinary course of business within the meaning of Section
2. Administrative Costs, Debtor-in-Possession’s Duties

Administrative costs in Chapter 11 are heavy and must be paid in cash on the effective date of the plan. Administrative costs include fees of the debtor’s lawyers, the lawyers for the unsecured creditors’ committee and other professionals, such as appraisers and accountants. Typically, real estate debtors turn to rents (both pre- and post-petition) as a source to pay their expenses. Of course, from the mortgage lender’s perspective, these rents are part of its security and should not be available to pay administrative creditors without consent. In addition, the BAPCPA added a new administrative claim for goods sold to the debtor during the 20-day period before the petition date.48

3. Risk of Loss of Control of Business

a. Glare of the Spotlight

The debtor’s business is no longer only his or her business; it is open to scrutiny by creditors, the U.S. Trustee and, of course, the court. The debtor must file a list of all creditors with the Chapter 11 petition and must also file (within 30 days or as otherwise ordered by the court) a schedule of all assets and liabilities, a schedule of current income and expenditures and a statement of affairs. Detailed periodic reports of the debtor’s operations listing all cash receipts and disbursements must be filed with the court on a monthly basis. The debtor must also submit to examination under oath by the U.S. Trustee and creditors as to its operations, assets, transactions, proposed plan, etc.49

b. Business Impeded

Management of the debtor will be occupied with preparation of the debtor’s schedules and other required papers. Although the debtor continues to operate the business as “debtor-in-possession,” virtually every transaction outside of the ordinary course of business must be approved by the court after notice to parties in interest.50

547(c)(2) are not preferential. Thus, regular debt service installments are generally not preferential. Moreover, all pre-filing payments made to a fully secured lender are immune from preference attack since the lender received no more than it would have received if the debtor’s estate had been liquidated. In short, no harm, no foul. Id. § 547(b)(5).
49. Id. §§ 521, 1106; see also Fed. R. Bankr. P. 2004, which allows examination by any party in interest of the liabilities and financial condition of a debtor if the court so orders.
50. 11 U.S.C. §§ 363(b)(1), 364(b). In the context of determining whether a particular transaction is within the ordinary course of business, the Bankruptcy Code provides no definitional
c. Appointment of Examiner or Trustee

Creditors may seek the appointment of an examiner or trustee. The court may order the appointment of an examiner to investigate the debtor’s financial affairs if such appointment is in the best interests of creditors or other parties in interest.51 The examiner does not take control of the business. The court may also order the appointment of a trustee to take control of the assets of the debtor on grounds such as fraud or gross mismanagement by the debtor.52

d. Creditor Plans

During the first 120 days after the order for relief has been entered, the debtor is the only party who may file a plan of reorganization. After the debtor’s exclusive period has elapsed, then any party in interest, including any creditor, is free to file its own plan.53 The debtor’s exclusive period is often extended by the court on the debtor’s motion; however, it cannot be extended past 18 months.54 Creditor plans typically call for liquidation of the assets of the estate, via sale or foreclosure.

4. Impact on Business

A Chapter 11 filing disrupts business relationships. Key employees seek other employment, customers and prospective tenants become wary about reliability, trade credit becomes scarce, competitors

51. 11 U.S.C. § 1104(c). In a single asset case, it is unusual for a mortgage lender to seek the appointment of an examiner. The preparation of the examiner’s report results in both additional delay and additional costs. The former is invariably detrimental to the mortgage lender’s interests and the latter are often paid from the mortgage lender’s collateral.

52. Id. § 1104(a). The appointment of a trustee in a single asset case usually results in a sale of the real estate after some initial delay. Moreover, trustee’s fees and expenses (including the trustee’s attorney’s fees) will frequently be paid from the lender’s security and a trustee may investigate and pursue lender liability claims against the lender. For those reasons, appointment of a trustee in a single asset case is usually not in the best interests of a mortgage lender.

53. Id. § 1121.

54. Id. § 1121(d).
spread rumors and trade debtors hesitate to pay, among other problems.

5. Difficulties for Attorneys Representing Debtors

To represent a Chapter 11 debtor, a law firm must not hold or represent any interest adverse to the bankruptcy estate and must be "disinterested." If the law firm has represented the debtor prior to the bankruptcy case and is owed a significant amount of pre-petition fees unrelated to bankruptcy work, the firm is regarded as a creditor and is not disinterested. There also is the problem of compensation. Pre-petition retainers are permitted, but the amount is subject to court scrutiny and may be disgorged if found to be unreasonable. Lawyers receiving retainers are generally required to obtain permission from the court to apply the retainer. If no retainer or an inadequate retainer is paid, the lawyers must seek court approval for payment of fees as an administrative expense. Detailed time records must accompany the applications. Generally, administrative expenses may not be paid from a non-consenting mortgage lender's collateral, such as proceeds of accounts receivable or rents, so if the reorganization fails, counsel may not be paid. As a practical matter, the size of the retainer will be a useful indicator of the debtor's ability or willingness to engage in the type of protracted litigation necessary to propose and confirm a cram-down plan over a mortgage lender's objection.

IV. Tactical Considerations

A. Debtor

1. Building a War Chest

Prior to the filing, the debtor will have significant up-front costs, notably payment of bankruptcy counsel's retainer. Creating a "war chest" of unencumbered cash is one way to meet those needs, as well as to improve the debtor's leverage in dealing with secured creditors after the filing. In single asset cases, however, unencumbered cash should be scarce, since the only source of cash (the rents on the debtor's property) are generally cash collateral by virtue of an assign-

55. Id. § 327(a).
ment of rents in favor of the lender. But accumulated pre-petition rents may be unencumbered, depending on state law. For example, if state law requires that a mortgagee take an "affirmative" act in order to "activate" its security interest in pre-petition rents, those rents may be available to pay bankruptcy counsel.

2. Deadline for Filing a Confirmation Plan

Although a single asset debtor does not have to file a confirmation plan within the first 90 days after the bankruptcy filing, a debtor who fails to do so must either begin paying debt service or else face foreclosure of its property.

3. Search for Allies

The debtor cannot successfully reorganize without the consent of at least one class of impaired creditors. A useful tool in persuading creditors is a liquidation analysis showing that junior creditors will fare better with the debtor's plan than with a straight liquidation (or foreclosure). It is rarely difficult to make such a showing in a single asset real estate. Natural allies for the debtor are unsecured creditors and junior lien holders who would be wiped out by a foreclosure of the first mortgage.

---

58. Prior to the Bankruptcy Reform Act of 1994, debtors and mortgage lenders often fought about whether lenders were required to take some affirmative act to perfect their security interest in post-petition rents, with debtors arguing that post-petition rents were unencumbered and could be used without providing adequate protection to the lender. The Bankruptcy Reform Act, however, simplified the issue by providing that the lender's pre-petition security interest in rents applies to post-petition rents to the extent provided for in the security agreement. See In re De Cespedes, 241 B.R. 260, 262-63 (Bankr. S.D. Fla. 1999). In other words, so long as the assignment of rents or mortgage instrument is clear that the lender has a security interest in post-petition rents, then the debtor cannot use those rents without the court's approval. Because, however, courts routinely allow debtors to use cash-collateral to continue operations, arguments now focus on whether post-petition rents are part of the debtors' estate or whether the lender effectively took possession of the rents pre-petition. Compare Sovereign Bank v. Schwab, 414 F.3d 450 (3d Cir. 2005) (holding that lender obtained constructive title to rents by sending a pre-petition notice to the borrower's tenants) with In re 5877 Polar, L.P., 268 B.R. 140 (Bankr. W.D. Tenn. 2001) (holding that assignment of rents was not absolute and that under terms of assignment lender had to take possession of the property in order to deprive the debtor of title to the rents).

4. Sue the Lender

Debtors often resort to litigation or threats of litigation against a lender to encourage it to agree to a reorganization plan. Asserting lender liability claims and/or defenses in an action to determine the validity, extent and priority of a mortgage lender's claim is a favorite debtor tactic. Such litigation often provides leverage sufficient to force a favorable settlement from a threatened mortgage lender.60

5. Cramdown

Debtors often seek to obtain the mortgage lender's consent to a debt restructure by threatening to confirm a cramdown plan over the lender's objections. Cramdown plans can include features such as significant term extensions, reduced interest rates, negative amortization, balloon payments and principal writedowns, and sometimes, all of the above.61 A credible cramdown threat can create sufficient debtor leverage to obtain a favorable consensual debt restructure.

B. Lender Strategies

1. Pre-filing Workout Considerations
   a. Relationship with Borrower
   
   The mortgage lender's legal strategy should be guided by its overall business goals and objectives, not vice versa. To some degree, the lender's actions will be guided by its relationship with the borrower, including such factors as (1) the status and amount of other loans to the borrower or its principals, (2) the borrower's managerial capability, (3) its financial capacity, and (4) the integrity and credibility of the borrower. This latter point is key. If the borrower cannot be trusted, a workout is clearly not a viable option, regardless of the economics.

   b. Collateral Evaluation

   The lender should also evaluate its collateral position. What is the current value of the project? Is there an equity cushion or is the project underwater? A current appraisal will be necessary to answer these questions. A physical inspection of the project should also be conducted to determine whether deferred maintenance exists. The

60. For this reason, lenders often insist, with varying degrees of success, that a suit against the lender trigger the borrower's principal's springing guaranty.

61. For two justly celebrated analyses of the key legal issues arising in connection with an attempt to confirm a Chapter 11 plan over the objection of dissenting creditors. See Kenneth N. Klee, All You Ever Wanted to Know about Cram Down Under the New Bankruptcy Code, 53 AM. BANKR. L.J. 133 (1979), and Klee, Cram Down II, 64 AM. BANKR. L.J. 229 (1990).
lender should also focus on control of rents and other cash collateral. Depending on the jurisdiction, the lender may be able to take possession of the rents and avoid their inclusion in the bankruptcy estate, but doing so may require the appointment of a receiver or other equitable relief.

c. Risk/Reward Analysis

Possible workout scenarios should be evaluated in light of both the odds for success and the consequences of failure. If additional collateral and/or personal guaranties can be obtained, the lender may conclude that its realization prospects will be enhanced even if the workout ultimately fails. Even absent an additional investment by the borrower, lender concessions such as a debt service reduction or even a moratorium may be appropriate in circumstances where the prospects for ultimate success are good and the lender receives an equity participation or other upside consideration, but only if the workout structure provides adequate safeguards to ensure that the lender's position (and its collateral) will not be further eroded.

d. Evaluation of Legal Position

A mortgage lender dealing with a financially troubled debtor should make an early evaluation (before the automatic stay closes its ability to fix mistakes) of its secured position by reviewing its documentation and verifying perfection. Any defects in loan documentation should be corrected. Liens unperfected at the time of the Chapter 11 filing are voidable, leaving the creditor with an unsecured claim.

e. Forbearance and Workout Agreements

Before engaging in substantive negotiations with a defaulting borrower, the lender should require the borrower to execute a forbearance agreement, acknowledging the borrower's default and waiving the bankruptcy stay. Likewise, any workout agreement with the borrower should be made with the assumption that the borrower will subsequently default and seek bankruptcy protection. Pre-filing waivers of the automatic stay (or agreements not to contest a motion to lift the stay) in a workout context have been upheld by some courts, and, even if unenforceable, may help show bad faith if a Chapter 11 petition is filed. Admissions as to default, collateral value, lack of defenses, offsets, etc., can also be useful.

62. Although some courts find such agreements per se unenforceable, see, e.g., In re Pease, 185 B.R. 431 (Bankr. D. Neb. 1996), most courts instead scrutinize the circumstances in which
A lender agreeing to loan concessions as part of a workout will obviously expect something from the borrower in return. If the borrower’s principals did not execute a bankruptcy-triggered guaranty as part of the original loan documentation, now is the time to obtain a guaranty that terminates only in the event of a foreclosure not preceded by an intervening bankruptcy or other defensive efforts. The lender may also benefit from additional collateral. Letters of credit, if obtainable, are particularly valuable as additional collateral because they can be drawn without violation of the automatic stay since their proceeds are not the property of the debtor’s estate.

Additional collateral given within 90 days of the bankruptcy filing is a voidable preference, unless the lender gives contemporaneous new pre-filing waivers of the bankruptcy stay were given. Waivers are generally not given effect if included in the initial loan documents. The closer the waiver to the bankruptcy filing, the more likely it is to be enforced, particularly if the debtor was sophisticated and represented by bankruptcy counsel. See In re Bryan Road LLC, 382 B.R. 844, 848–49 (Bankr. S.D. Fla. 2008); In re Desai, 282 B.R. 527, 531–32 (Bankr. M.D. Ga. 2002); see also In re Club Tower L.P., 138 B.R. 307, 310–11 (Bankr. N.D. Ga. 1991); In re Citadel Properties, Inc., 86 B.R. 275 (Bankr. M.D. Fla. 1988); In re Orange Park South P’ship, 79 B.R. 79 (Bankr. M.D. Fla. 1987).

63. If the mortgage lender agrees to a workout, it should consider implementing the workout terms via a consensual Chapter 11 plan of reorganization. Pursuant to the plan, the mortgage lender can sometimes obtain revised loan documents and a “drop-dead” provision in the plan that allows immediate foreclosure if the debtor defaults under the plan. (Some judges, however, will not enter such “drop-dead” orders. See 11 U.S.C. § 362(d) (giving courts discretion to condition the automatic stay)). Moreover, if the debtor ultimately defaults under the Chapter 11 plan and attempts to file another bankruptcy, the second case may be subject to dismissal unless the debtor can show that unanticipated changed circumstances caused the second filing. E.g., In re 1633 Broadway Mars Restaurant Corp., 388 B.R. 490, 500 (Bankr. S.D.N.Y. 2008) (to protect “the integrity of the reorganization process,” courts will generally require “a showing of unanticipated changes in circumstances that were not foreseeable at the time the first [reorganization] plan was confirmed” in order to stave off dismissal). A change in market conditions alone will not satisfy the changed circumstances requirement. E.g., In re Motel Props., 314 B.R. 889, 896 (Bankr. S.D. Ga. 2004) (“Debtor did not present evidence that the decline in the economy was anything more than the general market fluctuations in an industry dependent upon the discretionary spending of its consumer base.”).

64. Although the law is clear that drawing on a letter of credit does not violate the automatic stay (on the theory that a letter of credit is a contract between the issuer bank and the beneficiary, and does not directly involve the debtor’s estate), see, e.g., In re Air Conditioning, Inc., 845 F.2d 293, 296 (11th Cir. 1988), courts have been known to interfere with letters of credit. See also In re Kaiser Group Int’l, Inc., 399 F.3d 558, 566–67 (3d Cir. 2005) (collecting cases). Creditors in workout negotiations should be careful to obtain the collateral securing the letter of credit from someone other than the potential bankruptcy debtor to avert this possibility. Cf., e.g., In re Air Conditioning, 845 F.2d at 297–98 (“There are several possible sources from which the [collateral for the letter of credit] could have come such that the transfer to the bank would not have created a preference.”). Further, letter of credit provisions must be carefully drafted so that declaring a default or another act forbidden by the automatic stay is not a condition to drawing on the letter of credit. See In re Student Fin. Corp., 378 B.R. 73, 78 (Bankr. D. Del. 2007).
value. But preference fears should not prevent a lender from acquiring additional collateral, if available. To be sure, the lender will lose the new collateral if it is later found to be preferential, but the lender will be no worse off than if it never got the new collateral in the first place.

2. What Is a Secured Claim?
   a. Definition

   A claim of a creditor secured by a lien on the debtor's property or that is subject to a right of setoff is a secured claim to the extent of the value of the creditor's interest in the collateral, or to the extent of the amount subject to setoff. To the extent that the value of the creditor's interest or the amount subject to setoff is less than the amount of the creditor's total claim, then the claim is unsecured. Even a mortgage lender whose loan is non-recourse is generally deemed to have an unsecured deficiency claim against the debtor in the amount of the deficiency.

   b. Components of a Secured Claim

   If a secured claim is oversecured (meaning that the collateral's value is greater than the debt), the secured creditor may receive post-petition interest on the claim and any reasonable fees, costs or charges provided for under the agreement on which the claim is based. Statu...
utory attorneys' fees based on a percentage of the debt are generally not allowed, but actual, reasonable attorneys' fees generally are allowed.\textsuperscript{68}

c. Section 1111(b) Election

An undersecured lender can elect to have the full amount of its claim deemed secured, regardless of the value of its collateral. This election eliminates the lender's unsecured deficiency claim. The electing lender retains its lien on the project in the full amount of its claim and must receive under the plan cash payments equal to the full amount of its claim; however, the stream of payments need only have a present value equal to the value of its collateral. In effect, the lender retains its principal in full without diminution, but receives interest at a rate sufficiently below market to make the discounted value of the payment stream equal to the value of its collateral. Section 1111(b) was enacted to eviscerate the holding in a notorious case decided under the former Bankruptcy Act\textsuperscript{69} in which the borrower crammed down two undersecured non-recourse mortgages by cashing out the value of their collateral and retaining ownership of the project, leaving the lenders no opportunity to realize the benefits of any subsequent appreciation or to recover their deficiencies. The Section 1111(b) election can be of benefit to an undersecured lender in a situation where it expects the value of the collateral to increase rapidly (or where the lender believes the bankruptcy court has seriously undervalued its security) and the plan calls for a short-term payout and contains a due-on-sale provision. The lender can make the election at any time prior to the conclusion of the hearing on the disclosure statement (i.e., after the lender knows how it will be treated under the plan).\textsuperscript{70}

\textsuperscript{68} See \textit{In re Welzel}, 275 F.3d 1308, 1314–16 (11th Cir. 2001) (en banc) (holding that all such attorneys' fees must be judged for reasonableness under 11 U.S.C. § 506(b)). Although most courts seem to agree that the section 506(b) reasonableness standard applies to attorneys' fees if the statute is triggered, there is some disagreement about when section 506(b) itself is triggered. \textit{Compare}, e.g., \textit{Welzel}, 275 F.3d at 1316 (holding that the section 506(b) reasonableness analysis applies regardless of whether the attorneys' fee claim vested pre-petition or post-petition) with \textit{In re Leatherland Corp.}, 302 B.R. 250, 256–58 (Bankr. N.D. Ohio 2003) (holding that section 506(b) analysis only applies to claims that vest post-petition, not those that vest pre-petition) and \textit{In re Vanderveer Estates Holdings, Inc.}, 283 B.R. 122, 131 (Bankr. E.D.N.Y. 2002) ("Interests, fees, costs and charges arising post-petition are part of the secured creditor's claim in the first instance, and are therefore not governed by § 506(b)."). \textit{See generally in re Robb}, No. 07-50429, 2008 Bankr. LEXIS 1680, at *7–*8 (Bankr. S.D. Ohio June 10, 2008) (unpublished) ("There is a split of authority as to whether § 506(b) limits prepetition amounts.") (collecting cases).


\textsuperscript{70} Fed. R. Bankr. P. 3014.
d. Constitutional Protection

A secured creditor's interest in property of the estate *(i.e., the lien)* is subject to constitutional protection and may not be discharged without just compensation.\(^7\) In general, the holder of a secured claim has the right to receive its collateral or to receive the value of its collateral.

3. Cash Collateral

The debtor is generally prohibited from using cash collateral absent court approval or the secured creditor’s consent,\(^7\) but a mortgage lender should not assume that the debtor will comply with this requirement. As a practical matter, courts will rarely sanction debtors severely for unauthorized use of cash collateral so long as the cash collateral is used to pay costs incurred in maintaining and operating the project. Consequently, upon filing of the Chapter 11 petition, a mortgage lender should *immediately* move to prohibit or restrict the debtor’s use of rents and other cash collateral.

The court cannot authorize use of cash collateral unless it finds that the debtor has provided the lender with “adequate protection” of its interest in the cash collateral. However, almost all bankruptcy courts will authorize a debtor to use rents to operate and maintain a real estate project on the understandable rationale that rents applied to the operation and maintenance of the project will maintain the value of the primary collateral *(i.e., the real estate)*. Thus, so the theory goes, the lender’s interest in the rents will receive “adequate protection” by use of the rents to maintain the real estate. Therefore, it is unlikely that a lender will be successful in absolutely *prohibiting* the debtor’s use of the rents, but bankruptcy courts will typically require budgetary limitations on expenditures, monthly reporting requirements, and the payment to the lender of the monthly net operating income. Frequently, a debtor will consent to a cash collateral order that, by its terms, provides that the debtor’s failure to file or confirm a plan by a specified deadline or the debtor’s unauthorized expenditure of cash collateral will automatically terminate the automatic stay (although some bankruptcy judges are reluctant or unwilling to enter such “drop dead” orders).


\(^7\)2. 11 U.S.C. § 363(c)(2) (2006). Cash collateral is defined, in part, as any cash proceeds or rents generated by property (including hotel lodging fees) subject to a security interest. *Id.* § 363(a).
4. Relief from the Automatic Stay

a. Effect of Stay

As noted, the automatic stay enjoins foreclosures and enforcement of any other remedies against the debtor or its property. In addition, a secured creditor that has taken possession of its collateral, but has not yet sold it or, if cash, applied it to the debt as of the time of filing, may be required to turn over the collateral to the debtor.73 For this reason, if a bankruptcy filing is thought to be imminent, a lender should immediately pay down its debt with any cash collateral in its possession, such as rents or escrow account proceeds, so that it will not be available to the debtor in the event of a bankruptcy filing. The lender should make sure that its records clearly reflect the payment. Even if a mortgage lender has been able to obtain appointment of a state court receiver in aid of foreclosure,74 the receiver must turn over possession of the property to the debtor upon the filing of a Chapter 11 petition.75 The bankruptcy court can order that the state court receiver remain in possession of the project if it finds it would be "in the interests of creditors."76 This power is not often exercised, but it has been employed in cases where pre-filing mismanagement or misconduct is present.77

b. Basis for Relief

i. Cause, Including Lack of Adequate Protection

A mortgage lender may move for relief from the automatic stay to permit it to exercise its remedies for "cause," which includes lack of "adequate protection" for the lender's interest in collateral.78 The

73. Id. § 542(a); United States v. Whiting Pools, Inc., 462 U.S. 198, 208 (1983).
74. Bankruptcy courts have no authority to appoint receivers themselves; they can only excuse the Bankruptcy Code's requirements and allow previously-appointed receivers to remain in place. See In re Stratesec, Inc., 324 B.R. 156, 157 (Bankr. D.D.C. 2004).
76. Id. § 543(d)(1); see In re Falconridge, LLC, No. 07-bk-19200, 2007 Bankr. LEXIS 3755, *17-*18 (Bankr. N.D. Ill. Nov. 8, 2007).
77. Courts use a variety of factor-based tests to determine whether the turnover requirement should be excused, given the particular facts of each case. Mismanagement is universally considered as a factor. See, e.g., In re R&G Properties, No. 08-10876, 2008 Bankr. LEXIS 3132, at *24-*25 (Bankr. D. Vt. Nov. 21, 2008); Falconridge, 2007 Bankr. LEXIS 3755, at *21-*22; In re Dill, 163 B.R. 221, 225 (E.D.N.Y. 1994). If the court allows a receiver to stay in place, the case may be over as a practical matter. Without the ability to operate the property and pay management fees to an affiliate, the debtor may quickly lose interest.
bankruptcy code does not define "cause" or "adequate protection," but it does provide a non-exhaustive list of examples of adequate protection, including periodic payments to the extent that the stay results in a decrease in the value of the lender's interest in the collateral or giving the lender an additional lien or replacement lien in the property, again to the extent that the stay results in a decrease in the value of the lender's interest in the collateral. Because adequate protection is intended to protect a creditor from a decrease in value of the collateral, a lender is not entitled to adequate protection payments to compensate it for lost opportunity costs.

If there is an "equity cushion" the debtor can argue that the equity provides adequate protection, even if the debtor is not making payments. Furthermore, if the lender is undersecured, a court may deny relief from the stay so long as the debtor makes periodic payments sufficient to protect the lender from a decrease in the value of the collateral due to the stay (even if the payments are not in the full amount specified in the note). Junior liens are not considered in determining whether an equity cushion exists.

ii. The Debtor Has No Equity and the Property is Not Necessary for Reorganization

A mortgage lender may also move for relief from the stay if the debtor has no equity in the property and the property is not necessary for a successful reorganization. The debtor's lack of equity in the property takes into account the amount of all secured claims against the collateral, not just the secured claims of the party seeking relief from the automatic stay.

81. Timbers, 484 U.S. at 372–73.
82. See, e.g., In re Gallegos Research Group, Corp., 193 B.R. 577, 584–85 (Bankr. D. Colo. 1995). If the property qualifies as single asset real estate, however, the debtor either must begin making interest payments at the non-default contract rate or file a plan with a reasonable likelihood of being confirmed within a reasonable time. Otherwise the lender is entitled to relief from the stay. See supra Section II.A.
84. In re Indian Palms Assocs., Ltd., 61 F.3d 197, 207 (3d Cir. 1995).
86. Although similar sounding, whether an "equity cushion" exists is different from whether the debtor has equity in the property. Because junior liens are not considered in calculating the equity cushion, an equity cushion may exist even if the debtor has no equity. See, e.g., In re King., 305 B.R. 152, 174 (Bankr. S.D.N.Y. 2004).
The lender has the initial burden of proving that the debtor lacks equity in the property. The burden then shifts to the debtor, who must prove that the property is important to the reorganization and that the planned reorganization is feasible.\textsuperscript{87} In a single asset case, the collateral will, by definition, be necessary for the debtor's reorganization. Accordingly, the key issue is whether reorganization is feasible. The Supreme Court has articulated this burden as requiring the debtor to show that there is an effective reorganization "in prospect" and that there is "a reasonable possibility of a successful reorganization within a reasonable time."\textsuperscript{88}

iii. The Debtor Is a Single Asset Entity and Has Not, Within Ninety Days of its Petition, Commenced Paying Interest on the Creditor's Interest in the Collateral or Filed a Plan with a Reasonable Likelihood of Confirmation.

As previously discussed in more detail, if the debtor is a single asset entity, a mortgage lender can move for relief from the automatic stay which must be granted unless, within the later of 90 days of the petition date or 30 days after the court has determined that the debtor is a single asset real estate entity, the debtor either begins to pay the interest at the non-default contract rate or files a plan with a reasonable likelihood of being confirmed.\textsuperscript{89}

5. Dismissal

a. Generally

The mortgage lender may seek dismissal of the case, although relief from the stay is a more common remedy, particularly in a single asset case where relief for the stay is tantamount to dismissal. The court may dismiss a Chapter 11 case (or convert it to a Chapter 7 liquidation) "for cause," including, but not limited to, (1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation, (2) inability to effectuate a plan, (3) unreasonable delay by the debtor that is prejudicial to creditors, and (4) failure to propose a plan within any time limit fixed by the court.\textsuperscript{90}

\textsuperscript{88} Timbers, 484 U.S. at 375–76 (citation omitted).
\textsuperscript{89} See supra Section II.A.
\textsuperscript{90} 11 U.S.C. § 1112(b) (2006).
b. Bad Faith Filing

The bad faith filing of a Chapter 11 case can constitute grounds for dismissal. Where the debtor has few assets and creditors and the petition is filed on the eve of foreclosure with little hope of reorganization, the court may dismiss the petition for lack of good faith.\(^9\) This doctrine is particularly well developed in the Eleventh Circuit.\(^9\) The risk of dismissal is greatest where the debtor is a newly created entity which received all of its assets on the eve of bankruptcy (the so-called "new debtor syndrome"), or where there has been a prior bankruptcy involving the debtor. Sanctions against counsel may be imposed in egregious cases.\(^9\)

c. Best Interests of the Creditors and Debtor

The bankruptcy court may abstain from exercising Chapter 11 jurisdiction if the interests of the creditor and the debtor would be best served by dismissal.\(^9\) This occurs infrequently. An example of the circumstances warranting abstention is the eleventh hour filing by a debtor to attempt to thwart an out-of-court workout.\(^9\)

d. Enforcement of Pre-Filing Workout Waivers and Stipulations

As previously discussed, depending on the circumstances, a lender may obtain a dismissal based upon the express conditions of a pre-filing forbearance or workout agreement.\(^9\)

---

91. *In re Gunnison Center Apartments, LP*, 320 B.R. 391, 399 (Bankr. D. Colo. 2005); *id.* at 400.
92. *In re Dixie Broadcasting, Inc.*, 871 F.2d 1023, 1027 (11th Cir.), *cert. denied*, 493 U.S. 853 (1989); *In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393, 1394-95 (11th Cir. 1988). Factors that are present in almost every single asset case have been cited as evidence of bad faith filings. These factors include whether the dispute leading to the bankruptcy is essentially a two-party dispute between the lender and borrower, the lack of significant amounts of unsecured debt, the fact that the case was filed on the eve of foreclosure evidencing an intent to delay a lender's rights, and the fact that the debtor has few, if any, employees. Many of these cases involved single asset debtors whose only asset was a real estate project. Congress has since amended the bankruptcy code in response to this situation. *See* 11 U.S.C. § 362(d)(3) (2006).
93. The Eleventh Circuit has flatly held that the Bankruptcy Reform Act of 1994 did not supersede the *Phoenix Piccadilly* bad faith analysis. *See In re State Street Houses, Inc.*, 356 F.3d 1345, 1346 (11th Cir. 2004) (per curiam) ("We therefore ... hold that the guidelines set forth by this court in *In re Phoenix Piccadilly* ... have not been modified by the Bankruptcy Reform Act of 1994."). Some other courts have already followed suit. *See*, e.g., *In re Springs Hospitality, Inc.*, No. 06-13331 HRT, at *11 (Bankr. D. Colo. Aug. 22, 2006) (finding that single asset real estate case was filed in bad faith). Accordingly, in some cases a lender may not ever need to wait until the time periods established by the Bankruptcy Code have elapsed to get its property.
96. *See supra* Section IV.B.1.e.
6. Liquidation Plan

As discussed below, after the debtor's exclusivity period expires, any party (including the mortgage lender) may file a plan.97

7. Appointment of Examiner or Trustee

In a single asset real estate case it is rarely advisable for a mortgage lender (or at least one with a first priority lien) to seek appointment of an examiner or trustee. A mortgage lender could, typically, only do so where the borrower is irrational and the property is valuable. An investigation by an examiner or trustee might uncover pre-petition transfers to insiders which are recoverable by the estate. Such recoveries, however, usually benefit junior creditors, not first mortgagees. Although, in an underwater project where the mortgage lender’s deficiency claim constitutes a substantial portion of the unsecured debt, a mortgage lender may benefit significantly if pre-petition transactions to insiders are disgorged. Nevertheless, it should always be kept in mind that a trustee’s central mission is to get the unsecured creditors paid and he may seek to do so by pursuing preference, lender-liability, or other real or imagined claims against a deep pocket lender. Moreover, a trustee, as a supposedly disinterested fiduciary, typically has more credibility with the bankruptcy judge than the debtor and, therefore, can be a much more dangerous adversary. Regardless of any potential threat of litigation, appointment of a trustee invariably delays the lender’s reclamation efforts because the court will afford the trustee time to investigate the debtor’s affairs and to ascertain prospects of reorganization. In other words, the clock starts all over again. The mortgage lender must weigh these risks against the potential benefits which might accrue to it by virtue of recoveries from insiders or the ouster of a dishonest debtor from control of the project.

V. Types of Plans

A. Cure and Reinstatement Plans

If the debtor is in a position to cure a default in a mortgage loan, it may reinstate a previously accelerated mortgage without the creditor’s consent if it compensates the creditor for any damage suffered in reliance on the acceleration.98 A simple cure and reinstatement plan may be appropriate in cases where the debtor’s problem is a temporary

97. See infra Section V.B.
98. 11 U.S.C. § 1124(2)(C) (2006). A mortgage lender’s damages include not only unpaid principal and interest that is owed, but also costs incurred by the lender, including attorneys’ fees, appraisal costs, and other expenses incurred in protecting or recovering its collateral.
cash flow shortfall that created the default leading to the acceleration. However, confirmation of the lender's plan requires locating funds to pay administrative claims.

B. Liquidating Plans

If the debtor has not filed a plan within 120 days of the petition, then the mortgage lender may propose a plan, which will typically call for liquidating all of the debtor's assets. A liquidating plan accomplishes in Chapter 11 what usually occurs in Chapter 7. In a single asset real estate case, the asset is simply sold through bidding or other processes designed to obtain the fair market value of the property. This type of plan can be confirmed where sufficient equity exists to generate some payment to junior lien holders and/or unsecured creditors. A mortgage lender is entitled to bid for the property in connection with any such sale and receive a credit for the amount of its mortgage debt.

C. Extension and Composition Plans

These plans typically extend the maturity of the loan and restructure its payment terms. Unsecured creditors (including undersecured lenders) are often asked to accept partial payment of their claims in full satisfaction thereof and/or to receive equity interests in the debtor in lieu of full payment. Existing loan documentation can be altered to change default terms and, in some circumstances, reduce interest rates.

VI. Key Confirmation Issues

A. Best Interests of Creditors Test

To be confirmed by the court, a plan must provide for each holder of a claim that has not accepted the plan to receive, through the plan, at least the present value of what the claimant would receive in a Chapter 7 liquidation. This is the so-called "best interests of creditors" test and requires a valuation of what the creditors are to receive.

99. See id. at § 1124(2)(B).
100. Id. § 1121(c).
101. Id. § 363(k).
102. Id. § 1129(a)(7). To determine what a creditor would receive in a hypothetical Chapter 7, the court conducts a liquidation analysis. When determining what the property in a single asset case would bring in a hypothetical liquidation, the theoretical costs of sale must be deducted prior to completing the liquidation analysis. Courts often assume that costs would be 2 or 3 percent of the value of the property.
under the plan versus what they would receive if the property were liquidated.

B. Feasibility

The plan must be “feasible,” i.e., not likely to result in eventual liquidation or the need for further reorganization. This determination, which must be made by the court, is a question of fact and usually requires, among other things, a valuation of the project and an analysis of cash flow projections.103

The feasibility question is frequently one of the most hotly contested issues in any reorganization attempt. The debtor inevitably offers testimony that an upturn in revenue is imminent and will generate sufficient funds to pay all creditors. A lender can counter the impact of rose-colored projections by relying on the project’s operating history, which, absent a dramatic (and favorable) change in circumstances, provides the most reliable guide as to how a property is likely to perform.104 As one court has said “[p]lans that involve ‘pipe dreams’ or ‘visionary schemes’ are not confirmable.”105 Courts have rejected plans where the debtor has, prior to filing its petition, accomplished little in the way of developing its property.106 In addition, several courts have rejected plans providing for payouts of ten years or more on the grounds that the projections are so inherently speculative in the outer years as to violate the requirement that the plan be feasible.107 Courts have also rejected on feasibility grounds plans that provide for negative amortization of the mortgage lender’s debt and therefore increase the lender’s exposure and risk.108

C. Good Faith

The plan must be filed in good faith and must not, for example, unduly favor insiders at the expense of creditors.109 Often, in single

104. See In re Inv. Co. of the Southwest, Inc., 341 B.R. 298, 311 (B.A.P. 10th Cir. 2006) (“A glaring discrepancy between the facts surrounding past performance and activity and predictions for the future is strong evidence that a debtor’s projections are flawed and the plan is not feasible.”)
106. Id.
asset cases, the debtor’s insiders also control the entities that provide management leasing and other services (on a fee basis, of course) to the project. A plan that enriches insiders at the expense of creditors may be proposed in bad faith.\textsuperscript{110} Therefore, in opposing such plans on “bad faith” grounds, it may be useful to compare the benefits (and risks) of the plan to creditors with those to be realized by the insiders and their affiliates.

D. Plan Must Receive the Favorable Vote of at Least One Impaired Class

In order to be confirmed, at least one non-insider class whose claims or interests are impaired must vote in favor of the plan.\textsuperscript{111} In single asset cases, this requirement has often led to plans, proposed by debtors, that separately classify a mortgage lender’s unsecured deficiency claim from the claims of unsecured trade creditors in order to create an impaired class which will vote in favor of the plan. Another technique has been to classify separately the claims of rejected executory contracts, such as landscaping and lawn maintenance contracts and equipment lessors, whose claims are negligible in amount but who can be induced to vote for the debtor’s plan, thereby satisfying the requirement that at least one impaired non-insider class vote for the plan.\textsuperscript{112} Having created the separate class, the debtor must then make sure that it is impaired. Courts are wary (or at least they say they are wary) of attempts to gerrymander an impaired class for the purpose of approving a plan.\textsuperscript{113} Virtually all bankruptcy courts pay lip service to this principle, but many bend over backwards to find some legitimate basis for the separate classification.\textsuperscript{114}

Unfortunately for secured creditors, the 1994 Bankruptcy Reform Act overturned \textit{In re New Valley}, which held that a class that had been paid in full, but was denied post-petition interest was \textit{not} impaired.\textsuperscript{115}

\textsuperscript{110} \textit{E.g., In re Rusty Jones, Inc.}, 110 B.R. 362, 375 (Bankr. N.D. Ill. 1990).

\textsuperscript{111} 11 U.S.C. § 1129(a)(10) (2006). Acceptance of a plan by a creditor class requires an affirmative vote of at least two-thirds of the \textit{amount} of creditor claims in the class and a majority of the \textit{number} of claim holders in the class. Acceptance by a class of equity interest holders requires at least two-thirds of the \textit{amount} of the interests held by the equity holders in the class. \textit{Id.} § 1126(c), (d).

\textsuperscript{112} For a particularly egregious court-sanctioned example of this technique, see Confederation Life Ins. Co. v. Beau Rivage, Ltd., 126 B.R. 632 (N.D. Ga. 1991); \textit{see also In re Club Assocs.}, 107 B.R. 794 (Bankr. N.D. Ga. 1989).

\textsuperscript{113} \textit{See In re Combustion Eng’g, Inc.}, 391 F.3d 190, 243 (3d Cir. 2004); \textit{In re Windsor on the River Assocs., Ltd.}, 7 F.3d 127, 132 (8th Cir. 1993); \textit{see also In re Sandy Ridge Dev. Corp.}, 881 F.2d 1346, 1353 (5th Cir. 1989).


\textsuperscript{115} \textit{In re New Valley Corp.}, 168 B.R. 73, 79-80 (Bankr. D.N.J. 1994).
Courts subsequently addressing the issue have found that a class is impaired, even if paid in full on the plan’s effective date, so long as the class does not receive post-petition interest. Accordingly, it may not be difficult for a debtor to create a class of creditors who will vote in favor of the plan.

E. **Plan Must Not Unfairly Discriminate**

The plan must not unfairly discriminate against classes of creditors. Essentially, this means that, although under some circumstances certain types of unsecured debt may be classified separately, the plan must not unfairly discriminate among the classes. For example, a debtor should not be able to classify the unsecured portion of a mortgage lender’s claim separately from the trade debt and then pay the trade debt class a higher percentage of its claims than the mortgage lender’s deficiency claim without convincing reasoning.

F. **Absolute Priority Rule**

1. **The Rule**

Under the absolute priority rule, codified by Section 1129(b)(2) of the Bankruptcy Code, holders of equity in the debtor may not receive or retain any interest in the project “on account of” their existing equity interests unless all dissenting classes of creditors are paid in full under the plan. This does not require a cash payment at confirmation, but the creditors must receive either cash or deferred payments over time which have a “present value” equal to the full amount of their claims.

---


117. See, e.g., *Mercury Capital Corp. v. Milford Conn. Assocs.*, L.P., 354 B.R. 1, 10 (D. Conn. 2006) (“A plan unfairly discriminates against a class if similar claims are treated differently without a reasonable basis for the disparate treatment.”).

118. See, e.g., *In re National/Northway Ltd. P’ship*, 279 B.R. 17 (Bankr. D. Mass. 2002) (extensively reviewing the First Circuit caselaw on the classification of mortgagee deficiency claims and rejecting plan which proposed to pay minor unsecured creditors 90% of their claims within 10 days of confirmation, while requiring the mortgagee to accept a new ten-year note at the U.S. Treasury Bond rate plus 1.75%, amortized over a 25-year period with a balloon payment at the end, and including a provision that could render the even the secured claim unsecured).

2. New Value Exception to the Rule

Invoking a doctrine articulated prior to the enactment of the Bankruptcy Code in *Case v. Los Angeles Lumber Products Co.*,120 and its progeny, some courts continue to recognize the so-called “new value” exception to the absolute priority rule. This exception allows the debtor to retain ownership of the project, despite its failure to pay objecting creditors in full, in exchange for a contribution of “new value” which is both substantial and necessary to the debtor’s reorganization.121

The Supreme Court, in *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 North LaSalle Street P’ship*, declined to extinguish, once and for all, the new value exception.122 The Court did, however, limit the scope of the exception, holding that a bankruptcy court should not have confirmed a plan over the mortgage lender’s objection, where the plan gave the debtor’s pre-bankruptcy equity holders the exclusive right to contribute new capital in exchange for ownership interests in the reorganized entity.123 The court held that absent a “market test” (such as

120. 308 U.S. 106 (1939).
121. See 11 U.S.C. § 1129(b)(2)(B) (2006) (a plan is “fair and equitable” only if the allowed value of each claim in an impaired, dissenting class is paid in full, or if “the holder of any claim or interest that is junior to the claims of such [impaired, dissenting] class will not receive or retain under the plan on account of such junior claim or interest in any property”).
123. Id. at 458. In *LaSalle*, the Court considered whether a single asset real estate debtor could, over the objection of its impaired mortgage lender, confirm a reorganization plan that afforded certain of the debtor’s partners the exclusive opportunity to contribute $6.125 million in new capital in exchange for ownership interests in the reorganized debtor. *Id.* at 437-40. Extensively analyzing the case law and policy justifications for the purported new value exception, *Id.* at 444-54, the Court ultimately held that, regardless of whether the new value exception in fact exists under the Bankruptcy Code, a plan that allows old equity the exclusive right to contribute new capital and thereby retain an equity interest in the reorganized debtor violates the absolute priority rule and, therefore, cannot be confirmed over the objection of impaired creditors. *Id.* at 458 In so holding, LaSalle squarely rejected the reasoning of the Ninth Circuit in *In re Bonner Mall P’ship*, 2 F.3d 899 (9th Cir. 1993), where the court expressly reaffirmed the existence of the new value exception for a plan under which the equity holders would retain control of the debtor (a real estate partnership whose sole asset was a shopping mall) by contributing $200,000 of new value, while the sole mortgage lender’s $6.6 million mortgage would be written down to $3.2 million (the fair market value of the shopping mall). *Id.* at 901-03, 905-06. The court held that the absolute priority rule would not be violated because the equity interests would retain their interests in the debtor in exchange for a “genuine and fair exchange of new capital,” and not “on account of” their existing ownership interests. *Id.* at 909, 917-18. *Bonner* expressly rejected the conclusion reached by the Fourth Circuit in *In re Bryson Properties*, XVIII, 961 F.2d 496 (4th Cir. 1992), where that court held that where a plan gives old equity the exclusive right to own the reorganized debtor in exchange for a new capital infusion, the equity holders necessarily retain their interests “on account of” their status as existing owners. *Id.* at 504-05 *LaSalle* effectively overruled *Bonner Mill* and adopted the approach in *Bryson*. Under the court’s holding in *LaSalle* it is now clear that even if the new value exception remains valid, it will not apply in cases in which the existing equity holders are given “exclusive opportunities free from competi-
an opportunity to offer competing plans or a right for outsiders to out
bid the insiders), decisions about whether a plan provided sufficient
new equity would be measured "by the Lord Chancellor's foot" and
that "an absolute priority rule so variable would not be much of an
absolute."\textsuperscript{124} Given the extensive analysis in \textit{LaSalle}, many courts
continue to assume that this exception exists,\textsuperscript{125} and these courts will
permit equity holders in bankruptcy debtors to utilize it—provided
that there are sufficient market safeguards in place to protect
creditors.\textsuperscript{126}

G. \textit{Negative Amortization}

1. Cannot Violate "Fair and Equitable" Requirement

It has been widely held that the "fair and equitable" requirement
for confirmation prescribed by Section 1129(b)(2) of the Bankruptcy
Code is not met merely by technical compliance with the absolute
priority rule codified in that Code section. Rather, the courts have made
it clear that Section 1129(b)(2) merely establishes the minimum stan-
dards that plans must meet, and "[the] court must consider the entire
plan in the context of the rights of the creditors under state law and
the particular facts and circumstances when determining whether a
plan is "fair and equitable.""\textsuperscript{127} The Fifth Circuit held that a proposed
cram-down plan flunked the "fair and equitable" test, regardless of its
technical compliance with Section 1129(b), where the lender was a
short-term construction lender and the plan proposed to defer repay-
ment of substantially all principal for fifteen years, with negative
amortization over the first twelve years.\textsuperscript{128} These cases support the
proposition that, regardless of technical compliance with Code re-

\textsuperscript{124} See, e.g., Deep River Warehouse, 2005 Bankr. LEXIS 1090, at *38 n.11.
\textsuperscript{125} Id. at 675-76; accord \textit{In re EFH Grove Tower Assocs.}, 105 B.R. 310 (Bankr. E.D.N.C.
1989); \textit{In re Spanish Lake Assocs.}, 92 B.R. 875, 878-79 (Bankr. E.D. Mo. 1988); \textit{In re Edgewater
& Keith W. Bartz, Negative Amortization and Plan Confirmation: Is it Fair and Equitable under
quirements, a plan is not “fair and equitable” if the risk of failure is essentially borne by the mortgage lender while most of the benefits accrue to insiders and their affiliates.

2. Not Impromissible Per Se

Most courts have refused to hold that negative amortization plans are per se unfair and inequitable. For example, in Great W. Bank v. Sierra Woods Group, the Ninth Circuit in rejecting the bankruptcy court’s ruling that negative amortization was per se impermissible, noted with approval a ten-factor test articulated in In re Apple Tree Partners, L.P., to be employed in determining whether a negative amortization plan passes the “fair and equitable” test:¹²⁹

1. Does the plan offer a market rate of interest and present value of the deferred payments;
2. [Are] the amount and length of the proposed deferral reasonable;
3. Is the ratio of debt to value satisfactory throughout the plan;
4. Are the debtor’s financial projections reasonable and sufficiently proven, or is the plan feasible;
5. What is the nature of the collateral, and is the value of the collateral appreciating, depreciating, or stable;
6. Are the risks unduly shifted to the creditor;
7. Are the risks borne by one secured creditor or class of secured creditors;
8. Does the plan preclude the secured creditor’s foreclosure;
9. Did the original loan terms provide for negative amortization; and
10. Are there adequate safeguards to protect the secured creditor against plan failure[?][¹³⁰]

Other courts use different analyses, but the ultimate inquiry is the same—whether the plan unfairly shifts the risk of loss to the creditor.¹³¹

H. Applicable Interest Rate

As noted, a secured creditor has a statutory (and constitutional) right to receive the present value of its secured claim, i.e., its collateral. Consequently, since most real estate Chapter 11 plans feature a long-term payout of the mortgage, the two prominent factual issues at

¹²⁹. 953 F.2d 1174, 1177–78 (9th Cir. 1992).
most confirmation hearings are (1) the fair market value of the project and (2) the appropriate interest rate to be paid the mortgage lender over the lifetime of plan. Litigating these issues requires use of expert testimony from appraisers and other professionals familiar with the applicable real estate and lending markets.

The proper method of determining the appropriate interest rate remains a matter of some dispute. A 2004 Supreme Court case, Till v. SCS Credit Corp., blessed the so-called “formula approach,” in which the court begins with a “risk-free” rate (the prime rate, for example) and then adds interest to account for the various risk factors that the court perceives. In Till, the Supreme Court purported to reject all other methods of calculating the interest rate besides the formula approach. However, because Till was a four-to-four decision, and because Justice Thomas’s concurring opinion was not squarely in line with either bloc’s logic, Till did not settle the issue definitively. Further, Till was a Chapter 13 case, and there remains some question about whether its reasoning should apply to Chapter 11 cases. Accordingly, courts could (in theory) still apply tests other than the formula approach.

VII. Conclusion

The bottom-line bargain of a mortgage lender with a first priority lien is really quite simple: either it gets its loan repaid or it gets the collateral. This result necessarily follows from the lender’s senior priority position: unless its mortgage is repaid in full, nobody else (including the borrower) gets anything, because the lender’s priority

134. See Till, 541 U.S. at 477 (“These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches.”).
135. See, e.g., In re Cook, 322 B.R. 336, 343 (Bankr. N.D. Ohio 2005) (“Due to the lack of consensus on a legal rationale, the Till decision results in no binding precedent.”) (emphasis in original).
136. E.g., Thomas R. Fawkes & Steven M. Hartmann, Revisiting Till: Has a Consensus Emerged in Chapter 11s?, 27-6 AM. BANKR. INST. J. 28, 28 (2008) (“In light of the fact that relatively few courts have addressed in detail the applicability of Till in a chapter 11 cramdown scenario, it would be overreaching to conclude that a ‘consensus’ has been reached on whether Till should be applied in the chapter 11 context.”).
137. See, e.g., In re Am. Homepatient, Inc., 420 F.3d 559, 568 (6th Cir. 2005) (declining to “blindly adopt Till’s endorsement of the formula approach for Chapter 13 cases in the Chapter 11 context” and instead creating a “nuanced approach” that looks first to whether there is an efficient market for debtor financing before utilizing Till’s formula approach as a last resort), cert. denied sub nom. Nexbank, SSB v. Am. Homepatient, Inc., 547 U.S. 1019 (2006). Indeed, courts in the Sixth Circuit have been particularly resistant to Till.
interest in the project and its income is superior to that of the borrower and all other creditors.

Even in a single asset bankruptcy this basic principle governs if there is equity in the project, since the debtor cannot retain an interest in the project unless the mortgage lender is paid in full. Of course, there is no requirement that the mortgage lender be paid in cash at confirmation, but the mortgage lender must receive the “present value” of its claim, i.e., if the loan is paid over time, the plan must provide for a market rate of interest. In other words, a fully secured lender’s loan may be modified by a Chapter 11 cramdown, but basically only as to term and interest rate. In such cases, the basic rule still applies: either the lender ultimately gets paid in full, at a market rate of interest—or it gets the collateral.

In a single asset case where the project is underwater, the rules can change dramatically. Invocation of the judicially crafted exception to the absolute priority rule, when combined with artificial classification and/or artificial impairment techniques designed to gerrymander the creation of the requisite one impaired credit class to vote for the debtor’s plan, can destroy the basic bargain between the mortgage lender and the borrower. Under this scenario, the borrower invests new “value” (typically as little as possible), retains ownership of the project and writes off all or most of the amount by which the mortgage debt exceeds the project’s value. In addition, the loan term can be extended and the interest rate reduced (if current market rates are less than the original loan rate).

All is not lost, however, for a lender to a single asset real estate entity. While the game remains the same, the rules have changed since the last major real estate recession. Springing, exploding, and other non-recourse carve-out guaranties may prevent borrowers from seeking bankruptcy protection in the first place. And, if a borrower files a bankruptcy petition, it will only have ninety days to either file a plan with a reasonable likelihood of being confirmed or begin to make interest payments to the lender. Even so, Chapter 11 is still a dangerous place for a mortgage lender, where passivity can be fatal. To avoid even more substantial losses (above the lost opportunity costs it will never recover), a mortgage lender must understand all of the weapons in its arsenal and be willing to use those weapons in an aggressive campaign to protect its interests.