LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 28, Number 11 • September 2011

Seventh Circuit Upholds Secured Creditors' Credit Bid Rights Under Cramdown Plan

By Lawrence V. Gelber, James T. Bentley, and Mike Paek

On June 28, 2011, in a decision of great significance to secured creditors, the United States Court of Appeals for the Seventh Circuit held that secured creditors have a statutory right to credit bid their debt at an asset sale conducted under a so-called "cramdown" plan. *River Rd. Hotel Partners, LLC v. Amalgamated Bank*, ___ F.3d ____, 2011 WL 2547615 (7th Cir. Jun. 28, 2011). This decision is directly at odds with recent decisions in the Third and Fifth Circuits regarding a secured creditor's right to credit bid under a plan. *See In re Phila. Newspapers*, 599 F.3d 298 (3d Cir. 2010); *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

Facts

In *River Road*, two Chapter 11 debtors (the "Debtors") filed proposed bid procedures and liquidating plans seeking to sell substantially all of their assets free and clear of liens at an open auction. *River Road*, 2011 WL 2547615 at *2. The stalking horse bids for each Debtors' assets were for significantly less than the amounts owed by the Debtors to their prepetition secured lenders (the "Lenders"), and under the Debtors' proposed bid procedures, the Lenders were not permitted to credit bid their

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In re Soho 25 Retail, LLC Benefits Mortgage Lenders in New York

By William M. Hawkins

Earlier this year, Judge Sean H. Lane of the Bankruptcy Court for the Southern District of New York held that the post-petition rental income of a debtor-in-possession's commercial real property in New York City was not property of the debtor's estate under section 541 of the Bankruptcy Code, even though the underlying condominium units were owned by the debtor and had become estate property. The bankruptcy court concluded that control of the rental income had transferred to the debtor's mortgagee, who had begun (but not completed) a foreclosure on the commercial property interests of the debtor, before the bankruptcy's filing. In the decision, *In re Soho 25 Retail, LLC*, No. Adv. 11-1286-SHL, Bkr. 10-15114-SHL, 2011 WL 1333084 (Bankr. S.D.N.Y. Mar. 31, 2011), the exclusion of the rental income stream from the bankruptcy estate thwarted the debtor-in-possession's attempt to reorganize over the mortgagee's objection and markedly improved the creditor's position. Ultimately, the lender won its stay relief motion and completed its foreclosure. The bankruptcy case was dismissed.

Judge Lane's decision merits the attention of mortgage lenders and potential bankruptcy debtors alike, because it could provide significant leverage for secured parties, particularly in single asset real estate cases involving New York property. The holding supports the relatively new theory that New York law permits a mortgagor to transfer its entire interest in rents to a mortgagee upon executing the mortgage, such that the transfer will remain effective in the mortgagor's eventual bankruptcy. The decision also holds that a mortgagee's diligence in enforcing against a debtor upon and after default can cut off the ability of a debtor to use the rental proceeds of the mortgaged property in a subsequent bankruptcy. However, while the bankruptcy court's ruling is certainly good news for mortgage lenders and provides some guidelines for future strategy by both mortgagees and borrowers in distressed situations, the decision also leaves areas of doubt as to how these parties might best guide their behavior

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to maximize their benefits in a post-*Soho 25* world.

Background

In 2006, Soho 25 borrowed $8.5 million from Greenwich Capital Financial Products, Inc. *In re Soho 25 Retail, LLC*, 2011 WL 1333084, at *1. To secure repayment, the lender obtained a mortgage lien on Soho 25's two commercial condominium units located in a New York City building. *Id*. at *2. The borrower also executed and delivered an Assignment of Leases and Rents for the lender's benefit. *Id*. (After the transaction closed, the note, mortgage and assignment of rents were assigned from Greenwich to the current "lender.") In the Assignment, the borrower agreed that it "'absolutely and unconditionally'" assigned to Greenwich and its successors "'all right, title and interest [of the borrower] in and to all present and future Leases and Rents,'" and further stated that the "'Assignment constitut[ed] a present and absolute assignment and [was] intended to be unconditional and not as an assignment for additional security only.'" *Id*. at *2. Though the recitals of the agreement provided that the "'Assignment [was] being given as additional security for the Loan,'" the lender took the position that it owned the rent stream until the underlying debt was satisfied and that the borrower enjoyed the use of the rental income in the meantime only thanks to a "'revocable license,'" which was limited by the terms of the Assignment of Leases and Rents. *Id*. at *2 and fn. 7.

In June 2009, the debtor defaulted on payments under the loan. *Id*. at *3. On June 18, 2009, the lender sent the borrower a default notice, which "advised the Debtor that, 'by virtue of the Defaults, [its] license to collect rents from the [condominium units was] terminated and the Lender [was] entitled to all present and past due rents.'" *Id*. In late 2009 and in 2010, the lender wrote to the borrower's tenants, instructing them to pay rent directly to the lender, and the borrower joined in one of these letters. *Id*.

The Suit

Soho 25 remained in default under the loan. So, on Nov. 13, 2009, the lender filed a complaint in New York state court to foreclose on the condominium units. *Id*. In the suit, the lender also requested the appointment of a receiver to take control of the property and the rents. *Id*. Soho 25 did not appear in the action, and the state court entered a default judgment against the borrower and all other defendants. *Id*. While the state court did not appoint a receiver, the default order appointed a referee to "'ascertain and compute … the amount due to the [Lender] under the Loan Documents … and to examine and report … whether the mortgaged premises can be sold in one parcel.'" *Id*. On July 12, 2010, the referee issued a report, determining the debt owed at more than $11 million. *Id*. The state court entered a judgment of foreclosure and sale on Aug. 11, 2010, which directed the referee to sell the condominium units. *Id*. The public foreclosure auction was scheduled for Sept. 29, 2010, but the sale was stayed when the debtor filed for protection under Chapter 11 of the Bankruptcy Code as a "single asset real estate" case (an "SARE") on the day before the auction. *Id*. at *4.

The Bankruptcy Court Excludes Post-Petition Rent from the Estate

The lender filed a stay relief motion in the bankruptcy case, alleging that the rent payments from the debtor's property did not belong to the bankruptcy estate. *Id*. at *1. The debtor opposed the lender's motion and also filed a complaint against the lender, alleging that the mortgagee was improperly collecting and retaining the tenants' rent

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William M. Hawkins practices creditors' rights, restructuring and bankruptcy law as a partner at Loeb & Loeb LLP, in the firm's New York office. He can be reached at 212-407-4126 or whawkins@loeb.com.

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The Bankruptcy Strategist® (ISSN 0747-8917) is published by Law Journal Newsletters, a division of ALM.

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, PA 19103
www.ljnonline.com

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The Uncertain World for Individual Chapter 11 Debtors

By William L. Norton III

Individuals have always had a difficult time reorganizing under Chapter 11, and many who represent individual debtors believed that the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" or "2005 Amendments") would make it easier for individuals to operate and reorganize under Chapter 11. Several amendments to the Chapter 11 provisions of the U.S. Bankruptcy Code were added and amended to create a similar path that individuals follow under Chapter 13. Unfortunately, either as an oversight or by design, certain provisions that exist under Chapter 13 were not included in the Chapter 11 provisions, and recent cases have made the reorganizations of individual Chapter 11s in those jurisdictions as difficult as prior to the BAPCPA. This article discusses the major uncertainties that currently exist in these types of cases.

Post-Petition Income

BAPCPA added Code § 1115, which added to property of the estate under § 541 all "earnings from services performed by the debtor after the commencement of the case." This provision is identical to Code § 1306 that exists for Chapter 13 cases, and one would expect it to operate in a Chapter 11 case with similar results. But because of the failure of Congress to also amend companion sections relating to post-petition operations, the Chapter 11 debtor must face obstacles that do not exist for the Chapter 13 debtor.

First, the Internal Revenue Code has always created a taxable estate for Chapter 11 debtors pursuant to 26 U.S.C. § 1398(a). This taxable estate is easily dealt with in the context of a corporation or operating entity. However, for an individual who often receives income through the payment of wages from third parties, the dual estate presents some tax complications that are difficult for the most sophisticated of tax experts and are mind boggling to most bankruptcy counsel. In fact, many do not appreciate the complications until it is too late. These complications do not exist in Chapter 13 because the Internal Revenue Code does not create a separate taxable estate when a Chapter 13 case is commenced.

For example, which taxable entity, the individual or the estate or both, is taxed on wages paid by a third-party employer to the Chapter 11 debtor? The Internal Revenue Service has issued Revenue Notice 2006-83, which states that the W-2 should be issued to the individual so that self-employment taxes and other withholdings that apply only to individuals will continue to be withheld. *See* 2006-2 CB 596 (Sept. 18, 2006). On the other hand, Notice 2006-83 states that 1099s should be issued to the estate. The party receiving the W-2 or 1099, however, may not be the party that includes the income as taxable revenues. 26 U.S.C. § 1398 sets forth the required treatment during the Chapter 11 case. However, post-confirmation treatment of the debtor's income is less clear. The confirmation of a plan typically vests the property of the estate with the debtor. But under § 1115, post-confirmation income remains the property of the estate until the case is "closed, dismissed, or converted." Over five years after the enactment of BAPCPA, the IRS has yet to provide guidance regarding the tax treatment of this post-confirmation income.

Another question is how post-petition earnings paid by a third-party employer of the debtor should be taxed when the bankruptcy court allows the debtor to retain this income to pay personal living expenses. The treatment is easier when the bankruptcy estate generates this income and pays the amounts to the debtor for the payment of administrative expenses. The estate would be able to deduct these payments as administrative expenses. An individual, on the other hand, is not be able to deduct personal expenses. Again, guidance on this treatment is lacking.

Second, Code § 330(a)(4)(B) creates an exception in Chapter 12 and 13 cases, in which the debtor is an individual, that allows the debtor to use property of the estate to pay the fees of the debtor's attorney for services benefiting the debtor, even though those interests may not benefit the bankruptcy estate. This allows the debtor to compensate counsel using post-petition earnings for such services as divorce matters and defense of dischargeability actions under Code § 523.

Unfortunately, Congress failed to amend Code § 330(a)(4)(B) to include Chapter 11 cases. Thus, the debtor must show to the court some benefit to the estate in order to allow compensation to the debtor's counsel from post-petition earnings that constitute property of the estate. This has caused some attorneys, particularly in cases where a dischargeability action is contemplated or a divorce proceeding is pending, to use pre-petition paid-on-receipt retainers prior to accepting such cases. Because of the amount of cash that is required up front in such instances, the inability to use post-petition income to pay for the services needed for the debtor is a severe limitation in Chapter 11 cases.

Third, limitations exist in Chapter 11 as to how much post-petition

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William L. Norton III is a partner in the Bankruptcy, Restructuring and Distressed Investing practice at Bradley Arant Boult Cummings LLP (Nashville, TN), where he focuses his practice on Chapter 11 business cases, representing debtors, secured creditors, unsecured creditors, committees and trustees. He can be reached at bnorton@babc.com or 615-252-2397.

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income is permissible to be used by the debtor in the payment of personal expenses. Code § 363(b)(1) authorizes a debtor to use property of the estate without court permission if it is in "the ordinary course of business." In a Chapter 11 context, however, an individual may, but does not always, operate a business. Even when the debtor has a business, the debtor will undoubtedly have personal expenses for which this authorization under Code § 363(b) would not apply. In such instances, the debtor will need to apply to the court for approval to pay these expenses, typically through a budget following notice and hearing the creditors. Although theoretically, the same issue would apply to individuals in Chapter 13 cases, the matter is not nearly as significant in Chapter 13 cases because a plan is usually proposed and confirmed in relatively short period of time following the commencement of the Chapter 13 case. In the Chapter 11 context, the length of time that it takes to confirm a Chapter 11 plan is typically months, thus requiring the debtor to operate under § 363 prior to confirming a plan and enabling creditors to object to the use of property of the estate for a debtor's personal expenses.

Confirmation of the Plan

It does not get easier for individuals in Chapter 11 cases when trying to confirm a plan of reorganization. Similar to the Chapter 13 model, Code § 1129(a)(15) requires the distribution of all "projected disposable income of the debtor that is received by the debtor during the five year period beginning on the date that the first payment is due under the plan … ." This section refers to Code § 1325(b)(2) in defining "projected disposable income."

While there remain some differences as to the distribution of projected disposable income in Chapter 11 cases as applied in Chapter 13 cases, the most significant difference is the continued application of the absolute priority rule under Code § 1129(b)(2)(B)(ii). [Note, the most notable difference is that a Chapter 13 plan is limited to an "applicable commitment period" under 11 U.S.C. § 1325(b)(4) while the Chapter 11 plan is limited only to the "value of property" received during a five-year period. *See* 11 U.S.C. §1129(a)(15).]

In Chapter 13 cases, there is no voting by classes of creditors and the absolute priority rule does not exist. As long as the debtor is able to demonstrate the payment of projected disposable income, the distribution of that income to unsecured claims in a Chapter 13 case is deemed fair and equitable. *See* 11 U.S.C. § 1325(b). BAPCPA amended the cramdown provisions of Code § 1129(b)(2)(B)(ii) in a manner that many presumed, when the statute was enacted, would create an exception for individuals to the absolute priority rule so that the focus would be on the projected disposable income in the same manner that exists in Chapter 13.

The Absolute Priority Rule

The existence of the absolute priority rule for individuals in Chapter 11 cases that existed prior to BAPCPA was a significant obstacle to confirmation of a successful plan of reorganization. *See Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963 (1988) (absolute priority rule precludes debtor-farmer from retaining interest in farm operations). The absolute priority rule imposes an obligation on the debtor to pay all unsecured claims in full before the debtor can retain, without the creditors' consent, any property of the estate under a plan of reorganization. Corporations that cannot obtain the consent of unsecured creditors can still reorganize by terminating existing stock and transferring ownership of the entity to the creditors. This option does not exist for an individual. It is not feasible for an individual to surrender ownership of everything the individual owns to creditors. [Note, some courts have held that the individual debtor may retain exempt property and not violate the absolute priority rule. *See In re Bullard*, 358 B.R. 541 (Bankr. Conn. 2007); *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga. 2010) (debtor may retain exempt property).]

The 2005 Amendment

The 2005 amendment to Code § 1129(b)(2)(B)(ii) created an exception to the absolute priority rule that allows the individual to retain property of the estate despite the fact that the debtor's plan is not paying the unsecured creditors the full amount of their claims and the unsecured creditors have not voted to accept this treatment under the plan. A split has occurred among the courts, however, as to how broadly to interpret this exception. The narrow view limits the retained property to post-petition income generated by the debtor pursuant to Code § 1115. *See In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Calif. 2010) (Court held that § 1129(b)(2)(B)(ii) means that the debtor may retain only the property added to the estate by § 1115 and not all property under § 541). Accord. *In re Mullins*, 435 B.R. 352 (Bankr. W.D. Vir. 2010); *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010); *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga. 2010); *In re Walsh*, 2011 WL 867046 (Bankr. Mass. 2011); *In re Kamell*, 2011 WL 1760282 (Bankr. C.D. Cal. 2011).

However, the broader view allows the debtor to retain all property of the estate in the same manner allowed in Chapter 13 cases. *See In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010) (holding that Congress intended to make individual Chapter 11 cases more like Chapter 13 and since there is no "absolute priority rule" in Chapter 13 cases, the amendments were intended to have the same effect in Chapter 11).

Limiting the Retained Property

Limiting the retained property to post-petition income does not provide the debtor much relief from the absolute priority rule. Since this income would normally be used by the debtor to fund the Chapter 11

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plan in paying the projected disposable income to claimants, a typical Chapter 11 debtor would not be retaining a significant portion of this income anyway. Thus, this narrow interpretation of this exception to Code § 1129(b)(2)(B)(ii) effectively leaves the debtor in the same position that the debtor existed prior to BAPCPA.

Conclusion

Chapter 11 cases for individuals will continue to be a limited option until Congress: 1) amends 26 U.S.C. § 1398 eliminating double taxation for Chapter 11 individuals; 2) amends 11 U.S.C. § 330(a)(4)(B) to allow the payment of attorney services to individual Chapter 11 debtors under § 330; and 3) makes it clear that the exception to the absolute priority rule under Code § 1129(b)(2)(B)(ii) includes all property of the estate. It is a shame that the effectiveness of BAPCPA for the benefit of individuals in Chapter 11 cases has been hampered by these provisions. In many instances, Chapter 11 is the only option for an individual to reorganize, and although there is no legislative history making this clear, it seems that the only logical purpose of BAPCPA for individual Chapter 11s was to provide individuals an avenue for paying projected disposable income and reorganizing in the same manner that existed in Chapter 13. Until there are statutory corrections, however, the existence of the complications created by the Internal Revenue Code, the lack of authority for compensation for debtor's counsel, and the narrow interpretation of the exception to the absolute priority rule will continue to limit the reorganizing options for individuals.

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payments. *Id*. The bankruptcy court ruled that the lender had taken full control of the rents before the bankruptcy, even though the lender had not completed its foreclosure, thereby depriving the debtor-in-possession from any ability to use rent proceeds from its real property for a reorganization. The bankruptcy court set forth two rationales for this conclusion.

1. The Debtor Had Made an 'Absolute Assignment of Rents Prepetition'

While Judge Lane initially asserted that it was unnecessary to do so (further comment below), he ultimately determined in his opinion that the debtor had effected an "absolute assignment of rents prepetition" pursuant to its mortgage and so retained only "a revocable license in the rents at issue," pursuant to the Assignment of Leases and Rents. *Id*. at *9. The court also ruled that the lender had successfully revoked this license before the bankruptcy filing. *Id*. This revocation, coupled with the remaining debt owed under the mortgage and note, lead the bankruptcy court to conclude that "the rents are not property of the estate." *Id*.

Prior to the *Soho 25* decision, courts had generally concluded that an assignment of rents under New York law by a mortgagor cannot alone alienate the mortgagor's property interest in the rents. *Id*. at *6 (and citations therein); *see also, e.g., In re Pine Lake Village Apartment Co.*, 17 B.R. 829, 833 (Bankr. S.D.N.Y. 1982); *Sullivan v. Rosson*, 223 N.Y. 217, 119 N.E. 405 (1918). *Soho 25* is important in part because it rules to the contrary and concludes that a borrower's "absolute" assignment of rents in New York instead can transfer rents to a mortgagee, with effects even after a subsequent bankruptcy filing by the mortgagor. While *Soho 25* is not the very first case where a bankruptcy judge reaches this conclusion (*see, e.g., In re Loco Realty Corp.*, No. 09-11785, 2009 WL 2883050, *5 (Bankr. S.D.N.Y. June 2009) (a pre-bankruptcy receiver was also appointed in this case); *In re Brooklyn Props. Ltd. P'ship* No. 2, No. 193-15707-352, slip op. (Bankr. E.D.N.Y. Mar. 21, 1994) (unpublished order cited in Rubin, P., Absolute Assignments of Rents Survive Filings, *Am. Bankr. Inst. J.* 50, fn. 5 (Feb. 2011)), it stands at or near the forefront of this nascent doctrine.

Despite this importance, the decision also leaves some doubt concerning the pre-bankruptcy transfer of rents, because the court's conclusion that the debtor maintained only a revocable license is undermined by the court's earlier statement in the holding that it did not need to resolve the "threshold question" of "whether the Assignment is absolute and thus effective … " *Id*. at *5, 7. In short, the court's announcement that it would avoid this issue calls into question the determination of this very point that later appears in the decision, *Id*. at *8, 9, and may limit the use of *Soho 25* as precedent for the position in subsequent cases.

Judge Lane left open another issue regarding the ability of a borrower/owner to assign absolutely its interest in rents when it grants its lender a mortgage. In *Soho 25*, the court states that even "[a]n absolute assignment of rents prepetition does not necessarily mean that the estate has no interest in the rents for the purposes of section 541 analysis," but then does not elaborate what this lingering interest might be. *Id*. at *8. Lenders analyzing the decision can take comfort that this remaining interest certainly appears not to be the ability to use the rental income stream to reinstate the lender's debt pursuant to a Chapter 11 plan, since the debtor in *Soho 25* had declared early in the case that it intended to do just that, yet the court still concluded that the debtor-in-possession's bankruptcy estate excluded the rental income stream. Judge Lane's nod to some potential remaining interest under section 541 of the Bankruptcy Code, therefore, likely raises little practical challenge to the advantages of a secured lender in a SARE case as described in *Soho 25*, and the debtor-in-possession's

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corresponding disadvantage.

2. The Lender Took Sufficient Enforcement Steps to Enforce Its 'Right to the Rents'

In its other line of reasoning, the court concluded that the rents fell outside the bankruptcy estate thanks to the "numerous affirmative steps" that the lender had taken to enforce its right to the rents after the June, 2009 default notice. *Id*. at *7. Among these steps, the court listed the following as potentially significant:

- The commencement of a foreclosure action.
- The lender's request for a receiver of rents in the foreclosure complaint.
- Soho 25's failure to appear in the foreclosure action, and its admission that it had "no good faith defense" in the foreclosure.
- The state court's "order entering default."
- The letters to the tenants — from the lender alone and together with the borrower — instructing the tenants to pay rent to the lender.
- The state court's appointment of a referee.

Id.

The bankruptcy court highlighted that New York law permits the "right to rents and profits" to "vest" with the foreclosing lender, prior to a foreclosure sale, if the secured creditor takes sufficient "affirmative steps" to enforce its right. *Id*. at *7. In fact, numerous court decisions before *Soho 25* had marked this vesting not at the mortgage's delivery, but later when the lender takes possession of the property, or, more often, obtains an order for the sequestration of the rents or a receiver's appointment in a foreclosure action. *See, e.g., In re Pine Lake Village Apartment Co.*, 17 B.R. 829, 833 (Bankr. S.D.N.Y. 1982); *In re Northport Marina Assocs.*, 136 B.R. 911, 916 (Bankr. E.D.N.Y. 1992); *Sullivan v. Rosson*, 223 N.Y. 217, 224-25, 119 N.E. 405, 408 (1918). For some courts, simply a mortgagee's request for a receiver's appointment in a foreclosure, *see, e.g., In re Flowers City Nursing Home, Inc.*, 38 B.R. 642, 645 (Bankr. W. D. N.Y. 1984), or a formal demand for possession of the property, *see, e.g., 1180 Anderson Ave. Realty Corp. v. Mina Equities Corp.*, 95 A.D.2d 169, 173 (N.Y. App. Div. 1st Dept. 1983), suffices. *But see, inter alia, In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 106 (Bankr. S.D.N.Y. 1991) (pre-bankruptcy receiver required, as a custodian under section 543 of the Bankruptcy Code, to turn over collected rents to the debtor-in-possession, as estate property, though subject to the mortgagee's rights pursuant to section 363 of the Bankruptcy Code.)

Under this line of reasoning, *Soho 25* represents an important decision because it holds that a mortgagee's enforcement actions before and even after a bankruptcy case's filing can determine whether the debtor-in-possession will enjoy use of rental proceeds from real property subject to the mortgagee's lien. If *Soho 25* is followed, more aggressive lenders will deprive their borrowers of the ability to use this cash in a borrower bankruptcy. Despite this strong incentive for diligent enforcement efforts by mortgagees, the *Soho 25* decision does not indicate a specific, single step that caused the lender in that case to trump the rights of the bankruptcy estate in the rental cash flow. The court even mentioned the lender's post-petition actions in its analysis, but did not expressly state whether the lender's motion for stay relief in the bankruptcy case added weight to the court's conclusion that the debtor's state law property rights as of the bankruptcy filing excluded the rental income. *Id*. at *8.

The court's unwillingness to fix the precise point in the lender's pre-bankruptcy enforcement activity that excluded the rents from the debtor's estate makes the *Soho 25* decision challenging to use in formulating future strategies. The court's reference to post-petition actions by the lender brings further doubt to both lenders and borrowers seeking to predict what is enough in the mortgagee's state law enforcement efforts to exclude a debtor's commercial rental income from its bankruptcy estate. Certainly, a mortgagee reading the *Soho 25* decision would know that it should revoke any license that it issued in the rent assignment document upon a default (if the agreement requires an act by the lender to effect revocation.) The *Soho 25* decision and its predecessor, *Loco Realty* (cited above), also teach that an order appointing a receiver in the foreclosure will likely exclude the rents from a debtor's use in a subsequent bankruptcy, if *Soho 25* and *Loco Realty* are followed. However, in a situation where, as in *Soho 25*, the lender successfully collects rents directly from the tenants, would the mortgagee really want to request and achieve a receiver's appointment in a foreclosure? *Soho 25* and *Loco Realty* both indicate this step as an important sign of a sufficiently aggressive lender, but a receivership would introduce a new third party to take over the collection of rents (who would require remuneration for doing so,) even though the lender might already be directly receiving these payments.

CONCLUSION

Other than the blunt guidance of simply doing everything it can to enforce and seeking a receiver's appointment, a lender cannot distinguish in the *Soho 25* decision what exact act in foreclosure and enforcement would assure that its control over rents will "stick" after a borrower files Chapter 11. As for the court's comment applauding the lender's post-filing stay relief motion, a lender could ask how post-petition activity can make a difference to the estate property present upon a bankruptcy case's commencement. A lender could also wonder if a stipulation for adequate protection in the bankruptcy — often a more cost-effective, short-term step rather than a full-blown stay relief motion — might unfortunately seem to represent insufficiently rigorous lender enforcement.

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A distressed commercial real estate owner faces a similar dilemma in applying the lessons of *Soho 25*. In most cases, such a debtor simply seeks more time, but would certainly prefer not to lose the right to rental income in bankruptcy as a cost of delay. At the extreme, the *Soho 25* decision suggests that the debtor should have filed for bankruptcy before the lender sent the default notice, because only that way would the debtor have headed off the revocation of the debtor's "license" to use the rents. However, the importance that the *Soho 25* court attributed to subsequent enforcement actions leaves a debtor to wonder if it could wait until the initiation of a foreclosure action or even later. Certainly, it is a difficult calculus for a debtor, especially where, as here, the bankruptcy is a SARE, implicating the Bankruptcy Code's requirements that the debtor-in-possession pay interest to its mortgagee or file an appropriate Chapter 11 plan in relatively short order. The more that such a debtor accelerates its bankruptcy filing, the sooner it starts the time running in the fast-paced SARE case and risks a stay relief motion under section 362(d)(3) of the Bankruptcy Code.

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Cramdown Plan

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debt *(i.e.*, offset their proposed purchase price by the amount of their secured claim). *Id*. The Lenders objected to the bid procedures, asserting that the proposed plans did not satisfy Bankruptcy Code section 363(k)'s requirement that secured creditors be given credit-bidding rights. *Id*. The Debtors argued that their plans complied with the Bankruptcy Code because sale proceeds would be distributed pursuant to the Bankruptcy Code's priority rules and the Lenders thus would receive the "indubitable equivalent" of their claims in accordance with section 1129(b)(2)(A)(iii). *Id*. The bankruptcy court sided with the Lenders.

Applicable Code Provisions

The Bankruptcy Code generally requires that, to be confirmed, a plan must either: 1) not impair a creditor's claim; or 2) be acceptable to the creditor if its claim is impaired. If a plan does not meet either of these requirements, however, a bankruptcy court may still confirm it over the objections of a class of impaired creditors, if the plan is deemed to be "fair and equitable." *Id*. at *4-5. Plans confirmed over creditors' objections are colloquially referred to as "cramdown" plans because they are "crammed down the throats of objecting creditors." *Id*. at 11.

A cramdown plan is deemed "fair and equitable" as to a secured creditor if it, among other things, permits the creditor to credit bid the allowed amount of its secured claim at a sale free and clear of its liens (the "Sale Prong"), "or" gives the creditor the "indubitable equivalent" of the allowed amount of its secured claim (the "Indubitable Equivalent Prong"). 11 U.S.C. §§ 1129(b)(2)(A)(ii) and (iii). The Bankruptcy Code contains no specifics, however, as to what types of plans fall within the Indubitable Equivalent Prong or what constitutes the "indubitable equivalent" of a secured creditor's claim.

The statute's use of the word "or" between the two Prongs has been a source of confusion to courts evaluating cramdown plans. Specifically, courts have struggled to determine whether a plan is "fair and equitable" if it provides for the sale of a secured creditor's collateral free and clear of liens, with a distribution of sale proceeds to the creditor, but does not comply with the Sale Prong's requirement that the affected creditor be afforded credit bidding rights. In other words, is a plan "fair and equitable" if it bypasses the Sale Prong and provides for the sale of the debtor's assets free of liens under the Indubitable Equivalent Prong, thus denying a creditor its credit bidding rights under the Sale Prong? The Third and Fifth Circuits answered in the affirmative.

The Lenders in *River Road* (and the dissent in *Philadelphia Newspapers*) argued that the use of the word "or" in the statute created an ambiguity in the statute, requiring a review of the legislative history. The Lenders further argued that permitting a debtor to use the Indubitable Equivalent Prong to sell assets free and clear of liens under a "cramdown" plan would effectively swallow the Sale Prong entirely, which clearly was not Congress' intent in enacting the Bankruptcy Code.

The Seventh Circuit's Decision

Affirming the decision of the bankruptcy court, the Seventh Circuit held that the Sale Prong and the Indubitable Equivalent Prong are mutually exclusive. Thus, a debtor proposing to sell a secured lender's collateral must proceed under the Sale Prong and permit the secured lender to credit bid. *Id*. at *9. ("cramdown plans that contemplate selling encumbered assets free and clear of liens must satisfy requirements set forth in [the Sale Prong]"). The court also held that a creditor did not receive the indubitable equivalent of its claim when it received proceeds from an auction at which it was not permitted to credit bid. *Id*. at *6-7.

The Debtors contended that the plain language of the Bankruptcy Code enabled them to satisfy either the Sale Prong or the Indubitable Equivalent Prong. *Id*. at *6. According to the Debtors, the Indubitable Equivalent Prong is satisfied if a plan provides a secured creditor with the proceeds from the sale of an asset securing an obligation to that creditor, even at an auction that does not permit credit bidding. *Id*. In rejecting the Debtors' argument, the court held that the Debtors misread the Bankruptcy Code and that, in any event, plans such as the one proposed by the Debtor did not qualify for "fair and equitable" status. *Id*.

First, the court held that the Sale Prong would be "superfluous" were

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Lawrence V. Gelber is a partner and **James T. Bentley** and **Mike Paek** are associates in the Business Reorganization Group at Schulte Roth & Zabel LLP.

ON THE MOVE

Boyd & Jenerette has named **Ronald G. Neiwirth** partner at its recently opened Miami office. Neiwirth will chair the insolvency, reorganization and creditors' rights practice for the firm. His practice ranges from representation of debtors and creditors in Chapter 7 and Chapter 11 bankruptcy filings; Chapter 15 bankruptcy filings on behalf of foreign representatives; out-of-court workouts; assignments for the benefit of creditors under Florida state law; and a wide variety of transactional and litigation issues involving creditors' rights, asset protection and related matters.

Stradley Ronon has named **Michael Migliaccio** as of counsel to its 25-attorney finance & restructuring practice group. He will be based in the firm's Philadelphia office and will advise the firm's banking and other financial institution clients in all aspects of commercial restructuring and finance, including loan documentation, loan modifications, restructures, workouts, loan sales and related matters.

Polsinelli Shughart PC has appointed **Christopher A. Ward** as vice chair of its Bankruptcy and Financial Restructuring practice group. Ward is also the managing shareholder of the Wilmington, DE, office. He represents clients in various bankruptcy matters before courts in Delaware and nationally.

DailyDAC, LLC of Chicago has announced the launch of its flagship product, *DailyDAC*, a twice-weekly e-newsletter aimed at active investors focused on acquiring companies, or assets of companies in transition. The "DAC" in the title stands for "deal acquisition central."

Thorp Reed & Armstrong has opened a Wilmington, DE, office. The Pittsburgh,PA-based firm has also added bankruptcy attorney **Karen M. Grivner** from **Cole Schotz Meisel Forman & Leonard**, where she was an associate. She joins Thorp Reed as senior counsel in its bankruptcy and financial restructuring practice. Grivner will open the new Delaware office and work with Thorp Reed Philadelphia partner **Jeffrey Carbino**.

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Cramdown Plan

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the Debtor's interpretation correct. A plan could always qualify for treatment under the Indubitable Equivalent Prong even if it sought to dispose of encumbered assets in the manner discussed in the Sale Prong, but failed to meet the Sale Prong's requirements. *Id*. at *7-8 ("We cannot conceive of a reason why Congress would state that a plan must meet certain requirements if it provides for a sale of assets in particular ways and then immediately abandon these requirements in a subsequent subsection."). The court thus held that the Bankruptcy Code's use of the word "or" between the Sale Prong and the Indubitable Equivalent Prong was not dispositive of whether they were exclusive of one another. *Id*. at *9, n.5.

Second, the court held that a creditor could not receive the indubitable equivalent of its claim if it was not permitted to credit bid at an auction. *Id*. at *6-7. The court found that what constitutes the indubitable equivalent of a secured creditor's claim depends on whether the creditor is over- or undersecured. If a creditor is oversecured, then the indubitable equivalent of its claim is its face value, whereas if the creditor is undersecured, then the indubitable equivalent is the asset's current value. *Id*. at *6. Determining the value of an undersecured creditor's claim, however, is problematic because it is usually difficult to discern the current market value of the types of assets sold in corporate bankruptcies. *Id*. at *7. Thus, the Bankruptcy Code provides secured creditors the right to credit bid as a means to protect themselves from the risk that the winning auction bid will not capture the asset's actual value. *Id*. ("In essence, by granting secured creditors the right to credit bid, the Code promises lenders that their liens will not be extinguished for less than face value without their consent."). Thus, the court concluded that the text of the Indubitable Equivalent Prong "does not establish that it can be used to confirm plans that propose auctioning off a debtor's encumbered assets free and clear without allowing credit bidding." *Id*.

COMMENT

The *River Road* decision creates a clear spilt among the Circuits, and the Debtors are now seeking an appeal to the Supreme Court. Should the Supreme Court grant certiorari, the stage would be set for a final determination on whether secured lenders must be permitted to credit bid in sales under cramdown plans. Secured lenders should be aware of the current Circuit split when engaged in pre-bankruptcy discussions with borrowers contemplating a Chapter 11 filing. In addition to the usual decisions regarding the provision of debtor-in-possession financing or consent to the use of its cash collateral, when analyzing potential exit strategies lenders must also consider the proposed venue of the filing. The venue of the case could be key to the ultimate outcome (*e.g.*, the Third and Fifth Circuits permit asset sales under a cramdown plan without credit-bidding, but the Seventh does not). Finally, because some lenders may be willing to finance the debtor or allow use of their cash collateral only to permit a prompt sale under section 363 of the Bankruptcy Code, a specific preservation of the right to credit bid in the financing order is essential.

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