LOS ANGELES & SAN FRANCISCO

Daily Journal

www.dailyjournal.com

MONDAY, JULY 10, 2017

PERSPECTIVE

9th Circuit decision addresses cramdown valuation

By David Kupetz

In Chapter 11 and Chapter 13 bankruptcy cases, a reorganization plan may be imposed by court order on an objecting secured creditor. This is commonly known as "cramdown" since the plan is approved by the court over the creditor's objection. In a marked departure from state law, the federal Bankruptcy Code allows a debtor through a confirmed plan to retain and use a secured creditor's collateral. "The Code's cram down option displaces a secured creditor's state-law right to obtain immediate foreclosure upon a debtor's default. That change, ordered by federal law, is attended by a direction that courts look to the 'proposed disposition or use' of the collateral in determining its value." *Assoc. Commer. Corp. v. Rash*, 520 U.S. 953, 964 (1997). A creditor's claim is deemed secured to the extent of the value of its collateral. In a cramdown where the debtor will retain and use the collateral, the secured creditor generally must retain its lien and receive payments over time equaling the present value of the secured claim.

In *Sunnyslope Housing Limited Partnership*, 2017 DJDAR 6073 (June 26, 2017), the 9th U.S. Circuit Court of Appeals sitting en banc recently addressed a cramdown plan where the central issue was the valuation of the secured creditor's collateral, an apartment complex. Sunnyslope Housing Limited Partnership owns an apartment complex in Phoenix, Arizona. It obtained construction funding through three loans. The senior lender was Capstone Realty Advisors, LLC. Capstone loaned $8.3 million, at an interest rate of 5.3 percent, secured by a first priority deed of trust on the property. The U.S. Department of Housing and Urban Development (HUD) guaranteed the Capstone loan and funded it through bonds issued by the Phoenix Industrial Development Authority. The balance of the funding was provided by the city of Phoenix and the state of Arizona. The city loan was secured by a second priority deed of trust, and the state loan by a third priority deed of trust.

The public funding of the loans came with strings attached. To obtain the loans and tax benefits, Sunnyslope entered into multiple agreements requiring that a portion of the apartment project be used for low-income housing. These covenants ran with the land, but would be terminated in the event of foreclosure of a lien on the property. Subsequently, Sunnyslope defaulted under the Capstone loan. HUD then took over the loan and sold it to First Southern National Bank for $5.05 million. The sale agreement confirmed that the property remained subject to the covenants. First Southern began foreclosure proceedings. Next, Sunnyslope commenced a Chapter 11 bankruptcy case automatically staying the foreclosure.

Sunnyslope proposed a plan of reorganization under which it would retain the apartment complex. The plan provided for full payment of First Southern's claim over 40 years, with interest at the rate of 4.4 percent, and a balloon payment at the end of the term. First Southern opposed the plan. The bankruptcy court considered competing testimony of valuation experts. First Southern's expert valued the property at $7.7 million based on the "extraordinary assumption" that a foreclosure would remove the low-income housing restrictions. The expert, however, reduced the value to $4.9 million if the covenants remained in place. Sunnyslope's expert concluded that the value of the complex was $2.6 million subject to the low-income housing covenants and $7 million without the restrictions. Applying Section 506(a)(1) of the Bankruptcy Code, providing that value be determined in light of the proposed disposition or use of the property, the bankruptcy court adopted the conclusion of Sunnyslope's expert that the value was $2.6 million since the plan called for the complex to continue under the low-income housing requirements.

The bankruptcy court concluded that the plan met the cramdown requirements by providing First Southern retained its lien, would be paid interest at the prevailing market rate, and could foreclose (eliminating the low-income housing requirements) if Sunnyslope defaulted. On appeal, the district court affirmed the bankruptcy court's valuation ruling. Upon further appeal, the 9th Circuit, in a divided three-judge panel, reversed the bankruptcy court's order confirming the plan, holding that the bankruptcy court should not have considered the low-income housing restrictions in its determination of value. *In re Sunnyslope Hous. Ltd. P'Ship*, 818 F.3d 937, 940 (9th Cir. 2016). Subsequently, a majority of the active judges of the 9th Circuit voted to grant Sunnyslope's petition for rehearing en banc, and the panel opinion was vacated. *In re Sunnyslope Hous. Ltd. P'ship*, 838 F.3d 975 (9th Cir. 2016).

The en banc panel explained that, under Section 506(a)(1), a creditor's claim is secured to the extent of the value of its collateral and the collateral is to be valued "in light of the purpose of the valuation and of the proposed disposition or use of such property." The 9th Circuit stressed that the actual plan must be the focus, and that the U.S. Supreme Court in *Rash* "emphasized that, in a reorganization involving a cram down, the debtor will continue to use the collateral and the valuation must therefore occur 'in light of the proposed payment plan reality: no foreclosure sale.'" The valuation must reflect the property's actual use under the plan and not a hypothetical foreclosure. The 9th Circuit stated that "[t]he essential inquiry under *Rash* is to determine the price that a debtor in Sunnyslope's position would pay for an asset like the collateral for the particular use proposed in the plan of reorganization." In light of the language of Section 506(a)(1) and the *Rash* decision, the 9th Circuit rejected First Southern's argument that the property should be valued at its highest and best use — without the low-income housing restrictions.

In contrast, a dissenting opinion authored by Judge Alex Kozinski and joined by two other judges chastised the 9th Circuit majority for purportedly taking an approach that "festishizes a selection of the [Supreme] Court's words at the expense of the logic." The dissent asserts that the Supreme Court was focused in *Rash* on the double risks posed by cramdowns: that the debtor may default again and that the property may deteriorate from continued use. The majority emphasized the Supreme Court's direction that actual use and not foreclosure is the proper valuation standard and that the low-income housing restrictions could only be eliminated through foreclosure. Further, the majority pointed out the First Southern bought the loan at a substantial discount, with the knowledge that the risk that the property might remain subject to the loan-income housing restrictions, and that, accordingly, valuation of the property with those restrictions in mind did not subject First Southern to any greater risk than it consciously undertook.

The 9th Circuit pointed out that the *Rash* decision noted that "replacement" and "fair-market" value are consistent terms. *Sunnyslope* is an atypical case where foreclosure value is greater than replacement value. Regardless, the 9th Circuit summed ups it conclusion by stating that "we take the Supreme Court at its word and hold, as *Rash* teaches, that Section 506(a)(1) requires the use of replacement value rather than a hypothetical value derived from the very foreclosure that the reorganization is designed to avoid."

The 9th Circuit pointed out that the Rash decision noted that 'replacement' and 'fair-market' value are consistent terms. *Sunnyslope* is an atypical case where foreclosure value is greater than replacement value.

David Kupetz *is a shareholder in SulmeyerKupetz PC. He is an expert in bankruptcy, business reorganization, restructuring, assignments for the benefit of creditors, and other insolvency solutions. You can reach him at dkupetz@sulmeyerlaw.com.*

KUPETZ

Reprinted with permission from the ***Daily Journal***. ©2017 Daily Journal Corporation. All rights reserved. Reprinted by ReprintPros 949-702-5390.