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The 7th Circuit Considers the Indubitable Equivalent Standard – Again!

On June 28, 2011, the Seventh Circuit Court of Appeals decided *In re River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F. 3d 642 (7th Cir. 2011). The Court addressed Section 1129 (b)(2)(A) of the United States Bankruptcy Code in connection with a Plan of Reorganization to sell substantially all of the Debtor's assets. The Court held that the indubitable equivalent prong, (i.e., the "cram down" provisions of section 1129(b)(2)(A)(iii)) could not be used to preclude a secured creditor from credit bidding its claim under sections 363(k) and 1129(b)(2)(A)(ii) of the Code. The Seventh Circuit decision was in direct conflict with decisions by the Third Circuit in *In re Philadelphia Newspapers, LLC* , 599 F.3d 298(3d Cir. 2010), and the Fifth Circuit in *In re Pacific Lumber Co*., 584 F. 229 (5th Cir. 2009). In December of 2011 the United States Supreme Court granted a petition for certiorari to reconcile the split among the Circuits. See *RadLAX Hotel Partners, LLC v Amalgamated Bank*, No. 11-166, 2011 WL 3499633 (Dec. 12, 2011).

Six months later, in *In re River East Plaza, LLC v. Geneva Leasing Assocs., Inc*., No. 11-3233, 2012 WL 169760 (7th Cir. Jan. 19, 2012), the Seventh Circuit again addressed the indubitable equivalent standard, this time in the context of an attempted cram down of a claim of a secured creditor (LNV) in a single asset real estate case. In *River East*, LNV was owed $38.3 Million for a loan relating to a commercial building in downtown Chicago, IL. The building was worth approximately $13.5 Million, leaving LNV significantly undersecured. The debtor defaulted and LNV started a foreclosure action. In response, the debtor filed a Chapter 11 petition.

Under the Bankruptcy Code, an undersecured creditor has two claims, a secured claim up to the value of the collateral, in this case $13.5 Million, and an unsecured claim under for the deficiency portion, and is entitled to distributions as both a secured and an unsecured creditor. However, in connection with a plan of reorganization, the undersecured creditor is entitled to make an election under section 1111(b) to give up its unsecured claim and have its entire claim be treated as a secured claim. LNV made the election and voted against the plan.

In order for the plan to be confirmed, the plan proponent must meet the cram down provisions of section 1129(b)(2)(A). Under subsection (i) of that section, the creditor is entitled to retain its lien on the property and receive deferred cash payments equal to the total amount of its claim (in this case, $38.3 Million) with a

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value equal to the claimholder's interest in collateral ($13.5 Million). Under subsection (iii) of that section, the plan could also be confirmed if the creditor received the indubitable equivalent of its claim.

After LNV's election, the debtor filed a Second Amended Plan and provided that LNV's lien would be transferred from the real property to a United States Treasury Bond which would provide for the payment of $38.3 Million with the stream of payments having a present value of $18.5 Million. The debtor argued that this met the cram down test and that proposed treatment met the indubitable equivalent prong of section 1129(b)(2)(A), as the Treasury Bond provided to LNV was risk free.

LNV argued that the plan was not confirmable and moved to lift the stay. The bankruptcy court agreed, holding that substituting collateral was inappropriate in the face of an 1111(b) election. The debtor filed a Third Amended Plan in which LNV was provided with a lien on the Treasury Bond and retained its lien on the original collateral until the claim was fully paid. However, the bankruptcy court refused to consider the Third Amended Plan because it was filed well after the 90 days within which a plan which has a reasonable possibility of being confirmed within a reasonable time must be filed in a single asset real estate case. The Seventh Circuit accepted a direct appeal.

Judge Posner writing for the Seventh Circuit explained that a creditor is likely to make an 1111(b) election when the collateral is undervalued and likely to appreciate. If the election was not made, LNV would be entitled to $13.5 Million for its secured claim and share in whatever dividend is paid to unsecured creditors, which is likely to be little or nothing. However, by making the election, if the property appreciates in value and LNV subsequently forecloses, or if the property is sold, the benefit of the appreciation accrues to LNV up to its claim of $38.3 Million. The same result would have occurred if LNV had proceeded to foreclose its mortgage and taken title to the property in the foreclosure action. By substituting a Treasury Bond as collateral, the Court observed the debtor was trying to retain the benefit of the potentially increasing value of the property in a rising market. The debtor argued that LNV's election was done to thwart the reorganization proceeding, implying that this was somehow improper. The Court found nothing wrong with LNV's election, as LNV was merely using Code provisions to protect its interest and maximize its recovery. That is likely why LNV filed the foreclosure action in the first place, expecting to be the highest bidder at the foreclosure sale and gain the upside benefit when the property appreciated.

The Court then addressed the indubitable equivalent argument in the context of the attempted substitution of collateral. The Court noted that the bankruptcy court flatly banned any substitution of collateral when a creditor makes an 1111(b) election. However, the Court said that substituting collateral would be appropriate in a cram down context if the creditor was oversecured and the substituted property had sufficient value so as to not put the creditor at risk of becoming under secured in future. The Court went on to say substitution of collateral may also be appropriate when the creditor is undersecured provided that the substituted collateral was more valuable and no more volatile than the creditor's current collateral. However, the Court indicated that no rational debtor would make such a substitution because it would be making a gift to the creditor.

The Court then turned to the Treasury Bonds as the proposed substituted collateral. The Court said that while the risk of default was non- existent, if interest rates rose, the market for bonds with a lower rate would evaporate and a creditor who tried to foreclose after default would likely have to wait for the full term of the bonds to collect the amount owed. In contrast, with a retained lien on the property, upon default foreclosure could occur immediately. The Court did note that under section 1129 (b)(2)(A)(i), if the stream of payments were over 30 years and there was no default, the creditor would have to accept payment over time. However, the Court also noted that between a quarter and third of all debtors who emerge from Chapter 11 with a confirmed plan subsequently default. Finally, the Court observed that the substituted collateral may turn out to be actually more valuable than the original collateral and thereby provide LNV with even more security. However, because of the difference in risk profiles, the two forms of collateral are not equivalent, and there is no reason why the choice of which collateral is appropriate should be made for the creditor by the debtor.

The Court's decision appears to be correct. The purpose of section 1111(b) is allow a creditor who is precluded from exercising its legal rights because of a bankruptcy to assess the strategic risks and opportunities of retaining both an unsecured claim and a secured claim, or swapping the two claims for a single secured claim in the amount of the debt. In a rising market with undervalued collateral, it would seem the swap may be the best alternative. In any event, when it comes to substituting collateral once the choice is made, the creditor is entitled to its original collateral and not replacement collateral with a different risk profile selected by the debtor. This Reinhart E-Alert first appeared on Corporate LiveWire.