30-Year Treasury Bonds Not "Indubitable Equivalent" of Electing Secured Creditor's Mortgage Lien

May/June 2012

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In *In re River East Plaza, LLC*, 669 F.3d 826 (7th Cir. 2012), the Seventh Circuit Court of Appeals affirmed a bankruptcy court's ruling that a debtor could not "cram down" a chapter 11 plan over the objection of an undersecured creditor which had made a section 1111(b) election by substituting a lien on 30-year U.S. Treasury bonds as the "indubitable equivalent" of the creditor's mortgage lien on the property. The ruling, which explores the interaction between sections 1129(b)(2)(A)(i) and 1129(b)(2)(A)(iii), was an interesting prelude (and a corollary) to the highly anticipated ruling handed down on May 29, 2012, by the U.S. Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, ___ S. Ct. ___, 2012 WL 1912197 (May 29, 2012). In that case (which is discussed elsewhere in this issue of the *Business Restructuring Review*), the court resolved a split among the circuit courts of appeal concerning the ability of a debtor to confirm a chapter 11 plan that deprives a secured creditor of its right to credit-bid its claims in connection with a sale of its collateral under the plan.

The Bankruptcy Code's Cramdown Requirements

Section 1129(b) of the Bankruptcy Code sets forth the requirements that must be met before a bankruptcy court can confirm a chapter 11 plan over the objections of a dissenting class of creditors whose rights are impaired by the plan. Among these "cramdown" requirements is the dictate in section 1129(b)(1) that a plan "not discriminate unfairly" and that it be "fair and equitable" with respect to a dissenting class of creditors.

Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of *secured* claims: (i) the secured claimants' retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims.

Section 363(k) of the Bankruptcy Code establishes the right of secured creditors to "credit-bid" by providing that when a debtor sells any property secured by a valid lien, unless the court orders otherwise "for cause" and, if the holder of the secured claim purchases the property, "such holder may offset such claim against the purchase price of the property."

The Section 1111(b) Election

Section 1111(b)(1) of the Bankruptcy Code provides that a nonrecourse secured claim shall be treated as a recourse claim (meaning that such a claim will be bifurcated into a secured claim to the extent of the value of the collateral and an unsecured claim for the deficiency), *unless* the class of secured creditors, including the claim, elects under section 1111(b) to have the entire claim treated as secured. However, the election is not available if the collateral is sold under section 363 of the Bankruptcy Code or under a chapter 11 plan. In the event of an election under section 1111(b), a claim in an electing class would be fully secured, but the present value of distributions under a chapter 11 plan provided to the holder of the claim need be no greater than

the value of the collateral (e.g., a secured note bearing a rate of interest below the prevailing market rate).

Section 1111(b) is intended to protect a secured creditor against the possibility that the debtor can realize a windfall if collateral is assigned a low value (due to depressed market conditions or valuation error) and the creditor's secured claim is stripped down to the depressed value of its security interest. The exception for collateral that is sold is premised upon the idea that protection against low valuation is not necessary when the market determines the value of the collateral.

River East Plaza

"Indubitable equivalent" is not defined by the Bankruptcy Code, and the meaning of the term as it is used in section 1129(b)(2)(A)(iii) has been left to the courts to determine. In *River East Plaza*, the Seventh Circuit weighed in on this issue in connection with a chapter 11 plan proposing to substitute another form of collateral for the real-property collateral of a creditor that had made a section 1111(b) election.

River East Plaza, LLC ("River East"), owned a building in Chicago valued at $13.5 million. The property acted as security for a loan from LNV Corporation ("LNV") in the amount of $38.3 million. River East defaulted on the loan early in 2009. LNV commenced foreclosure proceedings, but River East filed for chapter 11 protection as a single-asset real-estate debtor in Illinois hours before the foreclosure sale was to occur.

The bankruptcy court denied confirmation of River East's initial chapter 11 plan after LNV elected to have its claims treated as fully secured under section 1111(b). In its second proposed chapter 11 plan, River East sought to satisfy the "fair and equitable" requirement for "cramdown" confirmation by substituting 30-year U.S. Treasury bonds with a face value of $13.5 million for LNV's existing collateral. According to River East, because (at the then prevailing rate of interest) the value of the bonds would grow in 30 years to equal $38.3 million—the full face value of LNV's claim—the bonds represented the "indubitable equivalent" of LNV's secured claim within the meaning of section 1129(b)(2)(A)(iii).

The bankruptcy court disagreed, stating "flatly" that an electing secured creditor cannot be forced to accept substitute collateral. It accordingly denied confirmation of River East's second plan. The court later refused to consider a third plan proposed by River East that would have allowed LNV to retain its lien on the building, ruling that the automatic stay should be vacated pursuant to section 362(d)(3)(A) (imposing a 90-day drop-dead date, albeit subject to extension, for the stay in single-asset real-estate cases) to allow foreclosure to proceed and dismissing the bankruptcy case. The bankruptcy court certified a direct appeal of its rulings to the Seventh Circuit, which stayed the sale pending resolution of the appeal.

The Seventh Circuit's Ruling

A three-judge panel of the Seventh Circuit affirmed. "Substituted collateral that is more valuable and no more volatile than a creditor's current collateral," the court wrote, "would be the indubitable equivalent of that current collateral even in the case of an undersecured debt." However, the court noted, such was not the case here, and moreover, "no rational debtor would propose such a substitution, because it would be making a gift to the secured creditor."

According to the Seventh Circuit, the 30-year U.S. Treasury bonds were not the indubitable equivalent of the building within the meaning of section 1129(b)(2)(A)(iii) because: (i) the bonds carried a different "risk profile"; and (ii) they impermissibly stretched out the time period over which LNV would be paid. The risk profile of the bonds was different, the court explained, because although Treasury bonds carry little default risk, long-term Treasury bonds carry "substantial inflation risk, which might or might not be fully impounded in the current interest rates on the bonds." In addition, the Seventh Circuit emphasized, River East might default under the plan in a relatively short time period, allowing LNV potentially to realize increased value by foreclosing upon and selling the building. However, the court explained, the value of the Treasury bonds could not be realized for quite some time, regardless of how soon River East defaulted, and would likely be lower at that time due to inflation and/or rising interest rates.

According to the Seventh Circuit, the substitution of the bond collateral was impermissible, but not only because it demonstrated that the bonds were something other than the indubitable equivalent of the building: such an approach would also improperly conflate cramdown under section 1129(b)(2)(A)(iii) with cramdown under section 1129(b)(2)(A)(i). Under the latter, the court explained, cramdown confirmation is possible if a secured creditor retains its lien on collateral, but the maturity of the debt is extended. River East could not both extend the maturity date (by substituting 30-year bonds) under subsection (i) and substitute collateral as an "indubitable equivalent" under subsection (iii). "By proposing to substitute collateral with a different risk profile, in addition to stretching out loan payments," the Seventh Circuit wrote,

"River East was in effect proposing a defective subsection (i) cramdown by way of subsection (iii)."

Outlook

River East is notable for several reasons. For example, the Seventh Circuit was clearly skeptical of what it perceived as machinations by the debtor to thwart an undersecured creditor's right to make a section 1111(b) election as a hedge against flawed valuation.

The ruling also acknowledged the circuit split (now resolved by the U.S. Supreme Court in *RadLAX*) over how the subsections of section 1129(b)(2)(A) can be utilized to confirm a chapter 11 plan over the objection of a secured creditor. The Third and Fifth Circuits had ruled that a plan contemplating the sale of collateral without honoring a secured creditor's right to credit-bid under section 363(k) can provide the creditor with the indubitable equivalent of its claim and therefore be confirmable as "fair and equitable" under section 1129(b)(2)(A)(iii) (as opposed to section 1129(b)(2)(A)(ii), which, as noted, expressly preserves a secured creditor's credit-bidding rights). *See In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3rd Cir. 2010); *In re Pacific Lumber Co.*, 584 F.3d 229, 246–47 (5th Cir. 2009). The Seventh Circuit rejected that approach in *River Road*, ruling that a debtor cannot skirt the dictates of section 1129(b)(2)(A)(ii) by attempting to provide the indubitable equivalent of a secured claim under 1129(b)(2)(A)(iii). In *RadLAX*, the U.S. Supreme Court unequivocally endorsed the *River Road* approach to this important issue.