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NINTH CIRCUIT HOLDS THAT HIGHEST AND BEST USE VALUATION IS NOT REQUIRED FOR CRAMDOWN PURPOSES

The United States Court of Appeals for the Ninth Circuit, sitting *en banc*, has held that a lender's collateral need not be valued at its highest and best use when determining whether a Chapter 11 debtor's plan of reorganization should be crammed down over the lender's objection.[1]

In re Sunnyslope Housing Limited Partnership, LLP ("*Sunnyslope*") was a Chapter 11 single asset real estate case involving an apartment complex in Phoenix, Arizona (the "Property"). The Property was subject to various restrictive covenants that required it be used for low-income housing. However, these restrictions were drafted to automatically terminate in the event of foreclosure.

Following a default on one of its secured loans and the commencement of foreclosure proceedings, the Debtor filed a voluntary Chapter 11 bankruptcy case with the United States Bankruptcy Court for the District of Arizona. The Debtor filed a Chapter 11 plan of reorganization, which provided that the secured claim of First Southern National Bank ("First Southern") would be paid over 40 years at an interest rate of 4.4%, with a balloon payment at the end.[2]

The cramdown provisions of the Bankruptcy Code require that a plan of reorganization that seeks to pay a secured lender over time must provide that the aggregate of all payments on the lender's secured claim be at least equal to the present value of the lender's interest in its collateral. It was not disputed by the parties that (i) the Property's value was greater without the low-income housing restrictions, and (ii) the low-income housing restrictions would terminate upon foreclosure.

The issue in *Sunnyslope* was whether the determination of the present value of the lender's interest in the Property should be based upon the value of the property as currently used with the low-income housing restrictions in place, which the Debtor referred to as replacement value, or the value of the Property unburdened by such restrictions, which would only occur upon foreclosure. In most scenarios, the replacement value would be greater than the foreclosure value. The facts of this case, however, are unusual in that the required aggregate payments to First Southern under the Chapter 11 plan would be greater if the Court accepted a foreclosure valuation that did not take into account the low-income housing restrictions.

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[1] *In re Sunnyslope Housing Limited Partnership*, 2017 WL 2294746 (9th Cir. June 26, 2017) (*en banc*). The United States Court of Appeals for the Ninth Circuit has jurisdiction over the district courts in the states of California, Nevada, Washington, Arizona, Oregon, Idaho, Montana, and Alaska. "Cramdown" is bankruptcy terminology for confirmation of a plan of reorganization over the objection of a class of claims that has voted to reject the plan. In a real estate bankruptcy case, the dissenting class of claims is typically a class consisting of the claim or claims of a secured lender.

[2] This rate was lower than the contract rate of interest under the loan.

First Southern objected to the Debtor's plan on numerous grounds, including that valuation of the Property for cramdown purposes should be based upon the Property's highest and best use, and therefore should not include the low-income housing restrictions.

The Ninth Circuit, sitting *en banc*, rejected First Southern's argument and affirmed confirmation of the Debtor's plan. According to the Ninth Circuit, Bankruptcy Code § 506(a) requires that property be valued "based upon its 'proposed disposition or use' in the plan of reorganization." The Court concluded that because the Debtor's plan contemplated that the Property would continue to be used for low-income housing, the Property's valuation should include the low-income housing restrictions.

The Ninth Circuit relied upon the Supreme Court's 1997 decision in *Associates Commercial Corp. v. Rash*,[3] which was not a real estate case, and which held that a "replacement-value standard," rather than a "foreclosure-value standard," should be applied to cramdown valuations.[4] Because foreclosure was the only mechanism through which the Property could be freed of the low-income housing restrictions, the Ninth Circuit concluded that any valuation that failed to take into account the low-income restrictions would necessarily be based upon a "foreclosure-value standard" and would violate the Supreme Court's *Rash* decision, even if such valuation was based upon the Property's highest and best use.[5] Thus, the Ninth Circuit concluded that the bankruptcy court was required "to determine the price that a debtor in Sunnyslope's position would pay to obtain an asset like the collateral for the particular use proposed in the plan of reorganization."

The *Sunnyslope* decision poses two potential risks to secured lenders. The first is whether valuation based upon the debtor's existing use, as opposed to a highest and best use, will apply in cases where there is no restrictive covenant requiring the existing use. This issue is not definitively answered in *Sunnylope*, but the breadth of the Ninth Circuit's opinion and interpretation of § 506(a) of the Bankruptcy Code suggests this expansive scope.[6]

The second risk is an underwriting risk that affects secured lenders whose collateral is subject to similar use restrictions that are drafted to restrict the borrower's use of the secured property, but not the use of a lender or purchaser at foreclosure. In the event of default and bankruptcy, distributions to such lenders may be based upon a valuation that may be less than the Property's highest and best use if the property is valued by the court with such restrictions in place, based upon the debtor's "proposed

[3] 520 U.S. 953 (1997).

[4] Also, *Rash* was a Chapter 13 (adjustment of debts of an individual with regular name), not a Chapter 11 (reorganization) case.

[5] Three justices dissented from the Court's opinion, rejecting the majority's view that *Rash* required a rigid application of a replacement value vs. foreclosure value dichotomy, especially in those cases where foreclosure value exceeded replacement value. In fact, to the dissenters, the term "replacement value" as used by the Supreme Court was not "self-interpreting" and did not compel the conclusions reached in the majority's opinion.

[6] The dissenting opinion posits that such a broad-reaching interpretation emanates from the Court's ruling. In the words of the dissenters: "Even though the Court has told us that cramdown valuations are supposed to limit a secured creditor's risk, we've adopted a new valuation standard that turns entirely on the debtor's desires – creditors be damned."

disposition or use" under Bankruptcy Code § 506(a). While the Ninth Circuit rejected the policy argument that its decision would adversely affect lending on properties containing use restrictions, the dissenting justices in *Sunnyslope* disagreed, stating that "in the end much of this risk will be passed on to borrowers in the form of higher interest rates – in which case, the joke's on future Sunnyslopes."

If you have additional questions, please do not hesitate to contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below.

CONTACTS:

Bruce J. Zabarauskas
310.203.6902
Bruce.Zabarauskas@tklaw.com

Paul E. Comeaux
214.969.2506
Paul.Comeaux@tklaw.com