BANKRUPTCY ISSUES INVOLVING REAL PROPERTY AND TRUSTS

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A. THE AUTOMATIC STAY

1. <u>What is Stayed</u>

The filing of a bankruptcy petition invokes a statutory injunction effective immediately as to any action by a creditor in the continuation of a lawsuit or the enforcement of rights in collateral. 11 U.S.C. § 362(a).

Specifically, Section 362(a) operates as a stay of the following:

(a) the commencement or continuation of a judicial, administrative, or other similar proceeding against the debtor based on a pre-petition claim;

(b) the enforcement of a judgment obtained before the commencement of the case against the debtor or property of the estate;

(c) any act to obtain possession of property from the estate or exercise control over property of the estate;

(d) any act to create, perfect or enforce a lien against property of the estate;

(e) any act to create, perfect of enforce a lien against property of the debtor to the extent that such lien secures a pre-petition claim;

(f) any act to collect, assess or recovery a pre-petition claim against the debtor;

(g) setoff of any pre-petition debt owing to the debtor; and

(h) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

The provisions of § 362(a) are for the most part self-explanatory. The case law has focused on the following issues:

(i) The automatic stay operates as a stay of all litigation against the debtor including employment of process, discovery and the filing of counterclaims. See, e.g., In re Towner Petroleum Co., 48 B.R. 182 (Bankr. W.D. Okla. 1985); Lessig Construction, Inc. v. Schnabel Associates, Inc. (In re Lessig Construction), 67 B.R. 436 (Bankr. E.D. Pa. 1986).

(ii) The automatic stay operates as a stay of administrative proceedings such as license revocation proceedings. See H.R. Rep. No. 989, 95th Cong. 1st Sess. 340 (1977).

(iii) The automatic stay prohibits termination of contracts, including contracts of insurance. See, e.g., In re Computer Communications, Inc., 824 F.2d 725 (6th Cir. 1987).

(iv) The automatic stay operates as a stay of any efforts to collect a pre-petition claim including repossession, foreclosure, notification of account debtors, demand letters and telephone calls. See, e.g., Riggs National Bank v. Perry (In re Petty), 729 F.2d 982 (4th Cir. 1984). The automatic stay operates as a stay of any setoff by a bank creditor against the debtor's account. See Ren Hyman v. Fulton National Bank, 423 F. Supp. 1006 (N.D. Ga. 1976); cf. Big

Ben Super Market No. 3 v. Princess Baking Corp. (In re Princess Baking Corp.), 5 B.R. 587 (Bankr. S.D. Cal. 1980).

(v) The automatic stay does not bar pursuit of post-petition claims against the debtor and the debtor's property. See generally Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.), 744 F.2d 332 (3rd Cir. 1984), cert. denied, 469 U.S. 1160 (1985). Whether a claim arises pre-petition or post petition is a question of federal bankruptcy law and does not depend upon when the claim arises for purposes of state law. See, e.g., Grady v. A.H. Robins Co. (In re A.H. Robins Co.), 839 F.2d 198 (4th Cir. 1988). The general rule is that the claim arises upon the occurrence of the acts that give rise to the alleged liability. Id.; see also Roach v. Edge (In re Edge), 60 B.R. 690 (Bankr. M.D. Tenn. 1986).

(vi) Several courts have dealt with the issue of whether the real property remains in the debtor's estate even after the foreclosure sale if the foreclosure is not consummated prior to the filing of the bankruptcy case. In In re Stork, 212 B.R. 970 (Bankr. N.D. Cal. 1997), the purchaser recorded its deed beyond the 15 day grace period permitted by California law, and therefore was not entitled to a relation back to the date of the foreclosure. As a result, the recording of the deed violated the automatic stay, but the court nevertheless held that § 549(c) protected the purchaser against avoidance of the post-petition transfer since the purchaser recorded

his deed before the bankruptcy petition was recorded in the real property records. In such instances, the court held that the automatic stay should be annulled to validate the post-petition transfer. In In re Johnson, 213 B.R. 134 (Bankr. W.D. Tenn. 1997), a foreclosure sale of the debtor's real property was not deemed final at the time of the filing of the debtor's Chapter 13 petition since a deed had not been signed satisfying the statute of frauds and consideration had not passed to the foreclosing party. See also In re Barham, 193 B.R. 229 (Bankr. E.D. N.C. 1996) (Property is not "sold at a foreclosure sale" for purposes of § 1322(c)(1) until the foreclosure sale is completed under state law. This means that in North Carolina a debtor may file for Chapter 13 protection within 10 days following the foreclosure sale (until the period for submitting upset bids expires 10 days after the sale) and cure the default on the mortgage.).

(vii) The actions by a financial institution to freeze funds in an account does not violate the automatic stay as long as the financial institution does not take an action to set off the funds and apply them to the debtor's indebtedness. In re Strumpf, 116 S.Ct. 286 (1995); In re Carpenter, 14 B.R. 405 (Bankr. M.D. Tenn. 1981).

(viii) Relief from stay waivers found in collateral agreements are not per se enforceable but may be a factor in determining whether relief

from say should be granted. Jenkins Court Associates, 181 B.R. 33 (Bankr. E.D. Penn. 1995).

2. Violation of the Automatic Stay

A willful violation of the automatic stay that causes damages to an individual entitles the debtor to recover "actual damages, including costs and attorney fees, and, in appropriate circumstances, may recover punitive damages." 11 U.S.C. § 362(h). Some cases applying this section are as follows:

(a) Failure to take affirmative steps to stop or cancel a garnishment proceeding after learning of the debtor's bankruptcy constitutes a willful violation of the automatic stay. An attorney is personally liable for a stay violation even though he acted in a representative capacity for a client. Moreover, the attorney is not insulated from personal liability by practicing as a professional corporation. In re Timbs, 178 B.R. 989 (Bankr. E.D. Tenn. 1994)

(b) Most courts have held that only debtors who are natural persons can recover damages under § 362(h). In re Chateaugay Corp., 920 F.2d 183 (2nd Cir. 1990); contra In re Atlantic Bus. & Comm. Corp., 901 F.2d 325 (3rd Cir. 1990). Recent cases, however, have permitted corporations and partnerships to recover under a civil contempt theory. Jove Engineering v. IRS, 92 F.3d 1539 (11th Cir. 1996).

(c) Violations may exist when they are attributable to a failure to reprogram the computer to prevent tax collection notices from being sent. Jove Engineering, Inc. v. IRS, 92 F.3d 1539 (11th Cir. 1996).

3. **Proceeds of Collateral**

Under § 552, property acquired by the debtor and considered property of the estate after the commencement of a case is not subject to any liens extending from security agreements entered into prior to the filing of the petition unless that property is traceable to existing property that was subject to a pre-petition security interest. This becomes very important when the collateral is accounts receivable and inventory since such pre-petition collateral will be liquidated over time. If the assets are converted into cash which is later depleted and new inventory is acquired post-petition, the new inventory may be free of the creditor's security interest. To protect creditors from this depletion, the Bankruptcy Code defines proceeds of such property as "cash collateral" under § 363(a) and the use of such cash collateral by a trustee or debtor-in-possession is prohibited without court permission.

A creditor which has a security interest in cash collateral should not assume, however, that the debtor is adhering to the requirements of § 363. If a creditor suspects that the debtor-in-possession is using proceeds from pre-petition accounts receivable or inventory, the creditor should file a motion requesting the court to prohibit the use of such proceeds, and compel the debtor-in-possession to establish a separate account for cash collateral in its custody or control. 11 U.S.C. § 363(c)(4). A creditor routinely should attempt to get such a separate accounting immediately following the filing of the petition.

If the debtor-in-possession needs to use the cash collateral but is unable to get the consent of the creditor, it must seek court permission and provide adequate protection to the creditor. 11 U.S.C. § 363(c)(2). This adequate protection is often in the form of a substitute lien on post-petition assets.

In working out an agreement for the use of cash collateral, the secured creditor should strive to negotiate the following:

(a) Cash flow analysis for the next three months;

(b) A replacement lien on all assets in which it has a security interest;

(c) A security interest in collateral which was previously unencumbered;

(d) An agreement to retain a certain percentage of the proceeds collected;

(e) Verification of insurance;

(f) Verification that taxes are paid as due;

(g) Requirement that the debtor adhere to the covenants provided in the loan and collateral documents;

(h) Regular reporting requirements of the activity in debtor's operating account, payroll account, aging of accounts receivable, sales of inventory and purchases of new inventory;

(i) Periodic payments to service the debt or provide for principal reduction; and

(j) A drop dead provision terminating the use of cash collateral and granting relief from the automatic stay if debtor fails to meet the requirements provided in the order;

One issue confronting financial institutions is whether it is a violation of the automatic stay for the institution to freeze the account of the debtor. This is particularly important when the proceeds in the account represent cash collateral to the financial institution. As discussed above, the debtor may not use cash collateral without the creditor's consent or court permission pursuant to § 363(c)(2). On the other hand, a bank may be violating the automatic

stay to take action against an account in order to stop the debtor from withdrawing cash collateral. The Supreme Court upheld the majority of the jurisdictions which had permitted financial institutions to freeze an account as long as the bank did not take an action to set-off the funds and apply them to debtor's indebtedness. In re Strumpf, 116 S.Ct. 286 (1995). After freezing an account, it is incumbent upon the creditor to file a motion for relief from the stay to gain permission before taking any further action against the account. If the freeze is equivalent to a set-off under state law, there is no dispute that such action violates the automatic stay. See In re Carpenter, 14 B.R. 405 (Bankr. M.D. Tenn. 1981) (freezing of funds does not violate stay provided motion for relief is promptly filed).

Bankruptcy Rule 4001 applies to the use of cash collateral and relief from the automatic stay. This rule should be consulted before filing any agreed order since it sets forth special notice procedures for the entry of such orders.

Rents may also be cash collateral, but unlike accounts and inventory, an assignment may not be considered "perfected" unless certain notice actions have been taken by the secured party in addition to recording the assignment. These extra actions have caused a race to the courthouse in many jurisdictions. If the debtor filed bankruptcy before the creditor took the necessary steps to enforce its lien in the rents (such as a notice to tenants or the filing of an action in state court to force the operator to turn the rents over to the secured party), the debtor in many jurisdictions was entitled to use the proceeds to fund the bankruptcy case free and clear of the creditor's lien.

Code § 552(b) also addresses another problem that existed in any jurisdictions prior to 1994 for creditors who had liens on facilities such as hotels, motels, or other lodging properties. Most jurisdictions treat the revenues generated from an overnight stay at a hotel as an

account receivable instead of a rent. Thus, if the creditor did not perfect its security interest by a UCC filing, that creditor was unperfected. Even more disturbing was the treatment of the accounts post-petition. Even in circumstances where the creditor was perfected in the accounts, the lien in the accounts receivables was less than satisfactory because the filing of the bankruptcy effectively cut off the security interest in post-petition accounts. In fact prior to 1994, most courts had treated revenues derived from post-petition customers staying at the lodging facility as revenues that were free and clear of the creditor's interest. The 1994 amendments addressed this problem by adding Code § 552(b)(2) which provided that a security interest which extended to lodging revenues, whether construed as rents or accounts, would also extend to such post-petition revenues as long as the creditor's interest was perfected pre-petition. It is important to note, however, that the 1994 Amendments did not resolve the issue whether the lodging revenues are UCC accounts or rents under real property law, thus the "perfection" issues still exist.

4. <u>Relief from Stay</u>

As soon as a secured creditor receives notice of the filing of a Chapter 11 petition, the creditor should initiate action to either obtain possession of its collateral or obtain adequate protection of the debtor's use of its collateral. If the creditor is unable to receive an immediate commitment from the debtor, then a motion for relief from stay should be immediately filed. Under § 362(e), the clerk must schedule a preliminary hearing within 30 days of the filing of the motion. Thus the debtor is forced to take relatively quick action on the creditor's security. If a secured creditor acts quickly, it should either have possession of its collateral or be receiving payments for debtor's use of its collateral by the time the meeting of creditors is held.

Section 362(d) provides the following grounds for the granting of relief from the stay:

(a) For cause, including lack of adequate protection. 11 U.S.C. § 362(d)(1)

(b) With respect to the stay of action against property.

(i) The debtor has no equity in the property; and

(ii) The property is not necessary to an effective reorganization. 11 U.S.C. § 362(d)(2)

(c) With respect to a stay of an act against single asset real estate, the debtor has failed within 90 days after the filing of the petition to either

(i) file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time, or

(ii) commence monthly payments to the secured creditor whose claim is secured by real estate in an amount equal to interest at the nondefault contract rate of interest on the value of the creditor's collateral. 11 U.S.C. § 362(d)(3)

"Single asset real estate" means real property constituting a single property or project, other than residential property with fewer than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto. 11 U.S.C. § 101(51B).

Typically, relief-from-stay litigation centers on the valuation of the collateral. If the creditor can show that the debtor does not have any equity in the property then the debtor must prove that the property is necessary for an effective reorganization. The valuation issue often puts both the debtor and the creditor in an early dilemma. If the creditor is able to show that the value is low and that the debtor does not have any equity, the creditor may be saddled

with a lower value for its secured claim in the plan of reorganization. Conversely, the debtor may want to prove high value to demonstrate that it has equity in the property, but low value in proposing a plan of reorganization.

5. Adequate Protection

As an alternative to obtaining relief from the stay, a creditor should seek adequate protection of its security interest. Sections 362 refers to adequate protection of an "interest in property." In order to determine what an "interest in property" means, one must look to the Supreme Court's decision in United States Savings Association of Texas v. Timbers of Innwood Forest Associates, Ltd., 484 U.S. 365,108 S.Ct. 626 (1988). There, the creditor was the holder of a security interest in an apartment complex owned by the debtor. The apartment complex secured an indebtedness in the amount of $4,360,000 and the value of the apartment complex was somewhere between $2,650,000 and $4,250,000. The apartment project was appreciating in value. The creditor moved for relief from the automatic stay urging that its interest in the apartment complex was not adequately protected. The bankruptcy court agreed, conditioning the continuation of the automatic stay on monthly payments by the debtor of interest at the market rate of 12% per annum. The Supreme Court reversed, concluding that the creditor was not entitled to any adequate protection payments. The Court observed that the "'interest in property' referred to by § 362(d)(1) includes the right of a secured creditor to have the security applied in payment of the debt upon completion of the reorganization and that interest is not adequately protected if the security is depreciating during the term of the stay." The Court further observed that, if the apartment project had been declining in value, the creditor would have been entitled to periodic cash payments or additional security in the amount of the decline.

The Court's decision in Timbers makes it clear that the secured creditor is entitled to adequate protection only to compensate the creditor for any impairment of the value of the collateral whether due to depreciation, use, consumption or the imposition of other liens. The fact that such impairment mandates adequate protection may not, however, entitle the creditor to cash payments or an additional lien. The existence of a significant equity cushion may be considered sufficient adequate protection to protect the interest in the property. See, e.g., Pistole v. Mellor (In re Mellor), 734 F.2d 1396 (9th Cir. 1984); McCombs Properties VI, Ltd. v. First Texas Savings Association (In re McCombs Properties VI, Ltd.), 88 B.R. 261 (Bankr. C.D. Cal. 1988).

The Supreme Court also made it clear that undersecured creditors are not entitled to adequate protection payments absent impairment of the value of their collateral. While the Court did not consider whether oversecured creditors are entitled to adequate protection payments to protect their equity cushion, the Court's reasoning would seem to preclude such payments. Courts considering the issue in light of Timbers have concluded that oversecured creditors are not entitled to adequate protection payments to protect against diminution of the equity cushion. See In re Delta Resources, 54 F.3d 722 (11th Cir. 1995).

Section 361 provides three methods of providing adequate protection, although these methods are not exclusive.

(1) Periodic cash payments reflecting a decrease in value. 11 U.S.C. § 361(1). In re Bermac Corp., 445 F.2d 367 (2d Cir. 1971); In re Nixon Machinery Co., 9 B.R. 316 (Bankr. E.D. Tenn. 1981). If the creditor has an over secured claim, 11 U.S.C. § 506(b) allows the creditor to receive interest on its claim and any reasonable fees, costs, or charges provided for under the

agreement from which the claim arose. There is no statutory provision for the payment of interest on under-secured claims.

(2) Additional or replacement liens to cover a decrease in value. 11 U.S.C. § 361(2).

(3) Indubitable equivalent. In re Sandy Ridge, 881 F.2d 1346 (5th Cir. 1989)(surrender of collateral satisfies secured claim).

(4) Equity cushion. In re Dixie Shamrock Oil & Gas, Inc., 39 B.R. 115 (Bankr. M.D. Tenn. 1984) (equity cushion of approximately $500,000 on debt in excess of $7,000,000 would ensure creditor of adequate protection).

(5) Super priority claim. Section 361(3) specifically states that the granting of an administrative expense is not adequate protection. Courts have allowed a super priority claim, however, if the adequate protection provided to a secured creditor proves inadequate. 11 U.S.C. § 503(b)(1)(A) and § 507(b); In re Becker, 13 B.C.D. 549 (Bankr. D. Minn. 1985); In re Callister, 8 B.C.D. 446 (Bankr. D. Utah 1981); In re Colter, Inc., 53 B.R. 958 (Bankr. D. Colo. 1985).

It may be advantageous for creditors to forego seeking to obtain possession of the collateral through a relief-from-stay motion and negotiate with the debtor on an adequate protection order. Such an order may provide the following advantages:

(ii) Avoids valuation dilemma;

(iii) Obtain from the debtor an admission of the validity of the security interest;

(iv) Provide an automatic termination of the stay for non-compliance with the settlement;

(v) Provide for continuation of insurance coverage and payment of taxes; and

(vi) Establish reporting requirements which will allow creditor a close scrutiny of debtor's operations.

B. PROPERTY OF ESTATE

Immediately upon the filing of a bankruptcy petition, a bankruptcy estate is created which contains all legal and equitable interests held by the debtor at the time of the filing of the bankruptcy petition. These assets are held for distribution to creditors existing at the time of the filing of the petition. Also included in property of the estate will be any property in which the trustee or debtor-in-possession can recover through an avoidance action such as a preference claim and property received by the debtor through inheritance within 180 days after the filing of the petition. 11 U.S.C. §541(a)(5).

Property interests are determined by state law. For example, if the debtor owns the property in fee simple, then the entire property is included in the estate. On the other hand, if the debtor owns the property as a tenant in common with other parties, then only the debtor's interest in the property is subject to the automatic stay and the rights of creditors. A third form of ownership exists between spouses in Tennessee--tenants by the entirety exist for property deeded to both spouses. In these instances, the estate's interest is limited to the survivorship interest of the debtor, which may be a future interest of nominal value. If both spouses have filed a joint petition, the trustee can sell the property to pay joint debts, notwithstanding the joint ownership of the spouse. See In re Grosslight, 757 F.2d 773 (6th Cir. 1985). As to survivorship

property, if both spouses have not filed bankruptcy, the trustee may only sell the debtor's survivorship interest. This interest will have substantially less value to the estate than a fee simple or a joint ownership interest. For this reason many trustees will abandon such property interest even though there may be equity in the property.

The debtor's property interests will be subject to state law limitations such as spendthrift provisions in trusts. 11 U.S.C. §541(c)(2). In fact, certain trust property and ERISA qualified plans have been held to be excluded from property of the estate. Patterson v. Shumate, 504 U.S. 753, 112 S. Ct. 2242 (1992). Thus when a beneficiary to a trust files bankruptcy, the interests held by that beneficiary in the trust is excluded from property of the estate. Once a distribution is made to the beneficiary from the trust, however, the property held by the beneficiary at the time of the bankruptcy filing will be property of the estate. If the trustee has discretion, the trustee for the trust may withhold making a distribution in order to prevent the assets from becoming property of the beneficiary's estate. Otherwise the bankruptcy trustee may require the trustee for the trust to make a distribution to the debtor for distribution to the debtor's creditors.

C. FRAUDULENT TRANSFERS

A trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that was made within two years before the filing of the petition if such transfer was made with actual intent to hinder, delay or defraud a creditor. 11 U.S.C. § 548(a)(1). The trustee may also avoid such transfers made voluntarily or involuntarily when the debtor receives less than a "reasonably equivalent value" in exchange for the transfer and the debtor was insolvent or became insolvent as a result of the transaction. 11 U.S.C. § 548(a)(2).

The second provision is the most frequently used means by trustees or debtors-in-possession to avoid transfers. To bring such a cause of action under § 548(a)(2), the trustee or debtor-in-possession must show the following elements:

(a) Transfer of an interest of the debtor or obligation incurred by the debtor;

(b) Transfer made or obligation incurred within two years before the date of filing of the petition;

(c) Debtor received less than reasonably equivalent value;

(d) Debtor was insolvent on the date transfer was made or became insolvent as a result of the transfer.

The courts have focused on a debtor involuntarily receiving less than "reasonably equivalent value" to allow a trustee to avoid a foreclosure of real property by a secured creditor. Fortunately for creditors, the U.S. Supreme Court has held that reasonably equivalent value for the purposes of a real property foreclosure sale is controlled by state law, which generally requires an element of fraud or unfairness instead of mere inadequate price. In re BFP, 114 S. Ct. 1757 (1994).

A trustee may also invoke the strong arm powers of § 544(b) of the Bankruptcy Code to bring a state law fraudulent transfer action that could have been brought by creditors of the debtor. These provisions are similar to the requirements of § 548(a)(2), provided the state law provisions may entitle the trustee to reach beyond two years—the reach back under the Uniform Fraudulent Transfer Act is four years.

Avoidance powers held by a trustee last for the later of two years after the entry of an order commencing the bankruptcy case, or one year after the appointment of the first trustee under Chapter 7, 11, 12 or 13, provided the appointment occurs within the first two years of the

case. The rights of the trustee also expire when the case is closed or dismissed. 11 U.S.C. § 546(a).

D. CHAPTER 11 REORGANIZATIONS

1. Exclusivity

One of the important rights of a debtor is its exclusive right to file a plan during the first 120 days of the case. 11 U.S.C. § 1121. Once this exclusivity period expires, the secured creditor can propose a plan of its own that would provide for the liquidation of the property. Thus creditors are advised to oppose any efforts by debtors to extend the exclusivity beyond the statutory limits.

After a plan is filed, the debtor must obtain acceptances of the plan within 180 days after the commencement of the case. 11 U.S.C. § 1121(c)(3). Additionally, Bankruptcy Rule 3016(a) states that a party, other than the debtor, may not file a plan after the entry of an order approving a disclosure statement unless confirmation of the plan has been denied or the court orders otherwise. This has been held to mean that the court has discretion as to whether to allow other plans to be filed after the debtor's disclosure statement is approved. See Creekstone Apartments Associates, 1995 W.L. 588904 (M.D. Tenn. 1995).

2. Classification of Claims

Classification of claims is an important area in the confirmation process. To confirm a plan, the debtor must obtain the acceptance of at least one class of impaired claims. 11 U.S.C. § 1129(a)(10). If the secured creditor in a single asset case has a large deficiency claim, then the vote of the unsecured portion of that claim would dominate and control the acceptance of the unsecured class. Since there are relatively few creditors in a single asset real estate case, it

is often crucial for the debtor to separately classify this deficiency claim in order to obtain an accepting class.

Section 1122 states that a plan may place a claim in a particular class "only if such claim or interest is substantially similar to the other claims or interest of such class." 11 U.S.C. § 1122(a). The Sixth Circuit concluded in In re U.S. Truck Co., 800 F.2d 581 (6th Cir. 1986), that the separate classification of a labor union's claim was proper since their interests were not similar to the other unsecured claims. The Sixth Circuit has not addressed the issue in single asset cases where the debtor seeks to separately classify the deficiency claim of the secured creditor.

A majority of the courts permit separate classification only upon a demonstration of good business reason. In re Greystone III Joint Venture, 948 F.2d 1123 (5th Cir. 1991); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990); In re Bryson Properties XVIII, 961 F.2d 496 (4th Cir. 1992); In re Briscoe Enterprises, 994 F.2d 1160 (5th Cir. 1993); In re Wabash Valley Power Association, 72 F.3d 1305 (7th Cir. 1995). The Seventh and Ninth Circuits have held that deficiency claims are not similar to other unsecured creditors' claim and therefore must be separately classified even without the demonstration of good business justification. In re Woodbrook Associates, 19 F.3d 312 (7th Cir. 1994); In re Johnston, 21 F.3d 323 (9th Cir. 1994).

3. Artificial Impairment

Before any debtor can confirm a plan, it must receive acceptance of a class of "impaired" claims. What constitutes an impaired class is an unsettled issue before the courts. The Eighth Circuit has ruled against allowing a plan that manufactured a class in order to obtain acceptances. In re Windsor on the River, Ltd., 7 F.3d 127 (8th Cir. 1993). In that case, the

unsecured creditors would be paid in full 60 days after the effective date of the plan. The Bankruptcy Code, however, does not have a materiality standard and instead some argue that the appropriate way to evaluate such impairment is under the rubric of "good faith." In re Hotel Associates of Tucson, 165 B.R. 470 (9th Cir. BAP. 1994). Judge Paine reviewed this issue and concluded that the Eighth Circuit decision effectively "rewrites § 109 of the Bankruptcy Code to exclude single asset real estate debtor's from eligibility under Chapter 11. Such policy choices are best left to Congress." In re Creekstone Apartments Associates, 1995 Bankr. LEXIS 552 (Bankr. M.D. Tenn. 1995). Accord The Beare Co., 177 B.R. 886 (Bankr. W.D. Tenn. 1994) (good faith is the real issue).

4. Unfair Discrimination

Under Code § 1129(b) a plan must not "discriminate unfairly" against an impaired class that has not accepted the plan. Two decisions by Judge Lundin have established a standard of review for determining unfair discrimination in Chapter 11 cramdown. In re Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989); In re Creekside Landing, Limited, 140 B.R. 713 (Bankr. M.D. Tenn. 1992). In these opinions, Judge Lundin has rejected a mechanical approach and instead has applied a four factor test for determining whether discrimination in the payment of claims was proposed fairly in the case.

(a) Whether the discrimination is supported by reasonable basis,

(b) Whether the debtor can conform and consummate a plan without the discrimination,

(c) Whether the discrimination is proposed in good faith, and

(d) The treatment of the classes discriminated against.

In a decision by Judge Paine applying these four factors, the court determined that the first factor was satisfied by testimony that the debtor had developed business relationships with vendors over the years that cannot be easily replaced. Thus the court concluded that it was not unfair discrimination even though the plan proposed to pay 10% to the unsecured deficiency claim and 100% to the trade creditors. The proof was also clear that the debtor could not possibly pay 100% of the deficiency claim and if it were to pay 10% to the trade debt, the business relations between the debtor and the trade vendors would be jeopardized. Judge Paine also appeared satisfied that the plan and the discrimination was in good faith and that the general partners or other insiders were not benefiting from the plan's discrimination. Finally, the court was satisfied that the plan's proposed 10% payment on the unsecured deficiency totaled approximately $760,000 and therefore was a meaningful recovery even though that the bulk of the cash to be paid on this claim was from post-petition cash collateral. In re Creekstone Apartments Associates, L.P., 168 B.R. 639 (Bankr. M.D. Tenn. 1994).

5. **Fair and Equitable**

A secured creditor must either negotiate acceptable payment terms under the plan of reorganization or face being forced to accept payments in conformity with the "cramdown" provisions of § 1129(b)(2)(A). This provision states that a court can confirm a plan only if the plan does not "discriminate unfairly" and is "fair and equitable" with respect to each class of claims that is unimpaired and has not accepted the plan. 11 U.S.C. § 1129(b)

To be "fair and equitable," the plan must provide that the secured creditor will retain its lien in an amount equal to the value of its collateral and will receive deferred cash payments totaling the allowed amount of its "secured" claim. 11 U.S.C. § 1129(b)(2)(A). The amount of the secured claim is determined under § 506(a) and will be equal to the value of the

creditor's collateral. The U.S. Supreme Court has held that when a Chapter 13 debtor retains collateral, the replacement value of the collateral is the appropriate valuation method. Associated Commercial Corp. v. Rush, 117 S. Ct. 1879 (1997).

The present value of the payments must equal the value of the collateral. To pay the present value, the debtor must pay a market rate of interest consistent with commercial loans on similar collateral in the region. See In re Roso, 76 F.3d 179 (8th Cir. 1996); Memphis Bank & Trust Co. v. Whitmans, 692 F.2d 427 (6th Cir. 1982). In a Chapter 13 case, the U.S. Supreme Court held that the appropriate means to determine this rate is to apply a formula approach determined by the prime national interest rate and an appropriate risk rate of one to three percent that is high enough to compensate the creditor for its risk but not so high so to doom the bankruptcy plan. Till v. SCS Credit Corp., 124 S. Ct. 1951 (2004). This standard is likely to applied in Chapter 11 cases.

If the value of the real property securing the claim is not sufficient to satisfy the claimant in full, then the creditor also holds an unsecured claim. This deficiency claim is not entitled to the same rights as the secured claim for the claim to be treated "fair and equitable." For example, there is no value determination as to the amount that is necessary to be paid and no interest rate determination is necessary since, unless the debtor is solvent, the debtor does not have to pay the present value of the claim.

If the plan provides for less than 100% payment to the unsecured claims, however, the debtor must satisfy the absolute priority rule. This rule states that no class of creditors or interest can retain any value or receive any distribution if a class of higher priority is not receiving the present value of its claim (100% payment on the effective date of the plan), unless that class consents to a lesser treatment. 11 U.S.C. § 1129(b)(2)(B). Thus, a mortgage

lender who has an unsecured deficiency claim must receive 100% on its unsecured claims if the equity interests in the debtor are to retain their interests.

Courts have created an exception to this rule known as the "new value" exception. In re U.S. Truck Co., Inc., 800 F.2d 581 (6th Cir. 1986). This exception permits the debtor's interest to be retained if the parties holding these interests contribute a present contribution to the reorganized debtor and such contribution is both necessary and valuable to the reorganization. In re Creekside Landing, Ltd., 140 B.R. 713, 717 (Bankr. M.D. Tenn. 1992). Many factors are used by the courts in determining the sufficiency of the new value. At the very least, this amount should be equal to the value of the equity interests in the reorganized debtor after the confirmation of the plan. Id. at 718. The factors generally applied by the bankruptcy courts in Tennessee have been as follows:

(a) The proposed new value is both substantial and essential;

(b) The new value is unavailable from any other source or the existing interest holders are the most likely source for the funds; and

(c) The new value is reasonably equivalent to what the contributors receive in exchange.

In re Creekside Landing, Ltd., 140 B.R. 713, 717 (Bankr. M.D. Tenn. 1992); In re Creekstone Apartments Associates, LP, 1995 Bankr. LEXIS 552 (Bankr. M.D. Tenn. 1995).

The U.S. Supreme Court has had several opportunities to either bless the new value exception or hold that it does not exist, but has stopped short each time by denying confirmation to the plan before it on other grounds. Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988); Bank of America National Trust & Savings Assoc. v. 203 North LaSalle St.,

119 S. Ct. 1411 (1999). In the process, however, some limits have been placed on what the Court has labeled the "new value corollary."

In Ahlers, the Court considered whether the efforts of the debtor-farmer to generate revenues after the confirmation of the plan was sufficient to satisfy the new value corollary. The Court reserved the issue of whether the new value corollary existed by holding that even if it did exist, the new value must be in money or money's worth and "sweat equity" was insufficient.

In LaSalle, the Court considered a plan that provided for significant contributions from the equity partners, but did not allow anyone else to contribute or otherwise bid for the property. Again the Court reserved the issue of whether the new value corollary existed by holding that the plan as proposed was insufficient to satisfy the new value corollary even if it did exist. The Court held that if unsecured creditors object to the plan, the new value can not be exclusive and the debtor must give other parties the opportunity to compete for the equity or to propose a competing plan. The impact of this holding will require debtors to either (i) allow the exclusivity period to expire so that competing plans can be proposed, or (ii) include within the debtor's plan a procedure for other parties to bid for the purchase of the property. It is anticipated that courts will continue to acknowledge the existence of the new value corollary with these limitations.

6. 1111(b) Election

A secured creditor may increase the allowed amount of its secured claim by making an election pursuant to § 1111(b). This election eliminates any recourse claim that the creditor may have on any deficiency and allows the creditor to increase its "secured" claim for purposes of § 1129(b) from the value of the collateral to the full amount owed the creditor. This

increase comes at a cost, however. The creditor loses its unsecured deficiency claim and the right to receive the present value of its collateral. Although the § 1111(b) election requires the debtor to pay the entire claim, it does not require the present value of the claim to be paid. Thus the plan will typically extend the payments over several years. As a consequence the actual present value of the payments will be far less than the full amount of the claim and usually will be less than the present value of the collateral value. If so, it is advisable for the creditor to retain its recourse or unsecured claim. This may permit the creditor to control the plan since the creditor will hold a claim in two separate classes. Additionally, retaining the unsecured claim gives the creditor standing to challenge the debtor's cramdown of the unsecured claims under § 1129(b)(2)(B). This provision requires the debtor to invest "new value" into the case if all claims are not paid in full. Determining the appropriate amount of new value is an uncertain fact issue that if set too high may make the plan too expensive for the debtor. At a minimum, the preservation of this claim gives the creditor leverage in the plan negotiation process.