Ninth Circuit Holds That Valuation of Secured Creditor's Collateral in Chapter 11 Need Not Be Based on Property's Highest and Best Use

On May 26, 2017, an *en banc* panel of the Ninth Circuit Court of Appeals issued an opinion with important ramifications for secured lenders.[1] The Ninth Circuit held that for purposes of determining the amount of a secured claim under a Chapter 11 plan, the collateral should be valued based on the debtor's proposed post-reorganization use of the property, even if the collateral would generate more value in a foreclosure sale.

Under Chapter 11 of the Bankruptcy Code, a debtor can modify payment terms of a secured loan over the objection of a secured creditor (a "cramdown") if, *inter alia*, the plan provides that the secured creditor will (i) retain its lien on the collateral, and (ii) receive payments over time with a present value of at least the amount of its secured claim.[2]

The amount of a creditor's secured claim—and thus the minimum present value it must receive under a cramdown plan—is equal to the value of the collateral securing the claim.[3] That value must "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[4] In *Associates Commercial Corp. v. Rash*, the U.S. Supreme Court held that for purposes of valuing a secured creditor's collateral in a cramdown plan, the proper standard is a "replacement-value standard" rather than a "foreclosure-value standard."[5] As the Supreme Court recognized in *Rash*, the replacement value standard typically results in a higher valuation than the foreclosure standard.[6] For this reason, *Rash's* replacement value standard has been described as a "secured-creditor-friendly" standard.[7]

In the Ninth Circuit case, the debtor ("Sunnyslope") owned an apartment complex in Phoenix, Arizona. The apartment complex was subject to several covenants requiring that it be used for low-income housing. These restrictive covenants, however, would be vitiated in the event of foreclosure. First Southern National Bank ("First Southern") held a first mortgage on the property.

The parties agreed that it would cost Sunnyslope approximately $3.9 million to replace the apartment complex with a similar property with the same low-income housing covenants in place. They further agreed that the property would be worth $7 million–$8 million absent such restrictions. *Sunnyslope* is thus an atypical case in which the collateral's foreclosure value (*i.e.*, the value of the complex without the covenants) exceeded its replacement value.

So how much present value must the secured creditor receive under the plan: $3.9 million, or the $7 million–$8 million estimated foreclosure value?

In a divided *en banc* opinion, the Ninth Circuit held $3.9 million. The majority of the panel concluded that *Rash's* "replacement value" standard compelled this result, stating that "[t]he essential inquiry under *Rash* is 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**."[8] The court rejected First Southern's argument that the property should be valued based on "its 'highest and best use'—housing without any low-income restrictions," noting that the Bankruptcy Code "speaks expressly of the reorganization plan's 'proposed disposition or use.'"[9] Furthermore,

the low-income restrictions could only be eliminated by a foreclosure sale, and *Rash* "expressly instructs that a … valuation cannot consider what would happen after a hypothetical foreclosure—the valuation must instead reflect the property's 'actual use.'"[10]

In a spirited dissent, Judge Kozinski accused the majority of "fetishiz[ing] a selection of [*Rash's*] words at the expense of its logic," resulting in the adoption of "a new valuation standard that turns entirely on the debtor's desires—creditors be damned."[11] The dissent argued that the *Rash* holding was motivated by a desire to ***protect*** secured creditors from the risks of post-bankruptcy default and/or deterioration of collateral value. The majority opinion is "at odds with these motivations" because it values the secured creditor's collateral at less than what would be obtained from an immediate sale.[12] The dissent predicted that lenders would respond to the court's holding by passing on the risk to borrowers in the form of higher interest rates.[13]

The Ninth Circuit's opinion may not be the last word in *Sunnyslope*. Judge Kozinski's dissent implicitly urged the Supreme Court to grant *certiorari* to clarify *Rash's* "replacement value" valuation standard. In the meantime, *Sunnyslope* is binding on Ninth Circuit bankruptcy courts and will be persuasive precedent in other jurisdictions. Secured lenders should be aware of the risk that debtors will attempt to value collateral in light of the "particular use proposed in the plan of reorganization," regardless of whether that particular use maximizes the value of the property.

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[1]*See In re Sunnyslope Housing Ltd. P'ship*, 2017 U.S. App. LEXIS 9198 (9th Cir. May 26, 2017) (en banc).
[2]*See* 11 U.S.C. § 1129(b)(2)(A).
[3]*See* 11 U.S.C. § 506(a)(1).
[4]*Id*.
[5]520 U.S. 953, 956 & 960 (1997).
[6]*Id*. at 960.
[7]*See Till v. SCS Credit Corp*., 541 U.S. 465, 489 (2004) (Thomas, J., concurring). [8]2017 U.S. App. LEXIS 9198, at *14 (emphasis added).
[9]*Id.* (quoting 11 U.S.C. § 506(a)(1)).
[10]*Id*. at *15 (quoting Rash, 520 U.S. at 963). Because First Southern elected to have its entire claim treated as a secured claim under section 1111(b)(2) (a discussion of which is beyond the scope of this Client Alert), the Ninth Circuit did not analyze whether First Southern received at least as much value under the plan as it would have in a hypothetical Chapter 7 liquidation. *See* 11 U.S.C. § 1129(a)(7). Had First Southern not made the section 1111(b)(2) election, section 1129(a)(7) might have provided an additional basis for objection to confirmation of Sunnyslope's plan.
[11]*Id*. at *23 (Kozinski, J., dissenting).

[12] *Id.* at *25.
[13] *Id.* at *25 n.3.

This document is intended to provide you with general information regarding valuation of secured creditor's collateral in Chapter 11. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.