



## Insight from Carlton Fields

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# When Projects Go Bad: Bankruptcy Issues for the Construction Industry

By John J. Lamoureux

The construction industry in the state of Florida has enjoyed relative prosperity for almost two decades. There has not been a significant downturn in the economy since the early 1990s. However, real estate bankruptcy cases today are significantly different as a result of the changes in the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (2008) (the “Code”), the current economic climate, and tightening credit.

In the past, bankruptcy was primarily a vehicle used by debtors to restructure their finances. However, savvy lenders are using bankruptcy to accomplish sales of assets under 11 U.S.C. § 363, in lieu of using state law foreclosure actions, in order to “clean” such property of liens and encumbrances. Further, creditors must understand that their rights may be significantly impacted by bankruptcy and any creditor who fails to understand the significant impact of bankruptcy may jeopardize their position. This paper provides a general overview of the areas most construction lawyers should be aware of, the current status of the law, and actions to take with respect to bankruptcy matters.

### Single Asset Real Estate

In 1994, Congress amended the Code and added the definition of “single asset real estate.” 11 U.S.C. § 101(51B). In the 1994 amendments, Congress

also added Code §362(d)(3) that allowed relief from the automatic stay to a secured creditor where the debtor did not file a plan of reorganization or commenced payments to a secured creditor within ninety days of the petition date if the debtor constituted a “single asset real estate.” The original 1994 amendments provided that there was a \$4 million limitation. However, in 2005, Congress modified Code §101(51B) by eliminating the \$4 million debt limitation, thus greatly expanding the coverage of that section.

### *Definition of a “Single Asset Real Estate” and Relief From the Automatic Stay*

Code § 101(51B) defines the term “single asset real estate” (“SARE”) to mean:

real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

In addition, Code § 362(d)(3) provides that:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay... (3) with respect to a

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stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered in that 90 day period) or 30 days after the court determines the debtor is subject to this paragraph, whichever is later –

(A) the debtor has filed a plan of reorganization that has reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that –

(i) may, in the debtor's sole discretion, notwithstanding Section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate.

The key point for secured creditors to remember is that if the debtor is a SARE, the debtor is required to file a plan of reorganization or commence payments to the secured creditor within the later of (i) 90 days of filing the case, or (ii) 30 days after the court has determined that the debtor is subject to the SARE requirements. 11 U.S.C. §362(d)(3).

In order to obtain an extended time period to file a plan of reorganization or commence payments, some debtors have filed motions for a determination that the debtor is not subject to the SARE requirements with or near the original petition date. See, e.g., *In re Club Golf Partners, L.P.*, 2007 WL 1176010, p. 1, 47 Bankr. Ct. Dec. 229 (Bankr. E.D. Tex. Feb. 15, 2007). It is recommended that creditors should not

file motions for relief from stay until after the 90-day time period has expired or the court may find that the motion for relief from stay is premature. See *In re Hope Plantation Group, LLC*, 393 B.R. 98, 102 (Bankr. S.C. 2007); *In re National/Northway Limited Partnership*, 279 B.R. 17, 22 (Bankr. D. Mass 2002); but see *In re Duvar Apt., Inc.*, 205 B.R. 196, 200 (9th Cir. BAP 1996) (bankruptcy court has authority to grant relief from the automatic stay in SARE cases before expiration of 90-day period in which debtor must act in such case).

### *The Legal Test For Determining a Single Asset Real Estate Case*

In determining whether a debtor constitutes a SARE, courts have proposed various factors to distinguish which projects were intended by Congress to fall within the definition of a SARE and which projects do not. Although case law is not uniform, a list of factors considered by courts includes the following:

- (1) The real estate must generate substantially all the "gross income" of the debtor.
- (2) The debtor must not operate substantial business other than the "business of operating the real property and activities incidental" to the operation of such real property.
- (3) The real estate must be a "single" property or single project.
- (4) The debtor's operation must be based on "real property" and not from the sale of goods or services associated with the real property.
- (5) The net income must be viewed as passive (such as the collection of rent from tenants) and not from active operation. The income from the project cannot come from operations, i.e., the product of management or workers which brings in customers and sells them goods.

See, e.g., *In re Kara Homes, Inc.*, 363 B.R. 399, 404 (Bankr. D. N.J. 2007); *In re Heather Apartment, Limited Partnership*, 366 B.R. 45, 48 (Bankr. D. Minn.



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2007); *In re Scotia Development, LLC*, 375 B.R. 764, 776-778 (Bankr. S.D. Tex.), *aff'd*, 508 F. 3d 214 (5<sup>th</sup> Cir. 2007).

### Major Recent Cases Discussing SARE

In 2007, three major decisions were decided involving large complex projects and whether those projects were SARE cases. In *In re Kara Homes, Inc.*, 363 B.R. 399 (Bankr. D.N.J. 2007), the Bankruptcy Court held that a debtor and a group of 32 affiliates involved in a large-scale land development project qualified as a SARE under Code § 101(51B) and therefore, were subject to the stricter requirements that a debtor make monthly payments to its mortgage lender, or file a plan of reorganization within ninety days. *Kara Homes* is significant because the court was willing to find that the debtor falls within the definition of SARE, even when its business is not truly “passive” and where its development activities might be seen as falling outside of “operating” real estate project. For example, the acquisition of land, the design of homes, and the marketing of the homes could have been found to be related business activities but not necessarily being part of the “operation” of the project. Given the current economic environment involving distressed home-building projects, the *Kara Homes* case offers substantial protection to mortgage lenders.

*In re Heather Apartment Ltd.*, 366 B.R. 45 (Bankr. D. Minn. 2007) was another significant decision because there, the court held that there was a “presumptive right” to relief from the automatic stay and that “cause” to extend the time for making cash payments or filing a plan was difficult to establish. Specifically, the court held that Code § 362(d)(3) creates a statutory requirement “in which a grant of relief from stay in favor of a mortgagee against single asset real estate is presumptive” unless debtor proves “in hand realization of cash by the creditor, during the pen-

dency of the case.” The Court further stated that “if a debtor’s to be excused in having to surrender that cash right away, it must demonstrate the very substantial likelihood that the creditor would realize an equivalent value from another source, quickly enough to minimize the risk of recovering the time value of money.” *Id.* at 51.

Additionally, *In re Scotia Development, LLC*, 375 B.R. 764 (Bankr. S.D. Tex. 2006), *aff'd*, 508 F. 3d 214 (5<sup>th</sup> Cir. 2007) is significant because it contains a summary of the various factors the court evaluated in determining whether a SARE existed. The focus of the opinion is on the distinction between a “passive” investment, which falls within the definition of SARE, and an “active” investment which does not. The *Scotia* court ultimately held that the debtor was not a SARE debtor because it had substantial business activity other than the operation of business, and because it was not merely a “passive investor.” *Id.* at 776-77. The bankruptcy court found that the debtor was “actively using property in its operation” and the revenue derived was attributable to the operations and not to the property. *Id.* at 776. The bankruptcy court noted that “a debtor is not a single asset real estate debtor where its ‘real estate does not generate the revenue; revenue is the product of the efforts of management and workers conducted on the lands, bringing in customers and selling services and goods to them.’” *Id.*

Courts have analyzed the meaning of a SARE in other settings as well:

- a. Marina. A marina does not fall within the definition of a SARE, due to the variety of service offered at the marina which provides multiple source of revenue, and thus, causing it to fall outside the definition of Code § 101(51B). *In re Kkemko*, 181 B.R. 47, 51 (Bankr. S.D. Ohio 1995).



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b. Golf course. The cases appear fairly uniform that a golf course is not a SARE. As previously discussed in *In re Club Golf Partners, LP, supra.*, the bankruptcy court held that a golf course which conducted substantial business other than the operation of the real property was not a SARE. Other cases holding that golf courses are not SARE cases include *In re Larry Goodwin Golf, Inc.*, 219 B.R. 391, 393 (Bankr. M.D. N.C. 1997); *In re Prairie Hills Golf and Ski Club, Inc.*, 225 B.R. 228, 230 (Bankr. D. Neb. 2000); *In re Prairie Hollow Management, Co., Inc. (Commerce Bank & Trust Co. v. Prairie Hollow Golf Club, Inc.)*, 2000 WL 33679447 (Bankr. D. N.H. Apr. 6, 2000); *In re CGE Shattuck, LLC (Bank of America Commercial Finance Corp. v. CGE Shattuck, LLC)*, 1999 WL 33457789 (Bankr. D.N.H. Dec. 20, 1999).

c. Hotels. In general, courts have also found that a hotel is outside the definition of a SARE. See e.g., *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006) (court held that an operating eighty-nine room hotel that provided room cleaning, towel laundry service, served continental breakfast, maintained a swimming pool, and provided telephone high speed internet service was conducting substantial business “other than the business of operating real property” on which the hotel was located, including a bar, restaurant, gift shop, tour bus, etc., and that hotel property was not “a single asset real estate” as defined under § 101(51B)); *In re CBJ Development, Inc.*, (*In re Centofante v. CBJ Development, Inc.*), 202 B.R. 467 (9th Cir. B.A.P. 1996) (court held that an operating hotel was not a single asset case but did not decide that, as a matter of law, all hotels are not single asset cases; that issue had to be decided based upon the amount of services provided by the number of persons employed by the hotel in question).

(d) Undeveloped Land. Undeveloped land has consistently been held to be a SARE. See *In re Oceanside Mission Associates*, 192 B.R. 232 (Bankr. S.D. Cal. 1996); *In re Pensignorkay, Inc.*, 204 B.R. 676 (Bankr. E.D. Pa. 1997). Code § 101(51B) might be read to require that a SARE have “income,” and if raw land that does not have income and is held for future development, it is not income producing and not a SARE. Such

arguments have been rejected and courts have consistently ruled that raw land does fall within the meaning of a SARE. *Id.*

### *Is a Court Required to Grant Relief From Stay if the Debtor Fails to Comply With the Requirement to Timely File a Plan of Reorganization or Make Payments?*

If the debtor fails to commence monthly payment or timely file a plan of reorganization, is the court required to grant stay of relief? The bankruptcy courts appear to be split on whether it is mandatory or discretionary to terminate the automatic stay if the debtor fails to file a plan of reorganization or make payments.

(1) Cases holding termination of the automatic stay is not mandatory and the bankruptcy court has discretion in fashioning appropriate remedy include the following: *In re Hope Plantation Group, LLC*, 393 B.R. 98, 102, 104 (Bankr. D. S.C. 2007) (in denying creditor’s motion for stay relief the court held a motion filed before the 90th day was premature, that the debtor had reasonable chance of showing that it might have filed a plan and the court could fashion relief other than by terminating the stay); *In re National/Northway, Ltd. Partnership*, 279 B.R. 17, 22 (Bankr. D. Mass. 2002) (failure to file a plan within 90 days does not require automatic dismissal or termination of the automatic stay); *In re Planet 10, L.C.*, 213 B.R. 478, 481 (Bankr. E.D. Va. 1997) (termination of the automatic stay under Code § 362(d)(3) is not mandatory and court could fashion alternative remedy); *In re Archway Apartments, Ltd. (Condor One v. Archway Apartments, Ltd.)*, 206 B.R. 463, 465 (Bankr. M.D. Tenn. 1997) (court had discretion to tailor relief from the automatic stay under Code § 362(d)(3)).

(2) Cases holding termination of automatic stay is mandatory include the following: *In re Pensignorkay, Inc.*, 204 B.R. 676, 683 (Bankr. E.D. Pa. 1997) (termination of automatic stay is mandatory); *In re LDN Corporation (Nations Bank, N.A. v. LDN Corp.)*, 191 B.R. 320, 327 (Bankr. E.D. Va. 1996) (relief man-



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datory where debtor did not meet requirements of Code § 362(d)(3)).

### *What Constitutes a Reasonable Possibility of Being Confirmed Within a Reasonable Time?*

A limited number of cases have analyzed whether the debtor is required to demonstrate that a plan of reorganization that has been filed “has a reasonable possibility of being confirmed.” These cases indicate that the debtor must show a “reasonable possibility of being confirmed” by evidence that was more than merely “conclusory” or “speculative.” For example, in *In re Crosswinds Associates*, No. 96-CIV-4572, 1996 WL 350695, at 1-2 (S.D.N.Y. June 25, 1996), the district court affirmed the lower court’s order terminating the automatic stay because there was no reasonable possibility of the plan being confirmed in a reasonable time. *Id.* at \*2. The court stated that the evidence presented to the bankruptcy court included that the property was substantially in disrepair, the debtor had no ability to pay for repairs or maintenance of the property, the debtor had no ability to raise capital in a timely fashion, and that the plan was not feasible. *Id.* Based upon these facts, the bankruptcy court stated that “no feasible plan of reorganization existed” and terminated the automatic stay. *Id.*; see also *In re Duvar Apartment, Inc.*, 205 B.R. 196, 200 (9th Cir. B.A.P. 1996) (“a bankruptcy court has the ability to grant relief from stay for cause in single asset real estate case before expiration of the Code § 362(d)(3) 90-day period”).

Furthermore, other courts have stated that the standard for determining if a plan of reorganization “has a reasonable possibility of being confirmed” is “similar, if not identical,” to the standard for an “effective reorganization” under Code § 362(d)(2)(B) and cases which have analyzed that Code provision. See *In re 68 West 127<sup>th</sup> Street*, 285 B.R. 838, 847 (Bankr. S. D. N.Y. 2002); *In re Deep River Warehouse, Inc.*, No. 04-52749, 2005 WL 1287987, at 12 (Bankr. M.D.

N.C. March 14, 2005); see also *United States As’n v. Timbers of Inwood Forest Assoc.’s.*, 484 U.S. 365, 375-76 (1988) (Code § 362(d)(2)(B) standard requires that “there must be a reasonable possibility of a successful reorganization within a reasonable period of time.”). However, a reasonable possibility of a successful reorganization cannot be established by the debtor’s mere conjecture, speculation, or unfounded assertions. *In re Balco Equities, Ltd., Inc.*, 312 B. R. 734, 752 (Bankr. S.D. N.Y. 2004) (finding no reorganization in process because “debtor’s reorganization goals vacillate between a so-far equally fruitless hope to sell the vessels and a hope to charter them, and at the literal last hour, with strong objection, the debtors hinted at an “equity infusion”); *In re LDN Corp.*, 191 B.R. 320, 325 (Bankr. E.D. Va. 1996) (finding that the “naked hope of the debtor” as demonstrated by the debtor’s “inaccurate and unreliable” economic and financial projections and unrealistic debt service under the plan are insufficient to establish that an effective reorganization is reasonably within a reasonable time); *In re Pegasus Agency, Inc.*, 101 F.3d 882, 884 (2d Cir. 1996) (finding debtor’s “fanciful” calculations were “conclusory and unsubstantiated expressions of optimism”).

### *Are Required Monthly Payments Interest Payments or Principle Reduction Payments?*

Code § 362(d)(3)(B) provides as follows:

The debtor has commenced monthly payments that -- (i) may, in the debtor’s sole discretion, notwithstanding Section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unperfected statutory lien); and (ii) are in an amount equal to interest as the then applicable nondefault contract rate of interest on the value of the creditor’s interest in the real estate....



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What happens if the creditor is undersecured, *i.e.*, it is owed more than what the underlying property is worth. How are such payments to be applied? A leading commentator on bankruptcy law has stated that:

It should be noted that the payments [required under 362(2)(d)(3)] are not necessarily payments of interest, but are in an amount, "equal to" interest at the then applicable nondefault contract rate of interest. This suggests that the payments may be applied to principle rather than interest, which, if the creditor is undersecured, would reduce the obligation with which the debtor must deal in a plan.

3 Collier on Bankruptcy ¶ 362.075[5], p. 362-103 (15th Rev. Ed. 2008).

Not surprisingly, the courts are split on how adequate protection payments are applied to an undersecured creditor. *Beal Banks S.S.B. v. Waters Edge Ltd. Partnership*, 248 B.R. 668, 684 (D. Mass. 2000) (recognizing conflicting case law and ruling that adequate protection payments should not be applied to reduce a secured claim); *In re Union Meeting Partners*, 178 B.R. 664, 674-76 (Bankr. B.D. 1995) (see collection of cases showing split of opinion in the courts); *In re Flagler-at-First Associates, Ltd.*, 114 B.R. 297, 302-303 (Bankr. S.B. Fla. 1990) (recognizing the general rule in bankruptcy that to the extent such payments exceed a decrease in the value of the collateral, they should be applied to the secured portion of the claim but ruling that rents paid to undersecured creditor did not have to be applied to reduce the secured claim); *In re Canaveral Seafoods, Inc.*, 79 B.R. 57, 59 (Bankr. M. D. Fla. 1987) (adequate protection payment applied to reduce secured claim); *In re Sherwood Square Associates*, 87 B.R. 388, 393 (Bankr. D. Md. 1980) (adequate protection payment applied to reduce secured claim).

### **Bankruptcy Code § 363 Sales Free and Clear of Liens, Claims, and Encumbrances**

One of the significant advantages of sales in bankruptcy is the relative ease and quickness by which assets can be sold free and clear of liens, claims, and encumbrances through the use of Code § 363, and that the Code generally permits a secured creditor to credit bid the full amount of its claim for such asset. Code § 363 sales can occur relatively quickly and generally are much quicker vehicles to obtain property than through a state law foreclosure action. Such sales are believed to be free and clear of liens that would not normally be extinguished under state law such as tort claims, or other contractual claims.

Code § 363(f) provides that a sale of property may occur free and clear of liens, claims and encumbrances provided that one of five conditions is satisfied:

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

### ***Are Junior Lien Claims Required To Be Paid in Full?***

One disputed issue relating to Code § 363 sales is whether a proposed sale of property under Code § 363(f) must be in an amount greater than the face amount of the liens or the value of the collateral. The use of Code § 363(f) to sell assets may be more difficult if junior liens must be paid in full, and the debtor may be required to prove other requirements under Code § 363(f) in order to effectuate a sale. A recent



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bankruptcy case, *In re Levitt & Sons, LLC*, 384 B.R. 630 (Bankr. S.D. Fla. 2008), identified the split in the case law with respect to whether a sale free and clear of liens must be based upon the aggregate “value” of such liens or aggregate value based upon the “secured” value of the land as follows:

There has been a sharp divide among the courts as to the meaning of the word “value” in § 363(f) (3). A number of courts construe the term “value” to mean the face amount of the lien. Therefore, a sale free and clear of liens cannot be approved unless the sale price exceeds the total amount of debt against the property. See *Matter of Riverside Inv. Partnership*, 674 F.2d 634, 640 (9th Cir. 1982); *In re Heine*, 141 B.R. 185 (Bankr. S.D. 1992); *In re Terrace Chalet Apartments, Ltd.*, 159 B.R. 821 (N.D. Ill. 1993); *In re Julien Co.*, 117 B.R. 910 (Bankr. W.D. Ten. 1990). Other courts construed the term “value” to mean the secured value, and not the face amount of the lien. *In re Collins*, 180 B.R. 447 (Bankr. E.D. Va. 1995).

*Id.* at 648. Cases which provide that Code § 363(f) (3) sales can only occur if the sale price exceeds the aggregate amount of liens include: *In re Riverside Investment Partnership*, 674 F.2d 634, 640 (7th Cir. 1982); *In re Heine*, 141 B.R. 185, 189 (Bankr. D. S.D. 1992); *In re Stroud Wholesale, Inc.*, 47 B.R. 999, 1002 (E.D. N.C. 1992); and *In re PW, LLC (Clear Channel Outdoors, Inc. v. Knupfer)*; 391 B.R. 25, 40-41 (B.A.P. 9th Cir. 2008). Cases which provide that Code § 363 sales can occur only if the sales price exceeds value of the underlying collateral include: *In re Beker Industries Corp.*, 63 B.R. 474, 477 (S.D.N.Y. 1986); *In re Milford Group, Inc.*, 150 B.K. 904, 906 (Bankr. M.D. Pa. 1992); and *In re WPRV-TV, Inc.*, 143 B.R. 315, 320 (D.P.R. 1991), *aff’d.* on other grounds 983 F. 2d 361 (1st Cir. 1993).

### *Compelling a Creditor to Accept Money Satisfaction in an Equitable or Legal Proceeding*

The *Levitt* court also discussed whether sales of property could be approved under Code § 363(f)

(5) if a creditor could be compelled in an equitable or legal proceeding to accept a money satisfaction. The *Levitt* court stated that a sale under Code § 363(f)(5) requires a “money satisfaction” but that this does not require a “full money satisfaction.” *Id.* at 648 (citing *In re Grand Slam U.S.A.*, 178 B.R. 460, 461 (E.D. Mich. 1995)); see also, *In re Gulf States Steel, Inc. of Ala.*, 285 B.R. 497, 505 (Bankr. N.D. Ala. 2002).

The *Levitt* court further stated that the focus of Code § 365(f)(5) is on a “hypothetical sale” and such a sale of assets free and clear of liens may be used so long as a legal or equitable proceeding “might be used,” even if it results in junior lienholders being paid nothing on their liens. *Id.* at 648. The issue raised is whether the hypothetical procedure by which a secured creditor could be forced to accept the sale would allow the “cram down provisions” of Code § 1129(B) to satisfy the requirement that a creditor could be forced into such sale under Code § 365(f) (5).

The issue of what “equitable proceeding” courts could use in order to approve sales under Code § 363(f) (5) was identified and discussed in *In re PW, LLC (Clear Channel Outdoors v. Knupfer)*, 391 B.R. 25 (B.A. P. 9th Cir. 2008). In *Clear Channel*, the property was encumbered by a senior lien of over \$40 million and a junior lien of \$2.5 million. *Id.* at 29-30. At a Code § 363 sale, the senior lender credit bid its loan amount, was the successful bidder, and the bankruptcy court authorized the sale free and clear of liens under Code § 363(f)(5). On appeal, the Ninth Circuit Bankruptcy Appellate Panel (“Ninth Cir. BAP”) held that even though the junior lienholder failed to obtain a stay pending appeal and the transfer of title had occurred, the appeal was not moot because the sale was approved under Code § 363(f) and not § 363(b) or (c). Further, the Ninth Cir. BAP rejected the view that property could be sold under Code § 363(f)(3), and required all sales to be at a price greater than the



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face amount of all liens, not the value of the collateral. *Id.* at 40-41. Finally, the Ninth Cir. BAP remanded the case back to the Bankruptcy Court, refusing to allow the “cram down provisions” of Code § 1129(b) to be used as the “legal or equitable proceeding” to compel the sale without the protection the Code provides to creditors whose claims are to be “crammed down.” *Id.* at 46.

The Ninth Circuit B.A.P. decision is significant in that the mootness provision of Code § 363(m) did not protect the “lien stripping” provision of the bankruptcy court’s order authorizing the sale, and a hypothetical “cram down” provision of the Code cannot be used to approve a sale free and clear of liens under Code § 363(f)(5). *See also, In re: MMH Automotive Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008) (court held that despite Code § 363 sale free and clear of liens, court could fashion remedy to protect known but unrecorded leasehold interest that failed to receive notice of Code § 363 sale). The *Clear Channel* decision has come under increasing criticism, especially its ruling that the appeal was not moot. Levitin, *Ninth Circuit BAP Dressed Down Lien Stripping: Could This Be the Last Dance for 363 Sale?* Vol. 27, No. 8 Am. Bankr. Inst. Journal, 1 (Oct. 2008). Time will tell whether other courts will follow *Clear Channel’s* lead.

### *The “Cram Down Provision”: Code § 1129(B) and its Impact on Confirmation*

Code § 1129(b) sets forth the “cram down provisions” wherein a plan of reorganization may be confirmed over the objecting vote of a class of creditors and the mechanism for “cramming down” the throats of objecting creditors the plan of reorganization. In a typical troubled real estate transaction, the liens on the property will be restructured such that the principal amount of the outstanding loans will be reduced to the value of the underlying collateral. Further, the interest rate will be reset or redetermined pursuant to

federal bankruptcy law. Finally, the payment terms may be extended and such repayment terms may call for negative amortization and other terms that modify a secured lienholder’s rights. Given the current economic meltdown, the severe tightening of credit, and declining real estate values, this section will address various issues dealing with the valuation of collateral, rescheduling of interest rates, and the impact of the cram down scenario.

### *When is a Secured Creditor Impaired?*

A secured creditor has an impaired claim when the contractual rights of the creditor are modified under the terms of the plan. Specifically, Code § 1124 provides that the class of claims is impaired under a plan unless the plan “leaves unaltered the legal, equitable and contractual rights” of the claim holder, or cures any defaults that occurred, or reinstates the maturity date that existed before the default.

### *When is a Creditor a Secured Creditor?*

Code § 506 sets forth a determination of the allowed secured claim, providing that a creditor is secured to the extent of the value of the collateral and unsecured for the balance of its claim. The effect of Code § 506(a) is to bifurcate the secured creditor’s claim into two claims, an allowed secured claim and an allowed unsecured claim. *See, e.g. In re 680 Fifth Avenue Associates*, 156 B.R. 726, 731 (Bankr. S.D.N.Y. 1993), 29 F.2d 3D95 (2d Cir. 1994) (“An undersecured creditor has both a secured claim equal to the value of the collateral and an unsecured deficiency claim for the remainder. If the claim is nonrecourse, the secured creditor’s claim is capped at the value of the collateral....”); *see also In re Toy King Distributors, Inc.* 256 B.R. 1 (Bankr. M.D. Fla. 2000); *In re Feinstein Family Partnership*, 247 B.R. 502 (Bankr. M.D. Fla. 2000). *In re SM 104 Ltd.*, 160 B.R. 202 (Bankr. S.D. FL 1993).



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### Code § 1111(b) Election

Although Code § 506(a) bifurcates a creditor's claims into an allowed secured and unsecured claim, Code § 1111(b)(2) provides that a creditor may elect to have its allowed secured claim be treated as being equal to the full amount of the outstanding loan balance. Code § 1111(b)(2) provides that "if such an election is made, notwithstanding § 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed." An undersecured creditor who makes a Code § 1111(b) election has its claim treated as a fully secured claim in a Chapter 11 case, thereby retaining a lien for the full amount of the claim and to receive payments under the plan equal to the present value of the claim. However, the creditor relinquishes its rights to vote on the plan as an unsecured creditor and to share in the distribution to unsecured creditors. *Wade v. Bradford*, 39 F.3d 1126 (10th Cir. 1994); *In re 680 Fifth Avenue Associations*, 29 F.3d 95 (2d Cir. 1994) (Code § 1111(b) election is available to lienholders, whether or not privity of contract exists between lienholder and the debtor). Further, once the Code § 1111(b) election is made, the creditor cannot withdraw its election unless the plan is materially changed. *In re Keller*, 47 B.R. 725 (Bankr. N.D. Iowa 1985). However, the Code § 1111(b) election cannot be made in cases where the creditor's lien is of inconsequential value. *In re Stanley*, 185 B.R. 417 (Bankr. D. Conn. 1995). Further, the Code § 1111(b) election cannot be made in cases where there is a sale, abandonment, or foreclosure of the underlying collateral. *In re Union Meeting Partners*, 160 B.R. 757, 770 (Bankr. E.D. Pa. 1993).

### Valuation of Collateral

Code § 506(a) states that the value of the asset is to be determined in light of the purpose of the valuation and of the proposed disposition or use of such property. *In re Toy King Distributors, Inc.*, 256 B.R.

1 (Bankr. M.D. Fla. 2000); *In re Argiannis*, 156 B.R. 683 (Bankr. M.D. Fla. 1993). Generally, the value of collateral ordinarily will be the fair market value as opposed to a liquidation value. See *In re VIP Motor Lodge, Inc.*, 133 B.R. 41 (Bankr. D. Del. 1991); *In re Microwave Products of America, Inc.*, 118 B.R. 566 (Bankr. W.D. Ten. 1990); *In re Brinson*, 153 B.R. 952 (Bankr. M.D. Fla. 1992); *In re SM 104 Ltd.*, 160 B.R. 202 (Bankr. S.D. Fla. 1993).

### Date of Valuation

For cram down purposes of confirmation, collateral should be valued as of the effective date of confirmation. See *In re Landing Associates*, 122 B.R. 288 (Bankr. W.D. Tex. 1990); *In re Stanley*, 185 B.R. 417 (Bankr. D. Conn. 1995); *In re Crompton* 68 B.R. 831 (Bankr. E.D. Pa. 1987). Often valuation of collateral becomes a disputed issue in a bankruptcy case and valuation can vary depending on the time the collateral is valued and the purposes of the valuation. Quite often secured creditors will seek a low valuation at the beginning of the case so that such creditors can be deemed "not adequately protected" and may receive adequate protection payments. Conversely, at confirmation secured creditors may seek to argue that the value of the underlying collateral has increased significantly thereby increasing the secured claim of the creditor. Courts may value collateral at different times and in different amounts according to different purposes. See *In re Addison Property Ltd. Partnership*, 185 B.R. 766, 784 (Bankr. N.D. Ill. 1995). Generally, for purposes of confirmation, collateral should be valued at or near confirmation or the effective date. *Id.*, see also *In re Homestead Partners, Ltd.*, 200 B.R. 274, 280 (Bankr. N. D. GA 1996); *In re Delta Resources, Inc.*, 54 F.3d 722, 729 (11th Cir. 1995) (valuations for adequate protection should be determined at or near the petition date); and *In re Monnier Brothers*, 755 F.2d 1336 (8th Cir. 1985) (determined at confirmation or the effective date).



## When Projects Go Bad: Bankruptcy Issues for the Construction Industry

### Determining Interest Rates

Code § 1129(b) requires that a debtor pay its secured creditors deferred cash payments that have a “value, as of the effective date of the plan, of at least the value of such holder’s interest...” 11 U.S.C. § 129(b) (2)(A)(i)(ii). If the plan requires deferred payments to the secured creditor, the debtor must pay interest to the secured creditor because “a dollar in hand today is worth more than a dollar to be received a day, a month, or year hence,” and is to compensate the secured creditor for the time value of money. *In re Ivey*, 147 B.R. 109, 112 (Bankr. M.D. N.C. 1992) (citing 5 *Collier on Bankruptcy*, 91 1129.02, at 1129-83 (15th ed. 1990)); *In re Computer Optics, Inc.*, 126 B.R. 664, 671 (Bankr. D. N.H. 1991).

The key question then becomes what is the interest rate that must be paid to the secured creditor and how is that interest rate determined. Courts have utilized numerous methods for calculating the interest rates to be paid under plans of reorganization. There are at least four (4) methods of determining interest rates. They are the market approach, the risk free approach, the coerced loan, and the formula approach. See e.g., *In re Ivey*, 147 B. R. at 113 (listing various methods for calculating interest rates); *Till v. SCS Credit Corp.* 124 S. Ct. 1951 (2004).

In *Till v. SCS Credit Corporation*, 541 U.S. 465, 124 S.Ct. 1951, 158 L.Ed. 2d 787, (2004), the Supreme Court held that the method for calculating the interest rate to be paid to several creditors on deferred payment was the “formula approach” which involves the national prime rate and adjusting that rate for risk of nonpayment. 541 U.S. at 478. The Supreme Court also cautioned that “the interest rate should be high enough to compensate the creditor for its risk but no so high as to ‘doom the plan.’” If the Court determines that the likelihood of default is too high as to the interest rate to be “eye popping,” the court

should not confirm the plan. *Id.* The Supreme Court has placed the burden on creditors to prove that an upward adjustment to the prime interest rate is required under the facts of any given case, “starting from a concededly low estimate and then adjusting upward places the evidentiary burden squarely on the creditors, more likely to have readier access to any information absent from the debtor’s filing.” *Id.* at 479.

*Till* was a Chapter 13 case and considerable discussion has been had with whether *Till* is binding precedent in Chapter 11 cases. Some courts have ruled that *Till* is not binding. See e.g., *In re Cook*, 322 B.R. 336, 343 (Bankr. N.D. Ohio 2005) (due to the plurality decision and lack of consensus on the rationale, the *Till* case is not binding precedent); *In re Prussia Associates*, 332 B.R. 572, 583 (Bankr. E.D. Pa. 2005) (*Till* is instructive, but it is not controlling, insofar as mandating the use of the “formula approach ... in every Chapter 11 case”); *In re American Home Patient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005) (“we decline to blindly adopt *Till*’s endorsement of the formula approach . . . in the Chapter 11 context”). Other courts have followed *Till*’s formula approach. See e.g., *In re Investment Co. Southwest, Inc.* 341 B.R. 298, 326 (B.A.P. 10th Cir. 2006) and *In re Northwest Timberline Enter, Inc.*, 348 B.R. 412, 431-34 (Bankr. N.D. Tex. 2006), *In re Prussia Assoc.*, 322 B.R. 572, 590-91 (Bankr. E.D. Pa 2005).

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For more information, please contact:

**John Lamoureux**  
[jlamoureux@carltonfields.com](mailto:jlamoureux@carltonfields.com)  
[www.carltonfields.com/jlamoureux](http://www.carltonfields.com/jlamoureux)  
813.239.4224.