By Susan E. Trent

Brookfield: An 1111(b) Issue of First Impression in Seventh Circuit

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One of the greatest aspects of practicing in the area of chapter 11 bankruptcy is the ability and opportunity that it provides to advocate for clients in a creative manner. Whether it is developing a workable reorganization or liquidation plan that is responsive to the needs of a particular industry or circumstance, classifying and impairing creditors, developing pragmatic solutions for liquidating assets, or simply crafting legal arguments, chapter 11 provides lawyers and bankruptcy courts with an opportunity to engage in "academic fun."[1] Bankruptcy courts weigh the particular facts and inventive legal arguments posed by the parties while considering it within the backdrop of the Bankruptcy Code, legislative history, case law and other treatises. This gives the court the ability to craft original and disparate decisions that make for an excellent read, particularly when first-impression issues arise. *In re B.R. Brookfield Commons No. 1 LLC*[2] is a case that reflects the inherent creativity of chapter 11 practice.

Background

ValStone Asset Management LLC succeeded to the rights of a junior mortgage pursuant to the assignment of a claim concerning a shopping center owned by B.R. Brookfield Commons No. 1 LLC and B.R. Brookfield Commons No. 2 LLC (collectively, "Brookfield").[3] The junior mortgage held by ValStone on the shopping center secured a nonrecourse loan.[4] No equity existed for ValStone in the shopping center at the time of the filing of the petition.[5] As a result, Brookfield argued that ValStone's claim should be disallowed and objected to the claim.[6] The narrow issue before the Seventh Circuit was whether or not ValStone's claim should be disallowed under § 1111(b)(1)(A).[7]

Parties Square Off in Seventh Circuit

In addition to seeking disallowance of the claim, Brookfield elected to retain the shopping center as part of its reorganization plan rather than liquidating under § 363.[8] Brookfield contended that neither state law nor § 1111(b) permitted collection on the deficiency balance.[9] Brookfield argued that if the value of the lien was zero, there was simply no entitlement to an unsecured deficiency claim given the nonrecourse nature of the loan.[10]

Not surprisingly, ValStone opposed disallowance of its claim — and asserted that § 1111(b)(1)(A) converted its nonrecourse loan into a recourse loan by operation of law. Therefore, ValStone contended, its unsecured deficiency claim was both allowable and had to be classified and addressed in the plan.[11]

Brookfield advocated its position to the bankruptcy and district courts, both of whom ultimately adopted the arguments offered by ValStone. The persistence of Brookfield, however, was not without reason — for the issue presented was one of first impression in the Seventh Circuit, and controlling law did not exist.[12]

While the Seventh Circuit decision does not expressly explain the pragmatic reasons for Brookfield's vigorous pursuit of its argument, we can certainly speculate on the matter. First, where the amount of the debt vastly exceeds the value of the real estate, Brookfield might simply not have wanted a large, unsecured deficiency claim classified with its other unsecured creditors. It is certainly possible that a significant deficiency lender might control the vote of the unsecured creditors' class, reject the impaired treatment proposed and block confirmation. Ultimately, Brookfield might very well have anticipated both feasibility and thorny classification and/or impairment battles (strategic or artificial depending on one's viewpoint) at confirmation that could have come into play if the claim was not disallowed outright.

Section 1111(b)(1)(A): Room for Interpretation, or Plainly Written?

Section 1111(b)(1)(A) of the Bankruptcy Code reads as follows:

> A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the

1 Many thanks to Reanna L. Kuitse, a new RLW associate and recent Indiana bar admittee, for her assistance with this article.
2 *In re B.R. Brookfield Commons No. 1 LLC*, No. 13-2241, 2013 U.S. App. LEXIS 22385 (7th Cir. Nov. 4, 2013).
3 *Id.* at *1.
4 *Id.*
5 *Id.*
6 *Id.*
7 *Id.* at *4-5; 11 U.S.C. § 1111 (2013).
8 *Brookfield Commons*, 2013 U.S. App. LEXIS at *3.
9 *Id.* at *4.
10 *Id.*
11 *Id.*
12 *Id.* at *5.

holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse....[13]

The Seventh Circuit posited that in its view, the statute was plainly written and that the only express requirement was that the claim "be secured by a lien on property of the estate."[14] The Seventh Circuit stated that its function, given the plain meaning of the statute and lack of any contest regarding the enforceability of the lien, was reduced to enforcement of § 1111(b)(1)(A).[15] However, *how* the Code section should be enforced left room for interpretation.[16] The Seventh Circuit considered two entirely opposed bankruptcy court decisions presented by the litigants that interpreted the enforcement of § 1111(b)(1)(A).[17]

Brookfield Supports Its Enforcement View

The debtor in *In re SM 104 Ltd.* proposed a reorganization plan that separately classified one of its creditors holding a nonrecourse loan and junior mortgage (wholly unsecured) as an impaired class.[18] The particular circumstances made it advantageous for the debtor therein to include the impaired, friendly creditor for voting purposes. Consistent with § 1129(a)(10), the debtor set up a scenario where the friendly, junior lienholder voted to accept its impaired treatment under the plan, thereby setting into motion a cramdown of another, less friendly lienholder. The lienholder that was the target of the cramdown objected.[19]

Not only did the *SM 104 Ltd.* bankruptcy court find that the junior lienholder could not vote as an impaired class, it went further[20] and concluded that the junior lienholder *was not even a creditor*.[21] The court reasoned that because the junior lienholder's claim was wholly unsecured, the amount of its secured claim and lien was zero under § 506(a).[22] As a result, the junior lienholder did not have a "claim secured by a lien on property of the estate" and, furthermore, did not have a § 1111(b) deficiency claim pursuant to § 1111(b)(1)(A).[23]

The *SM 104 Ltd.* bankruptcy court held that § 502(b)(1) prevented the junior lienholder from asserting an unsecured deficiency because of the nonrecourse nature of the loan eliminating a right to payment from the debtor and excepting the junior lienholder from the definitions of "claim" and "creditor" set forth in §§ 101(5) and (10), respectively.[24] The court also held that the junior lienholder did not hold a "claim against the debtor" under § 102(2).[25] The impact of the decision was to render the junior, friendly lienholder's accepting vote in support of confirmation as invalid.[26]

ValStone Substantiates Enforcement Stance

In *In re Atlanta West VI*, the debtor did not recognize a wholly unsecured junior lienholder (holding a nonrecourse promissory note and deed to secure same) as having any claim in its proposed chapter 11 plan.[27] The junior lienholder objected to its treatment under the plan.[28] The debtor and the junior lienholder agreed that if the junior lienholder's objection was sustained by the court, the plan would be rendered unconfirmable.[29] The junior lienholder took the position that § 1111(b) converted its nonrecourse loan to one of recourse; therefore, its claim must be dealt with in the debtor's reorganization plan.[30]

In considering the issue, the *Atlanta West VI* bankruptcy court set aside § 502(b)(1) and opined that § 1111(b) was operative and transformed a nonrecourse claim secured by a lien on property of the estate into a recourse claim.[31] The *Atlanta West VI* court remarked that the only exceptions to § 1111 were in instances where the debtor's property is sold under either § 363 pursuant to the plan, or where a § 1111(B)(2) election is made.[32]

The *Atlanta West VI* bankruptcy court also noted that case precedent dealt with *partially* secured rather than wholly unsecured claims.[33] Those case decisions made it clear that *partially* secured, nonrecourse claims are converted to recourse claims under § 1111(b), and hence, associated deficiency claims must be addressed in the chapter 11 plan put forth by a debtor.[34] The *Atlanta West VI* court ultimately concluded that in the case of a *wholly* unsecured nonrecourse claim, those claims — just like *partially* secured claims — were converted to recourse claims and had to be addressed in any proposed reorganization plan.[35]

In reaching its decision, the *Atlanta West VI* court discussed the history behind the enactment of § 1111(b) — noting that its adoption was a reaction to the result reached in *In re Pine Gate Assocs.*, wherein a debtor used a cramdown strategy to cash out an undersecured creditor for the value of its lien at a time when the real estate market was quite depressed.[36] The *Pine Gate* creditor received only the value of the lien and nothing on its deficiency balance.[37] On the other hand, the *Pine Gate* debtor retained both the benefit of an improving real estate market and the concomitant appreciation in market value.[38] The *Atlanta West VI* bankruptcy court noted that § 1111(b) was implemented by Congress to correct the *Pine Gate* problem and "to restore the benefit of the bargain to the non-recourse secured creditor."[39]

The *Atlanta West VI* bankruptcy court also referred to conclusions drawn in *Collier on Bankruptcy* that opined that "a nonrecourse claimant, holding a wholly unsecured lien, is entitled to the allowance of a recourse unsecured claim in Chapter 11."[40] The court further reasoned that "the existence

13 11 U.S.C. § 1111(b)(1)(A).
14 *Brookfield Commons*, 2013 U.S. App. LEXIS 22385 at *6-7.
15 *Id.* at *7.
16 *Id.*
17 *Id.*
18 *In re SM 104 Ltd.*, 160 B.R. 202, 214 (Bankr. S.D. Fla. 1993).
19 *Id.* at 214-15.
20 *Id.* at 216.
21 *Id.*
22 *Id.*
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.*
27 *In re Atlanta West VI*, 91 B.R. 620, 621 (Bankr. N.D. Ga. 1988).
28 *Id.* at 622.
29 *Id.*
30 *Id.*
31 *Id.* at 623.
32 *Id.*
33 *Id.*
34 *Id.* (citing *In re DRW Property Co.*, 57 B.R. 987, 989-90 (Bankr. N.D. Tex. 1986); *In re Greenland Vistas Inc.*, 33 B.R. 366, 367-69 (Bankr. E.D. Mich. 1983)).
35 *Atlanta West*, 91 B.R. at 623-24.
36 *Id.* (citing *Great Nat'l Life Ins. Co. v. Pine Gate Associates Ltd.*, 2 B.C.D. 1478 (Bankr. N.D. Ga. 1976)).
37 *Atlanta West*, 91 B.R. at 623.
38 *Id.*
39 *Id.* (quoting *In re DRW Property Co.*, 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986)).
40 *Id.* at 623.

continued on page 64

from page 23

of the lien on estate property … triggers the recourse right under Section 1111(b)(1), not the existence of value to secure it."[41] As a result, the *Atlanta West VI* court concluded that the junior lienholder's claim was required to be classified and addressed in the plan.[42]

Seventh Circuit Characterizes *SM 104 Ltd.* as an "Outlier Opinion"[43]

The Seventh Circuit expressed its concern about the existence of the two dissimilar bankruptcy court decisions discussed herein.[44] In order to reach its ultimate decision, the Seventh Circuit also looked to the legislative history of § 1111. The congressional records noted by the Seventh Circuit described § 1111(b)(1) as codifying the general rule that secured claims are to be treated as recourse claims irrespective of the actual agreement and excluding circumstances of sale pursuant to § 363 or via a plan.[45] The Seventh Circuit considered congressional intent wherein Congress was said to have "promulgated § 1111(b)(1)(A) to allow a creditor's loan to surpass the limitations of nonrecourse agreements and state law."[46]

In addition to legislative history and the comment thereto, the Seventh Circuit also found the *Pine Gate* decision troubling and noted that the case "left the creditor with neither full payment of the loan nor the right to foreclose the property, resulting in a windfall to the debtor."[47] The Seventh Circuit also remarked that a nonrecourse creditor, in a state law context, would be allowed to bid and participate in the distribution of proceeds from a sheriff's sale.[48] The nonrecourse nature of the loan would only preclude Valstone from pursuing collection of the deficiency balance against Brookfield if sale proceeds were insufficient to satisfy its second mortgage.[49]

The Seventh Circuit, as did the *Atlanta West VI* bankruptcy court, observed that *Collier's* remarked that the addition of § 1111(b) to the Bankruptcy Code was designed to "strike a balance between the debtor's need for protection and a creditor's right to receive equitable treatment."[50] The Seventh Circuit observed that the judicial valuation of property, even with the use of expert witnesses and opinions supporting values proffered by the respective contestants, deprived a lienholder of the right to bid on the property and realize any upside from subsequent market appreciation.[51] The Seventh Circuit was ultimately persuaded that the judicial valuation specific to chapter 11 was not part of the deal struck between a nonrecourse lienholder and a debtor.[52]

The Seventh Circuit adopted the reasoning of *Atlanta West IV* and found the facts to be analogous as well. The Seventh Circuit expressly held:

> "[U]nder § 1111(b)(1)(A), the existence of a valid and enforceable lien is the only prerequisite for § 1111(b)(1)(A) to apply. Regardless of whether the claim is secured by any value in the collateral, § 1111(b)(1)(A) treats the nonrecourse … claim as if it had recourse" against the Debtor.[53]

As such, the law in the Seventh Circuit is that a wholly unsecured nonrecourse claim may not be disallowed, and must be classified and receive treatment under a chapter 11 plan.[54]

Seventh Circuit Decision: Beginning of an Emerging Issue for Other Circuits?

While the Seventh Circuit has provided clear direction regarding the enforcement of § 1111(b), the two very different bankruptcy decisions from Florida and Georgia that suggest that in the future, courts might continue to be split on this particular issue. Combine these divergent decisions with creative bankruptcy counsel, strategic plan-drafting incentivized by "all-or-nothing" potential confirmation outcomes, and an apparent uptick in the real estate market — and a great deal of § 1111(b) bankruptcy fun may well be ready to ensue! abi

41 *Id.* at 624.
42 *Id.* at 627.
43 *Brookfield Commons*, 2013 U.S. App. LEXIS 22385, at *13.
44 *Id.* at *7-8.
45 *Id.* at *8.
46 *Id.* at *10.
47 *Id.* at *9.
48 *Id.* at *10.
49 *Id.* at *2.
50 *Id.* at *9-10 (citing 7 *Colliers on Bankruptcy* ¶ 1111.03[1][a] (Alan N. Resnick and Henry J. Sommers eds., 16th ed. 2013)).
51 *Brookfield Commons*, 2013 U.S. App. LEXIS 22385 at *10.
52 *Id.*
53 *Id.* at *13.
54 *Id.*