THE RECORDER

BANKRUPTCY

Fighting a cramdown

When debtors attempt to place a secured creditor in a less favorable position, lenders have a way of fighting back

Julia Wei and Henry Chuang

Bankruptcy Law

In the past few years, there have been many bankruptcy debtors taking advantage of the falling real estate prices by utilizing a process known as a "cramdown." The cramdown is available to debtors in a reorganization (Chapter 11, 12 or 13) and can be difficult for lenders to navigate. This article explains the cramdown, how to oppose it, and why creditors might be willing to have their security interest substantially reduced.

Julia Wei and Henry Chuang are attorneys with The Law Office of Peter N. Brewer. The firm serves the legal needs of homeowners, real estate and mortgage brokers, agents, developers, investors, other real estate professionals and their clients. They can be contacted at 2501 Park Blvd., Second Floor, Palo Alto; 650-327-2900 (phone); 650-327-5959 (fax); or on the web at www.brewer-firm.com.

CRAMDOWN BASICS

A cramdown is just as unpleasant as it sounds. It is a two-step procedure in reorganization bankruptcies (usually a Chapter 13, but also available in a Chapter 11 or 12) that "crams down" a lender's secured position. Debtors qualify for one when the property has a loan that is only partially secured. Unlike a lienstrip, which is only applicable when a loan is entirely unsecured, a cramdown is available when the loan is more than the value of the property, but is still partially secured. This is because a cramdown will reduce the value of the loan to only the secured amount and convert the rest of the loan into unsecured debt. The unsecured portion is typically paid out at pennies on the dollar.

For example, if the property is worth $500,000, and there is a first loan for $400,000, a second loan for $200,000, and a third loan for $100,000, the first loan could not be reduced, the second loan would be subject to a cramdown, bifurcated to $100,000 secured and $100,000 unsecured, and the third loan would be subject to a lienstrip motion.

Further, in a Chapter 13, the interest rate itself may be crammed down as well. What would the rate be reduced to? To a formula rate pegged to the risk-free rate, such as the premium rate, with a modest increase to account for the risk of nonpayment. See *Till v. SCS Credit*, 541 U.S. 465 (2004).

In order for a debtor to successfully apply for a cramdown, several conditions must be met. If the cramdown is for real property, the property must be an investment property or second home — a debtor cannot cramdown a loan on his principal residence. See *Nobleman v. American Savings Bank*, 508 U.S. 324 (1993). If the cramdown is of a car loan, the debtor must have owned the car for 910 days before filing for bankruptcy.

If these requirements are met, the borrower must determine the value of the collateral. A debtor will either state a value of the property in the Chapter 13 Plan or will file a motion to value the property pursuant to 11 U.S.C. §506. As the name of the motion implies, the purpose is to set the value of the property at a certain amount — presumably because the value has fallen below the loan amount. Under bankruptcy law, the value of the property is determined as of the date of confirmation the plan.

Once a value of the property is determined, the Chapter 13 debtor must file a plan for reorganization. In the plan, the undersecured debt may be reduced to the value of the property and the interest rate may

be reduced to market rates plus a small risk premium. However, the plan must provide for the full payment of the secured amount within the time allowed in the plan, either three or five years. This can be done either by having a fully amortized loan for that period or a balloon payment where the debtor can demonstrate how the payment will be made.

CREDITORS' DEFENSES

There are several ways to attack a cramdown. The first way is to contest the value of the property. Admissible evidence ranges anywhere from the debtor's opinion of the value to an appraisal of the property. Many times, to save money, debtors will not seek an appraisal or a broker's price opinion, but instead file a declaration with a court stating their own opinion as to the value. If disputed, a creditor's challenge of value based on an appraisal would be more persuasive.

When the debtor and creditor dispute the valuation, the court will set an evidentiary hearing and it can come down to a battle of the experts (appraisers). Even in circumstances where the debtor has procured an appraisal, often times, the appraiser will apply a discount to the value if he or she learns the property is in foreclosure (such as a notice of default having been recorded) and therefore give the property a distressed value. However, under the Supreme Court's decision in *Associates Commercial v. Rash*, the foreclosure value standard was rejected and the court must apply the replacement value standard. See *In re Rash*, 520 U.S. 953 (1997). Accordingly, any discounts applied by the debtor's appraiser must be disregarded by the court.

The second way to attack a cramdown is to show that the debtor's plan is not feasible. In order for a plan to be confirmed, the debtor must demonstrate that he or she can make all of the payments as required by the plan. In a cramdown, this can be especially difficult as the entire secured amount of the loan must be paid back within the plan period. In the original example, this would mean that the debtor would have to pay back $100,000 of the second loan in three or five years. This would require either enormous monthly payments or a balloon payment at the end of the plan. However, courts are generally very hesitant to approve a plan with a large balloon payment even if the debtor agrees to sell the property.

Neither the debtor nor the lender has a crystal ball to see how property values may fluctuate during a three- to five-year bankruptcy. In the present economic climate, there is a desire to believe that prices will rise again. If the debtor who is overly optimistic — planning to sell or refinance the property near the end of the plan — a plan can be challenged for being too speculative. In that circumstance, the next best thing to a crystal ball is an economist expert to challenge the feasibility of the plan if the debtor's plan is based on future values.

Lastly, in a Chapter 11, a creditor can make an 1111(b) election, thereby forcing the debtor to treat the creditor's entire claim as a secured claim for valuation purposes. However, the decision to make the 1111(b) election must be made early, before the end of the hearing on the disclosure statement, unless a later time is set by the court. (Bankruptcy Rule 3014) When the debtor proposes its Chapter 11 plan for reorganization, it can only be confirmed if it is "fair and equitable." For a creditor who has made an 1111(b) election, §1129(A)(i) assures that if the debtor's plan is to keep the property, then the creditor secured by the property will receive deferred cash payments that total the allowed amount of the claim and have a value on the effective date of the plan at least equal to the value of the lien.

For example, if the creditor has a claim of $1 million secured by collateral having a value of $800,000, the creditor must receive payments that total $1 million over time and have a present value of at least $800,000. In exchange, the creditor having made the 1111(b) election waives its voting rights and also waives its potentially valuable recourse rights.

PRACTICAL CONSIDERATIONS

While a successful cramdown will effectively reduce the value of a creditor's loan, it may be in the lender's interest to work with the debtor and consent to a cramdown. However, winning can sometimes be a Pyrrhic victory — the creditor may be forced to foreclose and service the senior lender. This can be undesirable if the creditor is a small junior lienholder (such as a home equity line of credit or private trust deed) behind a mammoth institutional first lienholder.

In that circumstance, having the debtor make payments on any senior loans and some payments on the plan will be the better financial course over foreclosing.

Finally, in order for the cramdown to be completed, the debtor must make all of the plan payments. Failing to complete the plan will restore the loan to its original amount, minus any payments made. Accordingly, lenders who elect to fight the cramdown must weigh the costs of the litigation against the likelihood of debtor's ability to complete the plan and receive a discharge.

The bottom line is that while the Bankruptcy Code provides the debtor with multiple opportunities to set a value, a creditor does not have to passively accept the debtor's valuation and can oppose a cramdown by challenging the value of the property and by disputing the plan.