AN INTRODUCTION TO BANKRUPTCY CODE SECTION 1111(b)

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I.

INTRODUCTION

Section 1111(b) is sometimes regarded as one of the more recondite sections of the Federal Bankruptcy Code.[1] Although its semantics are sometimes complicated, and its true import depends on its relationship to other Bankruptcy Code sections, its concepts are actually quite straight forward. The purpose of this paper is to explain what section 1111(b) provides, and why. From that basic discussion emerges guidance for the practitioner on when to exercise the infamous "Section 1111(b) Election."

II.

SECTION 1111: THE TEXT

In keeping with Justice Frankfurter's view that the first two principles of statutory construction are "read the statute" and "read the statute," here is the text of section 1111(b):

> (b)(1)(A) 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 holder of such claim had recourse against the debtor on

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[1] 11 U.S.C. § 101 et seq. Any citation in the paper merely to a section number means that section of Title 11, United States Code.

account of such claim, whether or not such holder has such recourse, unless –

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if –

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.[2]

III.

A SUMMARY OF SECTION 1111(b)

A. Conferral of Statutory Recourse Claim

In simplest terms, section 1111(b)(1)(A) establishes a general rule that the holder of a secured claim in a chapter 11 case shall have recourse against the debtor for the amount of the claim, even if the holder would *not* have a recourse claim outside of a chapter 11 case. The purpose behind the enactment of section 1111(b) was to protect the rights of non-recourse

[2] 11 U.S.C.A. § 1111(b) (West 2006).

lienholders in Chapter 11 reorganizations."[3] By way of illustration, a secured creditor who waives recourse against its borrower, and who agrees to look only to its collateral for recovery, is still nevertheless given a statutory recourse claim against the borrower if the borrower becomes a chapter 11 debtor.[4] In starkest terms, this means that an undersecured creditor acquires a statutory deficiency claim against the chapter 11 debtor, even if that creditor would otherwise have no such claim. The statute also assures that if the holder already has a recourse claim, that claim is preserved. Another way of summarizing the statute is to say it either preserves *or* confers a deficiency claim, thus assuring that the undersecured creditor will have such a claim.

B. Exceptions to the Statutory Recourse Claim

1. Exception: Property Is Not Retained

However, section 1111(b)(1)(A) establishes two exceptions to the general rule conferring a statutory recourse claim. The easiest exception to understand is actually the second one mentioned in the statute, namely: if the secured claim holder does not have recourse (that is, has no recourse outside of Chapter 11), *and* the property is sold under section 363 or is sold under the plan, then there is no statutory recourse (i.e., deficiency) claim.[5] That means that the statutory recourse claim applies, if at all, *only* if the chapter 11 debtor retains the property under a chapter 11 plan.

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[3] 680 Fifth Ave. Assocs. v. Mut. Benefit Life Ins. Co. (In re 680 Fifth Ave. Assocs.), 29 F.3d 95, 97 (2d Cir. 1994).

[4] See generally, 680 Fifth Ave. Assocs. v. Mut. Benefit Life Ins. Co. (In re 680 Fifth Ave. Assocs., 29 F.3d 95, 97-98 (2d Cir. 1994).

[5] See 11 U.S.C.A. § 1111(b)(1)(A)(ii) (West 2006). Notably, section 363 of the Code deals with the sale, use and lease of property of the estate; section 1125(a)(5)(D) specifically permits sales of property under a chapter 11 plan, as does section 1129(b)(2)(A)(ii).

2. Exception: The §1111(b) Election Is Made

There is a second exception to the statutory recourse claim, and its exception is contained in section 1111(b)(1)(A)(i). In essence, this second exception is that the *class* of claims of which the claim having statutory recourse is a part *may* elect to have the claim treated as secured to the extent allowed. The foregoing is, of course, the infamous "Section 1111(b) Election," (sometimes hereafter, simply, the "Election"), and its significance is discussed in Part IV of this paper.

There are two limitations, or exceptions, governing when the Section 1111(b) Election can *not* be made. The first limitation is when the lien is of "inconsequential value."[6] This limitation follows from the nature of the Section 1111(b) Election, which is to elect to have the *entire* claim treated as secured. Such an election makes no sense if the lien has no value or very little value; indeed, without this limitation, the Election would gratuitously confer secured creditor status upon an unsecured creditor. It should be noted, however, that as long as there is *some* value to the lien, even if it is so inconsequential that the Section 1111(b) Election is unavailable, the statutory unsecured recourse claim is still available because it operates in the absence of the Election.[7]

The second limitation on the Section 1111(b) Election is that the Election is *not* available if the holder has recourse against the debtor, *and* the property (i.e., the collateral) is sold under

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[6] See 11 U.S.C.A. § 1111(b)(1)(B)(i) (West 2006).

[7] In re Stanley, 185 B.R. 417, 427 (Bankr. D. Conn. 1995); In re Atlanta W. VI, 91 B.R. 620, 623-2 (Bankr. N.D. Ga. 1988). See also Collier on Bankruptcy ¶ 1111.03[i][a] (15th ed. rev. 2005).

the chapter 11 plan or under section 363 of the Code.[8] The second limitation also follows from the nature of the Election, which is that the creditor's entire claim is treated as secured *if* the debtor keeps the property *and* the creditor waives any deficiency claim. But this second limitation assumes that the debtor is *not* keeping the property and, further, that the creditor *does* have a recourse (or deficiency) claim. In those circumstances, which are the precisely opposite of those on which the availability Election is predicated, it makes perfect sense for the Election not to be available.

IV.

SIGNIFICANCE AND JUSTIFICATION OF THE SECTION 1111(b) ELECTION

The Election requires that, even though any recourse (deficiency) claim against the estate is waived, the claimant's entire claim, to the extent it is allowed, must be treated as a secured claim under a Chapter 11 plan. Section 1111(b)(2) provides: "[i]f such an election is made, then notwithstanding Section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed".[9] Conversely, if no election is made, the claim remains bifurcated into secured and unsecured portions, the deficiency portion being, of course, unsecured.[10]

[8] See 11 U.S.C.A. § 1111(b)(1)(B)(ii) (West 2006).

[9] 11 U.S.C.A. § 1111(b) (West 2006).

[10] See 11 U.S.C. § 506(a)(1) (West 2006) (providing that an allowed claim is secured to extent of the value of the collateral; the balance is an unsecured claim); In re Gato Realty Trust Corp., 183 B.R. 15 (Bankr. D. Mass. 1995) (noting that by not making the Section 1111(b) Election, a creditor has both a secured claim and a separate unsecured deficiency claim).

A. Significance of the Election: Treatment of Claims Under § 1129

The significance of the Election, however, appears nowhere in Section 1111. Rather, its significance lies in the provisions of §1129(b), which prescribe the minimum treatment that a secured claim must receive if a Chapter 11 plan is to be confirmed, where the plan has not been accepted by the class to which that secured claim belongs.[11] Thus, while the Section 1111(b) Election is sometimes summarized as the waiver of a deficiency claim, it is more analytically helpful to think of it as electing the plan treatment required by section 1129(b)(2)(A).

Section 1129(b)(1) requires confirmation of a plan if all conditions for plan confirmation are satisfied, other than voting acceptance, provided "the plan does not discriminate unfairly and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[12] Section 1129(b)(2), in turn, defines "fair and equitable" as:

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[11] In order to confirm a chapter 11 plan, it is necessary to designate classes of claims and interests. See 11 U.S.C.A. § 1123(a) (West 2006). Classes must consist internally of "substantially similar claims or interests." See 11 U.S.C.A. § 1122(a) (West 2006). At least one impaired class must accept the plan, and each class must either accept the plan or not be impaired by the plan. See 11 U.S.C.A. § 1129(a)(10) (West 2006) and 11 U.S.C.A. § 1129(a)(8) (West 2006). A class accepts if more than two-thirds in amount and one-half in number vote to accept. See 11 U.S.C.A. § 1126(c) (West 2006). There is an interesting issue whether claims eligible for the Section 1111(b) Election may be separately classified for plan purposes. Compare In re Woodbrook Assocs., 19 F.3d 312, 316-17 (7th Cir. 1994) (holding that a Section 1111(b) deficiency claim requires separate classification from general unsecured claims) with Lumber Exch. Bldg. Ltd. P'ship v. Mut. Life Ins. Co. of N.Y. (In re Lumber Exch. Bldg. Ltd. P'ship, 968 F.2d 647, 649 (8th Cir. 1992) (prohibiting the separate classification of a Section 1111(b) deficiency claim from other unsecured claims).

[12] 11 U.S.C.A. § 1129(b)(1) (West 2006). An undersecured creditor who qualifies to make the Section 1111(b) election is one whose property is being retained under the plan and who, therefore, is "impaired" by statutory definition. Section 1124 defines a claim as "impaired" unless the plan leaves unaltered the legal, equitable and contractual rights of the claim holder. See 11 U.S.C.A. § 1124(a)(1) (West 2006). A debtor's retention and use of property under a chapter 11 plan compromises the secured creditor's right of recourse to the collateral and, therefore, impairs it.

> (A) with respect to a class of secured claims, the plan provides --
> (i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
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> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
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> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.[13]

In sum, subsection (A)(i) assures that if the property securing a claim is retained, then the claimant will receive deferred cash payments that both 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 claimant's lien. For example, if the creditor has an allowed claim of $100 secured by collateral having a value of $70, the claimant must receive payments that aggregate $100 over time and have a present value of at least $70.

Of course, subsection (A)(iii) holds open the possibility of providing the "indubitable equivalent of such claim" (whatever that may be) in lieu of the cash payments prescribed in subsection (A)(i). 680 Fifth Ave. Assocs. v. Mut. Benefit Life Ins. Co. (In re 680 Fifth Ave. Assocs.), 156 B.R. 726, 733 (Bankr. S.D.N.Y.), aff'd, 169 B.R. 22 (S.D.N.Y. 1993), aff'd, 29

[13] 11 U.S.C.A. § 1129(b)(2)(A) (West 2006).

F.3d 95 (2d Cir. 1994). Moreover, if a Section 1111(b)(2) Election is made, Section 1129(a)(7)(B) requires that "property" be furnished. Section 1129(a)(7) provides as follows:

> (B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.[14]

Interestingly, despite the unspecified generic "indubitable equivalent" alternative of Section 1129(b)(2)(A) and the generic property requirement of Section 1129(a)(7)(B), research has not unearthed a case where anything other than cash payments have been made to a creditor excercising the Section 1111(b) Election.

It is generally held that when a creditor makes the Section 1111(b) Election, it may not vote on the plan.[15] The rationale seems to be that upon receiving section 1129(b) treatment, the claim is no longer considered impaired.[16] Such rationale is questionable: the fact that the debtor retains the property, thus delaying or preventing foreclosure, seems enough to constitute an impairment under § 1124,[17] even if the statute attempts to confer payments equal to the full value of the lien. And, the rationale seems to get even weaker if the creditor has to give up a recourse

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[14] 11 U.S.C.A. § 1129(a)(7)(B) (West 2006).

[15] Wade v. Bradford, 39 F.3d 1126, 1129 (10th Cir. 1994).

[16] See In re 680 Fifth Ave. Assocs., 156 B.R. at 733 ("under Section 1111(b)(2), a claim is treated as nonrecourse to the full value of the claim. A creditor therefore forfeits his right to vote on the plan because there is no undersecured deficiency claim and the secured claim is unimpaired"). Note that only impaired claims may vote to accept or reject a chapter 11 plan. See 11 U.S.C.A. § 1129(a)(8) (West 2006). By contrast, unimpaired claims are conclusively presumed to have accepted the plan. See 11 U.S.C. § 1126(f).

[17] See note 12, supra.

claim (even if that recourse claim only exists because of the Bankruptcy Code, but even more so if the recourse claim exists outside of chapter 11, for example by reason of contract).

However, the loss of voting rights does not make the creditor exercising the Section 1111(b) Election powerless to influence the plan. Confirmation of a plan requires that "the plan complies with all applicable provisions of this title" [*i.e.*, of title 11].[18] Accordingly, the electing creditor has the opportunity to be heard at the plan confirmation hearing concerning whether the deferred cash value of payments equals the present value of the collateral (*i.e.*, litigate the discount rate) as well as to contest the debtor's ability to make the payment (*i.e.*, litigate plan feasibility). And, in theory, the electing creditor, being a party in interest, may be heard on any other issue relevant to confirmation.[19]

B. Justification For The Election

The treatment mandated by Section 1129(b)(2) is self-evidently driven by the concept of adequate protection – indeed, the provision in subsection (b)(2)(A)(iii) assuring realization of the "indubitable equivalent of such claims" is the quintessence of adequate protection as expressed in the famous Murel Holding case[20] and codified in Section 361.[21] Similarly, subsection

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[18] 11 U.S.C. §1129(a)(1) (West 2006).

[19] See 11 U.S.C. § 1109(b) (West 2006) (noting that a creditor may be heard on "any issue" in a chapter 11 case).

[20] Metro. Life Ins. Co. v. Murel Holding Corp. (In re Murel Holding Corp.), 75 F.2d 941, 942 (2d Cir. 1935). See also generally Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 61 S. Ct. 196, 85 L. Ed 184 (1940), and Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 55 S. Ct. 854, 79 L. Ed 1593 (1935).

[21] Section 361 provides, in relevant part:

(Continued…)

(b)(2)(A)(i)(II) seeks to assure conferring value "on the effective date of the plan" (i.e., present value) at least equal to the value of the lien.[22] In short, Section 1129(b)(2) is designed to assure that if property in which a creditor has a security interest is retained under a plan, then the secured creditor will realize the value of its interest in the property. One might well summarize the Code's scheme as follows: Section 361 is designed to assure preservation of lien value, and Section 1129(b) to assure its realization.

In the absence of the Section 1111(b) Election and thus in the absence of the consequent ability to be treated in accordance with §1129(b), the undersecured creditor would be at enormous risk of becoming a victim of judicial evaluation. Indeed, in the absence of a Section 1111(b) Election, secured creditors often were victims in proceedings under Chapter XII of the Bankruptcy Act of 1898.[23] The following paraphrases and condenses a hypothetical example of abuse given by a notable bankruptcy treatise:

> A debtor partnership owns real property encumbered by a $5 million first mortgage, a $3 million second mortgage and a $2

(Continued…)

> When adequate protection is required . . . such adequate protection may be provided by –
>
> * * *
>
> (3) granting such other relief, . . . as will result in the realization . . . of the *indubitable equivalent* of such entity's interest in such property.
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> [Emphasis added].

[22] 11 U.S.C.A. § 1129(b)(2)(A)(II) (West 2006).

[23] Former 11 U.S.C. § 1, *et seq*., Chapter XII, Real Property Arrangements By Persons Other Than Corporations, was Codified in Former 11 U.S.C. § 801 through § 926.

> million third mortgage. The court values the property at $7.5 million. As a result, a plan is confirmed assuming the first mortgage, trimming the second mortgage to $2.5 million and cancelling the claim on the third mortgage. Post-confirmation, the Debtor sells the Property for more than $7.5 million and keeps all proceeds in excess of $7.5 million.[24]

The foregoing sort of abuse, which really did occur in Chapter XII cases[25] is obviated because of the assurance that a secured creditor will get at least the treatment required by §1129(b). So, the bottom-line answer to, "Why is there an 1111(b) Election" is, "so the secured creditor isn't injured by an erroneous judicial valuation and inadvertently deprived of its constitutionally protected property rights.[26] One court summarized it this way:

> The statute thereby puts the Chapter 11 debtor who wishes to retain collateral property in the same position as a person who purchased property "subject to" a mortgage lien would face in the non-bankruptcy context. Outside of bankruptcy, if the owner wanted to retain the property after the mortgage went into default it would either have to work out a satisfactory resolution of the mortgage with the lender or bid on the property at a public foreclosure sale. Section 1111(b) puts Chapter 11 debtors to the same choice of either paying off the debt or forfeiting the property, and thereby allows the debtor to retain the property and effectuate its reorganization, but without frustrating the lienholder's rights. By giving the lienholder recourse against the debtor personally for the amount of any deficiency, § 1111(b) provides the lienholder the benefit it would otherwise obtain from its nonrecourse loan bargain--i.e., either full payment (or at least a claim against the estate for the full amount of the debt and the ability to vote on the

[24] 7 Collier on Bankruptcy ¶ 1111.03[i][a] (15th ed. rev. 2005).

[25] See e.g. In re Pine Gates Assocs., Ltd., No. B75-4345A, 1976 U.S. Dist. LEXIS 17366 (N.D. Ga. Oct. 14, 1976).

[26] See In re Jones, 152 B.R. 155, 174-75 (Bankr. E.D. Mich. 1993) (noting that the Section 1111(b) election is designed to enable an undersecured creditor to defend itself against the "stripdown" of its lien).

> plan to the extent of its claim), or the right to foreclose and bid on the property at public auction.[27]

V.

WHICH WAY TO CHOOSE?

Section 1111 thus gives an undersecured creditor a choice between retaining a deficiency claim (or having one conferred), on the one hand, versus surrendering that deficiency claim in exchange for having the whole claim treated as secured. The undersecured creditor's heuristic formula is relatively straight-forward: does it get more by bifurcating its claim into secured and unsecured (deficiency) portions, or by having its entire claim treated under §1129(b)(2)(A)? The answer, however, may not be so simple to divine. Not only may an appropriate discount rate be debatable, leaving some question as to the "real" present value of future payments, but the dividend to unsecured creditors may only be known within a broad range (depending, for example, on preference recoveries and the like). Further, the judicial valuation of the secured portion of a bifurcated claim may turn out to be a disappointingly low number (that, of course, being the risk which the Election is designed to obviate). The reality is that a creditor facing the Section 1111(b) Election will seldom have perfect information on which to predicate the decision to elect.

The risks and uncertainties of the Election are somewhat obviated by the timing of the Election, which can be made up until the conclusion of the hearing on the disclosure statement, or such later date as the court may fix.[28] This timing at least gives the creditor an opportunity to

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[27] In re Stanley, 185 B.R. 417, 426 (Bankr. D. Conn. 1995).

[28] See Fed. R. Bankr. p. 3014 (West 2006). Incidentally, the Election belongs exclusively to the creditor and cannot be exercised or forced upon the creditor by the debtor. In re Coventry (Continued…)

examine the debtor's assessment of lien value and of the prospective distribution to unsecured claims as set forth in the proposed disclosure statement. It should be noted that the election, once made, is generally considered irrevocable unless there is a material change in the chapter 11 plan.[29]

It seems to this author, however, that one underutilized approach available to a creditor is to push for a § 506(a)(1) hearing precisely to determine whether to exercise the election.[30] Under Bankruptcy Rule 3012, such a hearing can be triggered by a simple motion at any time.[31]

(Continued…)

Commons Assocs., 155 B.R. 446, 450 (E.D. Mich. 1993). See also Oxford Life Ins. Co. v. Tucson Self-Storage, Inc., 166 B.R. 892, 897 (BAP 9th Cir. 1994).

[29] See, e.g., In re Bloomingdale Partners, 155 B.R. 961 (Bankr. N.D. Ill. 1993).

[30] Section 506(a) provides:

> "(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."

11 U.S.C.A. § 506(a) (West 2006).

[31] Bankruptcy Rule 3012 provides:

> "The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct."

Fed. R. Bankr. p. 3012 (West 2006).

It seems clear that debtors have used such claims defensively in an effort to establish that a lien is of "inconsequential value" rendering the Election unavailable,[32] but it appears to have been little, if ever, used by creditors. More widely invoking § 506 hearings may help the creditor gain both knowledge helpful to deciding whether to exercise the Section 1111(b) Election and perhaps gain more influence over the plan process as well.

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[32] See e.g. In re 500 Fifth Ave. Assocs., 148 B.R. 1010 (Bankr. S.D.N.Y. 1993) (noting that "for purposes of the Section 1111 Election . . ., the collateralized property should be valued as of, or close to, the effective date of the plan, rather than by some speculative and presumptively appreciated future value"), aff'd, 1993 WL 316183 (S.D.N.Y. May 21, 1993).

"RAISING QUESTIONS ABOUT *QUALITECH*"

Copyright, 2004

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INTRODUCTION

In its broadest terms, the *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003) ("*Qualitech*") held that a sale order providing for a sale "free and clear of all liens, claims, encumbrances and interests" extinguished a lessee's possessory interest in property. 327 F.3d at 540. In Bankruptcy Code terms, the holding is that 11 U.S.C. § 363(f) trumps 11 U.S.C. § 365(h).

This paper is entitled, "Raising Questions About *Qualitech*," and it shall do just that - - raise questions, leaving it to the reader to settle upon his or her own answers. That the Seventh Circuit's opinion did not address the questions raised in this paper admittedly can lead to criticism of the opinion's analysis and/or result. Nevertheless, the questions raised below are, the author hopes, interesting in their own right irrespective of whether one agrees with the *Qualitech* decision.

CASE BACKGROUND

A brief description of the *Qualitech* case is as follows. Qualitech Steel SBQ, LLC ("Qualitech"), a chapter 11 debtor, owned and operated a steel mill on a 138-acre tract in Pittsboro, Indiana. 327 F. 3d at 540. Pre-petition, Qualitech had entered into two agreements

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with Precision Industries, Inc. and Circo Leasing Co., LLC (collectively, "Precision"). The first agreement required Precision to construct a supply warehouse and to operate it; the second agreement ("Lease") leased the property under the warehouse to Precision for ten years. Id. This Lease was not recorded. Id.

Following the commencement of its bankruptcy case, Qualitech conducted an auction sale of substantially all its assets. Id. The successful buyer was a group of senior pre-petition lenders that held a senior mortgage on the property. Id. The buyer prevailed with a $180 million credit bid. Id. The sale order provided for the conveyance of assets "free and clear of all liens, claims, encumbrances and interests" except for certain specified liens. Id. at 541 Precision did not object to the order Id. (The Court's opinion is silent whether Precision was served with any motion for entry of the sale order).

The purchaser also acquired the right to assume and assign contracts of the Debtor under 11 U.S.C. § 365. There were post-sale negotiations with Precision which did not lead to an agreement with the result "that Precision's lease and supply agreement were de facto rejected." Id. Precision then found itself locked out, and it commenced a diversity action against the buyer for trespass and wrongful eviction (among other causes of action).

The United States Court of Appeals for the Seventh Circuit held that Precision's possessory leasehold was an "interest" that was extinguished on the face of the sale order, and that Section 363(f) "on its face, authorized a sale free and clear of that interest." Id. at 545. The Court noted that the phrase any "interest", as used in 11 U.S.C. § 363(f) is sufficiently broad to include the lessee's possessory interest. Id. The Court emphasized Precision's lack of objection to the order, and upon the notion that Precision could have sought adequate protection under 11 U.S.C. § 363(e). Id., at 548.

QUESTIONS

1. Section 363(f) Questions

A. What subsections of 363(f), if any, authorized the sale free of the lessee's possessory interest? The Court did not explicitly address this issue. Appendix 1 hereto is an article by Collen, "What do the Subsections of Section 363(f) Really Mean? A primer on Selling Free and Clear of Interests", 6 Jrnl. of Bankr. L. And Practice 583 (1997). That article analyzes each subsection, (f)(1) through (f)(5), in detail, and should be read as background to address the following questions.

B. Re: § 363(f)(1): Does Indiana law permit a sale free of an unrecorded lease? Would a non-disturbance agreement be an effective preventative measure in the future?

C. Re: § 363(f)(2): Was Precision's lack of objection to the sale order "consent"? Did Precision or its counsel know, or should they have known, that the import of the proposed sale order would be to terminate the possessory leasehold interest?

D. Re: § 363(f)(3): Is this subsection inapplicable on its face because a lease is not a lien?

E. Re: § 363(f)(4): Is this subsection inapplicable on the facts because there is nothing in the record to indicate the lease was in dispute?

F. Re: § 363(f)(5): Does an exotic theory apply that just wasn't discussed by the Court? (See attached Collen article)

2. THE Section 363(e) Question

What would constitute adequate protection for the lessee's possessory interest? In principle, can the "indubitable equivalent" of such interest (See 11 U.S.C. § 361) *ever* be achieved, short of a holdover right of the sort provided by § 365(h)?

3. Section 365 Questions

A. *De facto* rejection of the Lease? Have "acts of rejection" been resurrected from pre-Code practice?

B. Where was (is, will there be) court approval of the Lease rejection? See 11 U.S.C. § 365(a).

4. Due Process Question

On the state of Section 363 law existing before the Seventh Circuit's Opinion in *Qualitech*, is notice of an order authorizing sale "free and clear of all liens, claims, encumbrances and interests" reasonable notice that a leasehold interest would be removed (and removed without § 365(h) holdover rights, as well)?

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PART I

Real Property Valuations

I. Understanding Appraisals -- Fee-Owned Property:

A. Cost Approach

1. definition: Focuses upon the cost of rebuilding the improvements plus the cost of land

2. when appropriate: Non-income producing property; unique single use facility; new construction.

3. shortcomings: No necessary correlation between cost and value; difficult to determine depreciation on older facilities.

B. Market Approach

1. definition: Focuses upon comparing the subject property to comparable properties that have recently sold.

2. when appropriate: When there is sufficient available data of market activity.

3. shortcomings: need market data from arms length sales; conclusions are based upon subjective adjustments due to the lack of exact comparability; in a depressed market, how do you deal with a lack of comparable sales? Comparable sales are a lagging indicator: they reflect previous market conditions.

C. Income Approach

1. definition: focuses upon quantifying the present value of anticipated future income.

2. when appropriate: for all income producing property.

3. shortcomings: process uses historical data to assess future value; problem accurately forecasting income stream and occupancy rates; need accurate financial data; subjectivity involved in determining the capitalization rate.

II. Understanding Appraisals -- Leasehold Properties:

A. Valuing Leases: Conduct a present value analysis of the differential between the market rent and the contract rent, over time, adjusting for:

1. Market Conditions: neighborhood, competition, new shopping area, demographics, size, surrounding vacancies, building characteristics, etc.;

2. Property Conditions: store size, configuration, frontage, location in shopping center, location of shopping center, parking, visibility, ingress and egress, etc.;

3. Lease Provisions: including assignment/sublet provisions, renewal options, percentage rent clauses, additional rent clauses, recapture clauses, use clauses, continuous operating clauses, radius restrictions, deed restrictions, REA's etc.;

4. Business Factors: ratio of occupancy costs to sales, four-wall contribution

5. costs of curing defaults;

6. for retail properties, the value of historically high sale's volume;

7. Bankruptcy Benefit: the potential increase in value as the result of the Bankruptcy Court's willingness to allow a debtor to assign a lease and not enforce the "use clause" or other lease covenants against the assignee. (See section below on new bankruptcy code provisions).

B. <u>Risk Factors Affecting Lender when Collateral is a Leasehold Estate:</u>

1. lease may be unassignable;

2. value of lease may be subject to recapture in whole or in part by landlord;

3. permitted use may become untenable;

4. a lease is a wasting asset;

5. existence of collateral is contingent upon borrower-tenant remaining out of default and in good standing;

6. a tenant who is operating under the protections of the Bankruptcy Code may reject its lease, 11 U.S.C. §365(a).

C. <u>Finding Replacement Tenants</u>

1. Factors: Whether you can find a replacement tenant to take the assignment of a lease depends upon a variety of factors. Those factors are, in essence, the same items innumerated in paragraphs II.A above. Particular aspects of some of the items include:

   a. with respect to the market conditions, if there are vacancies in comparable spaces, the marketability of the subject lease depends upon the nature of the vacancies and the concessions being offered by landlords.

   b. with respect to the property conditions, the configuration of some retail space is so specialized so as to severely limited the location's marketablility. For instance, Best Products' locations typically were two stories, with retail on the ground floor and warehouse space above. In the Best Products bankruptcy proceeding, there was nominal demand for their excess space.

c. with respect to lease provisions,

(i) retail leases frequently contain percentage rent clauses. The standards by which percentage rent clauses are established vary by retail industry. In a high value, low margin business such as a supermarket, for example, percentage rent is either set very low or completely avoided. Thus, the terms of the percentage rent clause (namely, breakpoint and percentage) affects the attractiveness and marketability of a lease.

(ii) certain lease provisions which restrict the transferability of leases are typically unenforceable as part of a Section 363/365 sale and assignment of a lease. For instance, insofar as the assignee of a lease frequently needs weeks if not months to renovate, refixture and re-inventory a store, such an assignee would be in breach of a "continuous operating clause" were it to close the store for such renovations. Bankruptcy courts will frequently refuse to enforce, for a reasonable period of time, a "continuous operating clause".

d. with respect to the costs of curing defaults, it is frequently the case in a bankruptcy that the retail-debtor has failed to pay a significant amount of pre-petition rent. The result is often that a substantial portion of the proceeds of sale got to the landlord to cure defaults. If the cure amount exceeds the market value of a lease, whether it makes sense to assume and assign the lease depends upon the size of the rejection claim and the eventual payout to creditors.

D. Goals of Lease Analysis

1. Obtain an understanding of:

   1. what you need to accomplish to restructure successfully the portfolio,

   2. what is the perspective of each landlord:

2. Obtain an understanding of tenant's ability to afford lease settlement costs:

3. Obtain an understanding of whether there is real estate value <u>only</u> achievable in a bankruptcy.

4. Determine possible action:

   1. Sell/assign/sublease
   2. Renegotiate

5. Determine if time spent on valuation is better spent on marketing

III. <u>Beyond The Appraisal:</u>

To be realistic, a valuation should account for or encompass:

A. actual deterioration to the property due to lack of maintenance;

B. availability of financing for:

1. sale to a third party, and/or

2. continued operations/completion of construction;

C. State of title: Have there been surprise transfers? Surprise easement, etc.? A title abstract will describe all liens and encumbrances on title. Additional endorsements will require the abstracter to search the records of regulatory agencies for notices of violations of building codes, fire codes, etc. Frequently, troubled real estate is burdened by tax liens, mechanics liens and judgments. Only by ascertaining the state of title, can one evaluate one's equity position.

D. Engineering Report: Are the buildings and related improvements structurally sound? Are the plans to proceed feasible?

E. Environmental Audit: An environmental audit provides a credible assessment of potential contamination. Contamination affects property values. Clean up costs associated with contaminated real property can exceed what otherwise might have been considered the property's fair market value.

F. Market Factors: What follows are some examples of factors that cause distress and the valuation implications thereof:

1. Overleverage:

   If a property is distressed as the result of being unable to carry its mortgage (which may have occurred because the mortgage loan, when originated, was based upon a projected cash flow that has not been realized), the distress may not be curable without an overall improvement in the market. A conservative projection of cash flow in a current appraisal may lead to the conclusion that a restructuring of the terms of the obligation is appropriate.

2. Industry Difficulty:

   Real estate generally has more value as a going concern than as a liquidated asset. If a troubled property is in a troubled industry, the valuation should be reflective of the fact that there may be a lack of buyers in this marketplace. Consideration should be given in the appraisal to alternative uses for the property.

3. Poor Operations:

   Property that is distressed as the result of poor management and operations can be valued at a price based upon reasonable projected earnings.

4. Location:

   While location is an invariable characteristic, the value of a location can change based upon surrounding circumstances. The addition of a traffic light or curb cuts can make a property more valuable, as can scale events such as the development of new residential areas, the addition of highway exit ramps, etc. The quality of a location has a direct relationship to its value.

PART II

Bankruptcy Code Revisions Affecting Treatment of Non-Residential Real Property Leases

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Bill") will significantly change the way real property leases are treated in a bankruptcy proceeding.

1. Timing To Assume or Reject

    a. Currently 60 days, subject to multiple extensions, frequently until confirmation.

    b. The Bill limits the time to assume or reject to 7 months (210 days).

        i. First 120 days are automatic,

        ii. Additional 90 days for cause,

        iii. Any additional time requires the consent of the landlord.

    c. Observations:

        i. 7 months is not a lot of time, particularly for a retailer with a lot of leases.

        ii. Assumption requires "curing" defaults. Thus, by forcing an "early" assumption, the landlord gets its pre-petition defaults paid quickly and paid in full, while other creditors wait for distributions under a plan.

        iii. Assumption creates administrative liability for remaining rent, subject to new two year cap (as discussed below).

    d. Implications:

        i. Pre-bankruptcy planning becomes more urgent.

        ii. Possibility of more liquidations. Will creditors' committees permit leases to be assumed?

        iii. Consider cash flow consequences of curing defaults.

        iv. Likely decrease in number and value of designation rights transactions.

        v. Increased negotiating leverage of landlords. What concessions will they extract for granting an extension beyond 7 months?

2. Rejection Claim

    a. Currently, upon rejection, landlord's claim capped pursuant to 502(b)(6) formula at 15% of remaining term's rent, not to exceed 3 years.

    b. The Bill provides that upon assumption, if the lease is later rejected, 2 years of rent are an administrative claim and thereafter, the landlord has a 502(b)(6) claim for any remaining rent.

3. Non-Monetary Defaults

    a. Bill clarifies that non-monetary defaults that are capable of being cured with the payment of money are to be cured and the landlord will have an administrative claim for damages.

    b. Bill clarifies that the failure to cure a non-monetary defaults that is incapable of being cured is not fatal to the assumption of the lease.

4. Over-Ruling The *Rickels* Decision

    a. While the Bankruptcy Code currently requires the assignee of a shopping center lease to comply with the "use" clause in the lease, the Court in Rickels found the use clause to be an anti-assignment clause because the market for replacement tenants who fit the use clause was so narrow as to be non-existent.

    b. The Bill makes clear that the assignment of a shopping center lease must not circumvent the use clause or tenant mix in the shopping center.

    c. Implication: Transfers value from the Estate to the landlord.

5. One Year Later – What Has Happened in the Real Estate Market

PART III

RELEVANT PROVISIONS OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

ITEM 1 – TIME TO ASSUME/REJECT A LEASE

CHAPTER 3--CASE ADMINISTRATION
SUBCHAPTER IV--ADMINISTRATIVE POWERS
Sec. 365. Executory contracts and unexpired leases

(d) 4) Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

Sec. 404. Executory Contracts and Unexpired Leases.

Subsection (a) of section 404 of the Act amends section 365(d)(4) of the Bankruptcy Code to establish a firm, bright line deadline by which an unexpired lease of nonresidential real property must be assumed or rejected. If such lease is not assumed or rejected by such deadline, then such lease shall be deemed rejected, and the trustee shall immediately surrender such property to the lessor. Section 404(a) permits a bankruptcy trustee to assume or reject a lease on a date which is the earlier of the date of confirmation of a plan or the date which is 120 days after the date of the order for relief. An extension of time may be granted, within the 120 day period, for an additional 90 days, for cause, upon motion of the trustee or lessor. Any subsequent extension can only be granted by the judge upon the prior written consent of the lessor either by the lessor's motion for an extension or on motion of the trustee, provided that the trustee has the prior written approval of the lessor. This provision is designed to remove the bankruptcy judge's discretion to grant extensions of the time for the retail debtor to decide whether to assume or reject a lease after a maximum possible period of 210 days from the time of entry of the order of relief. Beyond that maximum period, the judge has no authority to grant further time unless the lessor has agreed in writing to the extension.

ITEM 2 – REJECTION CLAIM

CHAPTER 5--CREDITORS, THE DEBTOR, AND THE ESTATE
SUBCHAPTER I--CREDITORS AND CLAIMS
Sec. 503. Allowance of administrative expenses

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including--

(7) with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6);

KEEN REALTY, LLC
KEEN STRATEGIC ADVISORS, LLC

ITEM 3 – CURING NON-MONETARY DEFAULTS

CHAPTER 3--CASE ADMINISTRATION
SUBCHAPTER IV--ADMINISTRATIVE POWERS
Sec. 365. Executory contracts and unexpired leases

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

ITEM 4 – ENFORCEMENT OF "USE" CLAUSE, ETC.

Report of the Committee on the Judiciary House of Representatives to Accompany S. 256 Together with Dissenting, Additional Dissenting, and additional minority views:

Section 404(b) amends section 365(f)(1) to assure that section 365(f) does not override any part of section 365(b). Thus, section 404(b) makes a trustee's authority to assign an executory contract or unexpired lease subject not only to section 365(c), but also to section 365(b), which is given full effect. Therefore, for example, assumption or assignment of a lease of real property in a shopping center must be subject to the provisions of the lease, such as use clauses.