

NINTH CIRCUIT HOLDS PROPER CRAMDOWN VALUATION IS REPLACEMENT VALUE

In an important decision for secured creditors, the Ninth Circuit recently held that the proper “cramdown” valuation of a secured creditor’s collateral is its replacement value, regardless of whether the foreclosure value would generate a higher valuation of the collateral. The appellate court’s decision has the potential to significantly impact lenders that include certain types of restrictions on the use of the collateral (such as low income housing requirements) in their financing documents.

In [*First Southern Nat’l Bank v. Sunnyslope Housing Ltd. P’ship*](#) (*In re Sunnyslope Housing Ltd. P’ship*), No. 13-16180, 2017 U.S. App. LEXIS 9198 (9th Cir. 2017) (*en banc*), the debtor owned an apartment complex in Phoenix, Arizona. The financing for the apartment complex came primarily from an \$8.5 million loan funded by Capstone Realty Advisors, LLC (“Capstone”), which was secured by a first priority deed of trust. The Capstone loan was guaranteed by the United States Department of Housing and Urban Development (“HUD”).

As a condition to receiving the funding, the debtor agreed to a series of agreements and restrictive covenants that required the apartment complex be used as low income housing. In 2009, the debtor defaulted on the Capstone loan. As guarantor, HUD took over the loan and sold it to First Southern National Bank (“First Southern”) for \$5.05 million. The agreement that memorialized the loan sale confirmed that the property remained subject to all other “covenants, conditions, and restrictions.” In other words, the low income housing requirements remained in effect.

First Southern later began foreclosure proceedings and an Arizona state court appointed a receiver. The receiver agreed to sell the apartment complex to a third-party for \$7.65 million. However, before the receiver’s sale could close, the debtor filed a chapter 11 petition. The chapter 11 plan of reorganization pursued by the debtor sought, over First Southern’s objection, to (i) retain and use the apartment complex, and (ii) pay First Southern’s claim in full over 40 years, at an interest rate of 4.4%, with a balloon payment at the end.

Section 1129(b)(2)(A) of the Bankruptcy Code permits a plan to be crammed down over a secured creditor’s objection where the plan provides that the secured creditor will retain the lien on its collateral and will receive payments over time equal to at least the present value of the amount of its secured claim. Accordingly,

the central issue at confirmation was the value of First Southern's collateral, *i.e.*, the apartment complex.

Not surprisingly, the parties' experts disagreed over the valuation of the apartment complex and thus the amount of First Southern's secured claim. More specifically, the parties disagreed whether the property should be valued assuming its continued use with the low income restrictions in place as contemplated by the debtor's plan or assuming a foreclosure and removal of the low income restrictions. The parties agreed that if the property was foreclosed upon and the low income restrictions were removed, the value of the property (its foreclosure value) would be significantly higher.

Ultimately, the bankruptcy court confirmed the plan and valued the apartment complex (and thus First Southern's secured claim) at the use contemplated by the plan, *i.e.*, with the low income restrictions in place. First Southern appealed and the district court affirmed. A divided panel of the Ninth Circuit reversed and held that the apartment complex should have been valued without regard to the low income housing restrictions. A majority of the judges on the Ninth Circuit voted to hear the case *en banc*.

The primary issue considered by the Ninth Circuit on review was whether the bankruptcy court erred by valuing the apartment complex assuming its continued use after reorganization as low-income housing. The Ninth Circuit began by analyzing the Supreme Court's opinion in *Assocs. Comm. Corp. v. Rash (In re Rash)*, 520 U.S. 953 (1997). In *Rash*, the Supreme Court concluded that section 506 of the Bankruptcy Code requires a court to use the replacement value rather than foreclosure value when valuing collateral for purposes of cramdown. The Ninth Circuit held that under *Rash*, cramdown collateral should be valued by the proposed disposition or use in the plan of reorganization and that the proper replacement value is the price a third-party would pay to obtain like property being used in that manner.

The Court rejected First Southern's argument that property should be valued at its highest and best use, which, in this case, would be the value derived from a foreclosure that resulted in no low income housing restrictions. Instead, the Ninth Circuit adopted a literal reading of *Rash* by holding that it expressly rejected the use of foreclosure value in cramdown valuations. In doing so, the Ninth Circuit pointed to section 506(a)(1)'s reference to a reorganization plan's "proposed disposition and use." The Ninth Circuit further explained that the Supreme Court implicitly rejected the notion that collateral should be valued at its highest and best

use by acknowledging that foreclosure value is “typically” lower and still not adopting a standard that would have required a court to use the higher of replacement or foreclosure value.

Notably, Judge Kozinski filed a dissent which was joined by Judges O’Scannlain and Friedland. In his dissent, Judge Kozinski took the majority to task for a ruling that “fetishizes the Court’s words at the expense of its logic.” Judge Kozinski focused on the Supreme Court’s instruction that cramdown valuations are supposed to limit a secured creditor’s risk, and concluded that he would have held that the appropriate value is the market price of the building without reference to the low income housing requirements.

Regardless, the implications of this decision for secured creditors may be significant. Because replacement value typically results in a higher valuation than foreclosure value (the opposite of the case here), *Rash* has not typically been challenged. However, the Ninth Circuit’s opinion clearly rejects the idea that cramdown is meant to necessarily result in the highest valuation of a secured creditor’s collateral. As a result, secured lenders should use care to ensure that they do not fall into a situation where foreclosure value may be higher than replacement value because of restrictive covenants like those at issue in *Sunnyslope*.