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From the Bankruptcy Courts: Loans From Shareholders During Chapter 11 Case Prime Existing Undersecured Mortgagees

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LOANS FROM SHAREHOLDERS DURING CHAPTER 11 CASE PRIME EXISTING UNDERSECURED MORTGAGEES

In today's depressed real estate market, it is not uncommon for owners of commercial property who are facing foreclosure to seek protection under chapter 11 of the Bankruptcy Code (the Code). The automatic stay under Section 362 of the Code gives the debtor breathing room to attempt to negotiate a consensual reorganization plan with mortgagees and other creditors. However, the absence of equity above the existing mortgages renders it difficult, if not impossible, to obtain new financing for repairs, maintenance, and renovations that may be needed to return the property to a profitable venture.

A possible source of new financing may be the existing shareholders of the debtor corporation. Of course, shareholders may make new equity investments in the debtor. However, one of the most controversial and unsettled issues in the bankruptcy field today is whether the "absolute priority rule" set forth in Section 1129(b) of the Code is violated if (1) a chapter 11 plan provides that shareholders making new capital contributions will continue to own the reorganized debtor and (2) the plan is "crammed down" against an unwilling class of creditors receiving less than full payment of their claims. The viability of this "new value exception" to the absolute priority rule has been called into question by many courts, including the U.S. Supreme Court.[1]

Another way that shareholders may invest in the debtor is to provide new financing in the form of loans. However, a different question may arise as to whether shareholders making a new loan to the debtor, instead of a capital contribution, may obtain a senior lien on the property that primes existing mortgagees who are already undersecured. When does Section 364(d), which

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[1] See, e.g., Northwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988); Kham & Nate's Shoes No. 2 v. First Bank, 908 F.2d 1351 (7th Cir. 1990); In re Drimmel, 108 Bankr. 284, (Bankr. D. Kan. 1989). Compare, e.g., In re Woodscape Ltd. Partnership, 134 Bankr. 165 (Bankr. D. Md. 1991); In re 222 Liberty Assocs., 108 Bankr. 971 (Bankr. ED Pa. 1990).

permits the granting of senior liens to new lenders, permit shareholders to prime mortgagees? Can the interests of existing mortgagees be adequately protected? Does the granting of a senior lien to a shareholder run afoul of the absolute priority rule that is mandated by Section 1129(b) of the Code? A recent case that focuses on these issues is *In re 495 Central Park Avenue Corp.*[2]

The Facts

The primary asset of the debtor, 495 Central Park Avenue Corp., is real property located in Scarsdale, New York, where the debtor has leased space to various commercial tenants. The debtor had acquired the premises in April 1991 subject to an existing $3.95 million mortgage held by John Hancock Mutual Life Insurance Company. Although the debtor did not assume the promissory note held by John Hancock and the seller remained liable on the note for any deficiency in the event of a foreclosure, the debtor nonetheless had to pay the mortgage to avoid foreclosure. In addition, the debtor gave the seller cash and a purchase money mortgage of $200,000 that was subordinate to John Hancock's mortgage.

The debtor defaulted on the first mortgage and, as a result, John Hancock accelerated the balance of the debt, which totaled approximately $3.94 million, and commenced foreclosure proceedings in state court in August 1991. The foreclosure was stayed when the debtor filed a chapter 11 petition in September.[3]

The debtor filed a motion in bankruptcy court requesting an order permitting it to obtain credit under Section 364(d) of the Code, either from its two shareholders or from third-party lenders supported by personal guarantees of the shareholders, and permitting the new lenders to obtain a security interest senior to all existing mortgages. The amount of the new credit would be approximately $650,000.

John Hancock opposed the debtor's motion and at the hearing before the bankruptcy judge argued that the debtor had failed to demonstrate that the requirements of Section 364(d)[4] had been met. John Hancock also argued that "the motion should be denied because subordination of its position would violate 11 U.S.C. § 1129(b) which provides that secured claims are

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[2] *In re* 495 Central Park Ave. Corp., 136 Bankr. 626 (Bankr. S.D.N.Y. 1992).

[3] See 11 U.S.C. § 362(a).

[4] 11 U.S.C. § 364(d) provides that:

> (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—
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> (A) the trustee is unable to obtain such credit otherwise; and
>
> (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
>
> (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection."

entitled to priority over junior claims."[5] The second mortgagee did not oppose the motion.

The Need for New Financing

At the hearing, one of the shareholders, who also is the president of the debtor, testified that borrowing money was necessary to make structural changes in the building to attract new tenants. Additionally, two of the debtor's primary tenants were experiencing financial difficulties and were paying rent that was substantially lower than the market rate. The leases of these primary tenants had expired and they were continuing to occupy the premises on a month-to-month basis paying rent that was less than the rent required under the expired leases. This substantial decrease in the rental income of the debtor had caused a significant depreciation in the value of the building. Appraisers for both parties testified that the low rental income generated by the building contributed to the decline of its market value.

The president also testified that the owner of a chain of furniture stores that operated in New York City expressed serious interest in renting space in the building. The agent for the furniture retailer stated in a letter that they were prepared to enter into a 15-year lease for a portion of the space that one of the two primary tenants was occupying, but the debtor would be required to spend $62,000 towards the cost of constructing a functional retail store; the new tenant would invest the rest of the $250,000 needed for store construction costs. However, additional renovations to the building would also be required at the debtor's expense. The debtor also would be required to grant the tenant rent-free occupancy for the first seven months, which is customary in the current economic climate.

Inability to Obtain Financing

The president of the debtor testified concerning his efforts to borrow money on behalf of the debtor from various financial institutions to fund the cost of renovations. Every bank he approached had refused to lend the debtor money despite the shareholders' offers to guarantee the debt personally. This testimony was supported by the testimony of a bank commercial loan officer, who was certified as an expert in commercial lending practices under the Federal Rules of Evidence.[6] The loan officer testified "that, in his opinion, all legitimate financial institutions would refuse to lend the debtor money because such a loan would be junior to Hancock's secured position." He explained that "banks ordinarily demand a first position on commercial real estate

[5] 136 Bankr. at 628.

[6] Rule 702 of the Federal Rules of Evidence provides: "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training or education, may testify thereto in the form of an opinion or otherwise."

loans and that a junior lien or an administrative priority simply will not suffice.''[7]

Testimony on Valuation

The debtor's real estate appraiser, employing the income approach to valuation that is based on the net income that the property was currently producing, concluded that the building was presently worth $2.25 million. However, he also testified that if the debtor invested $625,000 to renovate the property, the value of the building would increase immediately to $3.5 million based on the current discounted value of the increased rental income that he predicted would be generated during the next seven years. His estimate was that the building would be worth $4 million in three years and $5 million in five years. John Hancock's appraiser, also employing the income approach to valuation, testified that the building was presently worth $2.2 million and after the proposed renovations it would be worth approximately $2.8 million.

Both experts agreed that if improvements to the property were made with the proposed borrowed funds, the property would increase in value. The disagreement was only with respect to the extent of the increase.

Requirements Under Section 364(d)

Section 364(d) permits the court, under certain circumstances, to approve postpetition financing granting the new lender a lien that is senior to existing liens.

> The first prong of 11 U.S.C. Section 364(d) requires the debtor to show that alternate financing is unavailable. Because super priority financing displaces liens on which creditors have relied in extending credit, the debtor must demonstrate to the court that it cannot obtain financing by other means. The Bankruptcy Code permits a debtor to borrow money in various ways less onerous to secured creditors.[8]

These various ways include giving the lender (1) an unsecured administrative expense claim with priority status under Section 507(a)(1) of the Code; (2) an unsecured administrative expense claim that is senior to all other administrative expense claims; and (3) a junior lien.[9] Only after the debtor has exhausted all efforts to obtain financing by any of these various means is Section 364(d) available to grant the lender a lien that is senior or equal to existing liens.[10]

The court was persuaded that, apart from granting a senior lien under Section 364(d), the debtor was not able to obtain credit. ''Section 364(d)(1) does not require the debtor to seek alternate financing from every possible lender. However, the debtor must make an effort to obtain credit without priming a

[7] 136 Bankr. at 629.

[8] *Id.* at 630.

[9] See 11 U.S.C. § 364.

[10] See U.S.C. § 364(d).

senior lien."[11] The debtor's president had made such an effort, but no one was willing to lend the debtor money as an administrative expense, as an expense senior to all other administrative claims, or secured by a lien junior to Hancock's mortgage. Moreover, the debtor could not obtain financing secured by a lien on unencumbered property because there was no property in the estate that had not already been subject to a lien.

Adequate Protection

The second prong of Section 364(d) requires the debtor to show that the interests of holders of existing liens on the property are adequately protected. The Code does not expressly define adequate protection, but Section 361 sets forth examples. The court stated that these illustrations are not exclusive, and that a broad and flexible definition is suggested by Section 361(3), which provides that adequate protection may be satisfied by "granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."[12]

The court commented that the goal of adequate protection was to safeguard the secured creditor from diminution in the value of its interest during the chapter 11 reorganization.[13] To determine whether John Hancock was adequately protected, the court had to consider whether the value of the debtor's property would increase as a result of the renovations funded by the proposed financing. Although the appraisers disagreed as to what the value of the building would be following the infusion of $650,000, the court found that the proposed improvements would probably cause the property to increase in value to approximately $3 million. That represents an increase of $800,000 over the $2.2 million current appraised value according to John Hancock's appraiser.

> In light of the fact that the projected property improvements to be made with the requested credit will exceed the $650,000 loan, it follows that Hancock's secured interest will be adequately protected after the approval of the proposed $650,000 senior loan. . . . In effect, a substitution occurs in that the money spent for improvements will be transferred into value. This value will serve as adequate protection for Hancock's secured claim.[14]

Absolute Priority Rule Does Not Apply

The court also rejected John Hancock's argument that Section 1129(b) prevents the debtor's shareholders from injecting new value

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[11] 136 Bankr. at 631.

[12] 11 U.S.C. § 361(3).

[13] The court cited Bank of New Eng. v. BWL, Inc., 121 Bankr. 413, 418 (D. Me. 1990); *In re* Beker Indus. Corp., 58 Bankr. 725, 736 (Bankr. S.D.N.Y. 1986).

[14] 136 Bankr. at 630–631.

in the property and maintaining an ownership interest. "This section essentially provides that a plan of reorganization may not be confirmed if it unfairly discriminates or is not fair and equitable with respect to each class of claims. Under the statute, a plan may not be confirmed if a holder of claim or interest that is junior to the claim of a nonconsenting secured class would receive property on behalf of its claim before senior claims are fully repaid."[15]

The court observed that the Code does not provide for a "new value exception" to the absolute priority rule, but that several courts have recognized such an exception. "Under the exception, a plan may be confirmed when equity holders contribute new capital to retain an ownership interest in the reorganized debtor."[16] John Hancock urged the court to follow those decisions that have rejected the new value exception to the absolute priority rule.[17] However, the court rejected Hancock's argument as being irrelevant to the debtor's motion.

> Whether or not the new value concept is an exception to the absolute priority rule is an issue which need not be addressed in the context of a motion for senior credit pursuant to 11 U.S.C. § 364(d). The absolute priority rule is a confirmation standard which does not apply to a preconfirmation contested matter involving a debtor's request to obtain senior credit. If the debtor is unable to obtain credit without giving a senior or equal lien as security, the debtor may obtain credit secured by a senior or equal lien in accordance with § 364(d) only if the holders of senior or equal liens on the property are adequately protected. In such case, the critical issue is adequate protection and not absolutely priority.[18]

Conclusion

The bankruptcy court in *495 Central Park Avenue* granted the debtor's motion for authority to borrow money from its shareholders and to give the loan senior priority status that primes the existing first mortgage of John Hancock. Although courts are not in agreement on the viability of the new value exception to the absolute priority rule, it is clear that courts may permit shareholders who provide postpetition financing that improves the value of the debtor's property to obtain senior lien status if existing liens are

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[15] *Id.* at 632.

[16] *Id.* The court cited *In re* Woodscape Limited Partnership, 134 Bankr. 165 (Bankr. D. Md. 1991).

[17] John Hancock urged the court to follow the opinion of the court of appeals in Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture, 948 F.2d 134 (5th Cir. 1991), in which the court, in dictum, rejected the new value exception. On petition for rehearing a majority of the three-judge panel withdrew that portion of its original opinion that commented on the new value exception. Circuit Court Judge Edith Jones, who wrote the original opinion, dissented and reaffirmed her position rejecting the "new value exception."

[18] 136 Bankr. at 632.

adequately protected.[19] The essence of the court's holding was that the absolute priority rule applies only in the context of confirmation of a plan and that it is unrelated to the rights of shareholders as postpetition lenders.

[19] Compare Weintraub & Resnick, "Equitable Subordination of the Postpetition Financer and the Use of Shareholder Guarantees to Escape the Absolute Priority Rule: Lessons from the Seventh Circuit," 24 U.C.C.L.J. 400 (Spring 1992).