Nonrecourse Claimants Have A Claim In Bankruptcy

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In the matter of B.R. Brookfield Commons No. 1 LLC, the Seventh Circuit recently confirmed that Bankruptcy Code Section 1111(b)(a)(A) treats an otherwise nonrecourse loan as a recourse loan in bankruptcy, regardless of whether there is any equity in the property securing that loan, and the lender is entitled to a claim in bankruptcy.[1] Accordingly, Bankruptcy Code Section 1111(b)(1)(A) breaks from the traditional confines of bankruptcy law by telling courts to ignore state law and nonrecourse agreements as a protection to nonrecourse creditors who would otherwise be left in the cold where a judicial valuation of the property serving as their collateral is less than the value of their claim.[2] The effect of § 1111(b)(1)(A) is that an otherwise nonrecourse debt outside of bankruptcy is treated as recourse for purposes of a bankruptcy claim, and a nonrecourse creditor may elect to retain its unsecured deficiency claim against the estate.

The specific issue on appeal to the Seventh Circuit in the matter of Brookfield was whether an otherwise nonrecourse claim secured by a lien on property of the debtor should be disallowed in the debtor's bankruptcy case when there was no equity in the subject property to secure such claim at the time of the bankruptcy filing. While it was undisputed that the claim was secured by a valid lien against the property, the value of the property was expected to be less than the amount of the first mortgage on the same property, leaving the subject claim completely unsecured. The debtor objected to the secured lender's unsecured claim, arguing that because its claim was based on a nonrecourse loan and there was no equity in the subject property securing that loan, neither state law nor § 1111(b)(1)(A) allowed the creditor to pursue a deficiency claim against the debtor.[3] The creditor, on the other hand, argued that based on the plain language, § 1111(b)(1)(A) treats a nonrecourse claim as if it had recourse, and its unsecured deficiency claim should be allowed.[4]

Bankruptcy Code § 1111(b)(1)(A) provides that the holder of "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 account of such claim, whether or not such holder has such recourse. ..."[5] Relying on the plain language, the Seventh Circuit held that the subject loan must be treated as a recourse loan for purposes

of the debtor's Chapter 11 reorganization and its deficiency claim cannot be disallowed.[6] Specifically, the court held that under Section 1111(b)(1)(A), the existence of a valid and enforceable lien is the only prerequisite for Section 1111(b)(1)(A) to apply.[7] Regardless of whether the claim is secured by any value in the collateral, Section 1111(b)(1)(A) treats the nonrecourse claim as if it had recourse against the debtor.[8]

The court, noting that interpretation of Section 1111(b)(1)(A) is an issue of first impression in the Seventh Circuit, examined the scarce authority on this issue.[9] Indeed, only two prior bankruptcy court decisions addressed the exact issue under § 1111(b)(1)(A). The debtor relied on In re SM 104 Ltd., 160 B.R. 202, 216 (Bankr. S.D. Fla. 1993), where the bankruptcy court interpreted Section 1111(b) to disallow a creditor's nonrecourse claim completely because it was unsecured by any value in the collateral.[10] The secured creditor relied on In re Atlanta West VI, 91 B.R. 620 (Bankr. N.D. Ga. 1988), where the court held that a claimant holding a completely undersecured third lien on commercial property was still entitled to a claim in the bankruptcy case.[11] The court was persuaded by Atlanta West, which unlike in SM 104, examined the legislative history of Section 1111(b) and the plain meaning in determining that the "statute does not require that the lien on the property be secured by actual value" in order for the creditor to have a claim.[12]

The court also conducted an independent analysis of the intent behind Section 1111(b), holding that the purpose behind the addition of Section 1111(b) was to "strike a balance between the debtor's need for protection and a creditor' right to receive equitable treatment."[13] The court explained that, once a bankruptcy is filed, a nonrecourse creditor may lose the benefit of its bargain when the collateral is valued as part of the bankruptcy process.[14]

The decision ultimately means that the only prerequisite for a nonrecourse creditor to be entitled to a claim in a bankruptcy is the existence of a valid lien against estate property. The holding is significant in that it protects the holder of a claim secured by a lien on property of the estate when the value of its collateral is determined insufficient to repay that claim in full, or at all. The practical effect of the decision is that debtors must treat such nonrecourse claims as recourse claims under their reorganization plans and equity holders cannot retain their junior interests unless such senior secured claims are paid in full.

By so holding, the Seventh Circuit confirmed a protection for secured lenders under Section

1111(b)(1)(A) of the Bankruptcy Code that does not exist outside of bankruptcy. The court also created an obstacle for debtors and their equity holders looking to step over such nonrecourse creditors in the plan confirmation process.

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Foley & Lardner LLP represents the assignee of the secured lender discussed above.

[1] In re B.R. Brookfield Commons No. 1 LLC ("Brookfield"), 735 F.3d 596 (7th Cir. 2013).

[2] A "nonrecourse loan" is defined by the court in Brookfield as a loan that "limits a Creditor to look only to the Debtor's collateral for repayment." Id. at 2, citing Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 438 (1999).

[3] Id. at *3-4.

[4] Id. at *3.

[5] 11 U.S.C. § 1111(b)(1)(A) (emphasis added).

[6] Brookfield, 735 F.3d at *7.

[7] Id. at *13.

[8] Id.

[9] Id. at *5.

[10] Id. at *12.

[11] Id. at *11.

[12] In re Atlanta West VI, 91 B.R. at 624.

[13] In re B.R. Brookfield, 735 F.3d at *10, citing to 7 Collier on Bankruptcy ¶ 1111.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013).

[14] Id. at *8.