No. 17-455

IN THE

Supreme Court of the United States

FIRST SOUTHERN NATIONAL BANK,
Petitioner,

v.

SUNNYSLOPE HOUSING LIMITED PARTNERSHIP,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTRODUCTION 1

I. THERE IS A CIRCUIT SPLIT 3

II. THE DECISION BELOW IS INCORRECT 5

III. THE QUESTION PRESENTED IS IMPORTANT, AND THIS CASE IS A PERFECT VEHICLE FOR RESOLVING IT 10

CONCLUSION 11

TABLE OF AUTHORITIES

CASES

Page(s)

Associates Commercial Corp. v. *Rash*, 520 U.S. 953 (1997) 1, 5, 6, 7

Czyzewski v. *Jevic Holding Corp.*, 137 S. Ct. 973 (2017) 8

In re Bell, 304 B.R. 878 (Bankr. N.D. Ind. 2003) 3

In re Donato, 253 B.R. 151 (M.D. Pa. 2000) 3

In re Metromedia Fiber Network, Inc., 416 F.3d 136 (2d Cir. 2005) 11

In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935) 7

In re One2One Communications, LLC, 805 F.3d 428 (3d Cir. 2015) 11

In re Transwest Resort Properties, Inc., 801 F.3d 1161 (9th Cir. 2015) 11

In re Winthrop Old Farm Nurseries, Inc., 50 F.3d 72 (1st Cir. 1995) 3

In re Young, 367 B.R. 183 (Bankr. N.D. Cal. 2007) 3

RadLAX Gateway Hotel, LLC v. *Amalgamated Bank*, 566 U.S. 639 (2012) 8

United Air Lines, Inc. v. *Regional Airports Improvement Corp.*, 564 F.3d 873 (7th Cir. 2009) 3, 4

TABLE OF AUTHORITIES—Continued

Page(s)

STATUTES AND LEGISLATIVE MATERIALS

11 U.S.C.
§506 .... 5, 6
§1111 .... 8, 9
§1129 .... 2, 7, 8, 9

S. Rep. No. 95-989 (1978) 3

OTHER AUTHORITIES

7 *Collier on Bankruptcy* (16th ed.) 9

INTRODUCTION

There is a clear split of authority on the question whether the Bankruptcy Code allows a debtor to keep a secured creditor's collateral under a plan of reorganization and pay the secured creditor *less* than the creditor would realize in a foreclosure sale. The en banc Ninth Circuit's decision permitting that result broke with the Seventh Circuit and reflects a wider division of authority among the lower courts. Respondent's effort to dismiss this split as "fabricated" (Opp. 14) blinks reality.

Moreover, the question is exceptionally important. The Ninth Circuit's holding that a plan may force a secured creditor to accept less than foreclosure value undermines the foundations of Chapter 11's protections for secured creditors. And it has obvious practical effects on Chapter 11 practice and on the credit markets. The filings in this Court by retired bankruptcy judges, bankruptcy scholars, and bankers' association amici confirm this case's importance and the need for this Court's review.

Respondent's defense of the Ninth Circuit's decision only underscores that need. Echoing the Ninth Circuit's misreading of *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953 (1997), respondent urges that Chapter 11 allows a debtor to keep a secured creditor's collateral under a plan, even if that leaves the secured creditor worse off than it would be in foreclosure. That turns the relevant provisions of the Bankruptcy Code on their head. Outside bankruptcy, secured creditors are entitled to be paid in full or take their collateral. And the Code has always guaranteed secured creditors at least what they would receive outside bankruptcy: the value their collateral would realize in a foreclosure sale. Although Chapter 11's cramdown provisions permit a debtor to keep a secured creditor's collateral—thus preventing the creditor from foreclosing and selling the property—it can do so only if it provides the secured creditor with at least the equivalent "value." §1129(b)(2)(A)(i)(II).[1]

Respondent entirely fails to grapple with that fundamental point. Respondent stresses that, absent foreclosure, the property is subject to use restrictions that limit its market value. But that does not change what the Bankruptcy Code requires. Chapter 11 debtors may choose to keep a secured creditor's collateral and use it in a way that makes it less valuable than it would be in foreclosure. But Chapter 11 does not—in any scenario—permit the debtor to force the secured creditor to bear the cost of that choice. However desirable a reorganization might be for the debtor or other stakeholders, the Code has never required secured creditors to pay for it. The Ninth Circuit's decision flouts that basic principle. And none of respondent's other arguments in defense of the Ninth Circuit's decision have any more merit.

Finally, the doctrine of equitable mootness presents no "vehicle problem." By definition, "equitable mootness" is not Article III mootness and is not jurisdictional. Rather, it is a prudential doctrine bearing only on the appropriate remedy on appeal. If this Court grants review, it can leave respondent's equitable-mootness argument for consideration on remand, where the Ninth Circuit will surely reject it again, as the panel did, following established circuit precedent.

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[1] Statutory citations are to the Bankruptcy Code (11 U.S.C.), unless otherwise noted.

I. THERE IS A CIRCUIT SPLIT

Respondent argues that the split of authority is "fabricated" because the Seventh Circuit's rule requiring at least foreclosure value is "dictum." Opp. 14-15. As an examination of the Seventh Circuit's decision and the broader disagreement among the lower courts demonstrates, that is wrong.

There is clear disagreement as to whether foreclosure value is the minimum entitlement of secured creditors in Chapter 11. The First Circuit has stated that "forced sale liquidation value will be [the] minimum." *In re Winthrop Old Farm Nurseries*, 50 F.3d 72, 74 (1st Cir. 1995) (quoting S. Rep. No. 95-989, at 54 (1978)) (emphasis omitted). Other courts have held, to the contrary, that "*Rash* … mandates" that a creditor receive only the collateral's "replacement value," even if that is "lower than the foreclosure value." *In re Young*, 367 B.R. 183, 190 (Bankr. N.D. Cal. 2007). *See also, e.g., In re Donato*, 253 B.R. 151, 155-156 (M.D. Pa. 2000) (*Rash* requires only lower value of collateral as used in plan, not value reflecting collateral's highest and best use); *In re Bell*, 304 B.R. 878, 881 (Bankr. N.D. Ind. 2003) (*Rash* requires valuing collateral at its highest and best use, not lower-value use in plan); Pet. 18-19.

In *United Air Lines* v. *Regional Airports Improvement Corp.*, 564 F.3d 873 (7th Cir. 2009), the Seventh Circuit sided with the view that foreclosure value is a secured creditor's minimum entitlement. It thus reversed the bankruptcy court's valuation of the collateral, which valued airport-terminal space as unimproved space based on the rent the debtor was paying ($17 a square foot), because the secured creditor could have realized the collateral's higher market value as improved space in foreclosure. "A price for unimproved space does not measure the value of the collateral. If the Lender foreclosed and took over the space, it could rent the gates to United or some other airline at more than $17 a square foot—at perhaps four times that much[.]" *Id.* at 876-877.

Respondent contends (Opp. 14-15) that the Seventh Circuit's reference to foreclosure value is dictum because the space the debtor used actually was improved. Not so. The Seventh Circuit held that collateral's value may not be based on a debtor's idiosyncratic arrangement reflecting a lower-value use when foreclosure value, which by definition reflects the economically highest and best use, is greater. Its analysis focused on what the secured creditor, "were it to take over United's gates"—through foreclosure—"and rent them out, could … get." *United*, 564 F.3d at 877; *see also id.* at 878 (discussing amount trustee could rent space for "after foreclosure"). The court did not need to determine the exact amount because "[a]ny potential rental price higher than $30 would make the collateral worth at least $60 million," the amount owed to the secured creditor, and the creditor could realize at least $30 per foot in foreclosure. *Id.*[2] The secured creditor was entitled to no less in bankruptcy.

That holding cannot be reconciled with the Ninth Circuit's holding below. In the Seventh Circuit, a secured creditor in petitioner's position would have been entitled to the $7.65 million its collateral would have realized in foreclosure, and the plan approved by the Ninth Circuit could not have been confirmed. The

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[2] Respondent's attempt (at 15) to distinguish foreclosure value from "market price," and its insistence that the Seventh Circuit focused only on the latter, make no sense. As the Seventh Circuit recognized, foreclosure value is a *floor* for the market price.

Ninth Circuit, however, permitted the debtor to keep petitioner's collateral and pay petitioner approximately half the collateral's foreclosure value, creating a square circuit split that reflects the broader division of authority among the lower courts.

II. THE DECISION BELOW IS INCORRECT

Respondent defends the Ninth Circuit's decision by arguing that §506(a) and *Rash* required the court to value petitioner's collateral as the debtor's plan proposed to use it, for low-income housing. Opp. 9-14. But §506(a) does not require the court to value collateral according to the particular "use" the plan proposes when the collateral has an economically higher-value use, and the secured creditor could realize that higher value by foreclosing. Rather, §506(a)'s direction to value collateral in light of its "proposed disposition or use" looks to which "[cramdown] alternative the debtor chooses"; hence, "use" simply "distinguishes retention from surrender." *Rash*, 520 U.S. at 962. And *Rash* held that when the debtor chooses retention, the proper measure of value is fair-market value, which is defined not by the use to which the *debtor* chooses to put the property, but by the use to which a *buyer* could put the property. Fair-market value might be *higher* than foreclosure value, *see id.* at 958, but, by definition, it cannot be less. Here, the collateral's market value was far greater than the $3.9 million petitioner received under the plan: A buyer agreed to pay $7.65 million for the property in the foreclosure proceedings. Pet. 14.[3]

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[3] Respondent suggests that First Southern will receive "more than … foreclosure value" (at 27) and will "profit" (at 3) because the plan pays it $8.5 million (the note's face value) over time. That fails Economics 101. First Southern could realize $7.65 million

Respondent nonetheless argues that the property was correctly valued as used as affordable housing because that was the property's only permissible use. Opp. 10-14. That is wrong. As respondent acknowledges, the servitudes restricting the property's use to affordable housing terminated upon foreclosure. Pet. App. 5a-6a. There is no dispute that Sunnyslope could have consented to foreclosure and sale of the property and thus realized the foreclosure value for the bankruptcy estate. That is not to say that Sunnyslope was required to consent to foreclosure—it was within the debtor's rights to reorganize as it did. But the Code does not permit Sunnyslope to impose the economic cost of its choice on its secured creditor; rather, the cramdown provisions entitle the creditor to at least what it would have received outside bankruptcy. Pet. 24.

Equally flawed is respondent's insistence that *Rash* "rejected" foreclosure value as secured creditors' minimum entitlement. Opp. 10-13. *Rash* "rejected" foreclosure value because the secured creditor was entitled to *more*; §506(a)'s establishment of "use" as a valuation benchmark evidenced Congress's intent that secured creditors are entitled to the "generally higher" fair-market value of their collateral when reorganization enhances its value. 520 U.S. at 958, 960, 962-963. Nothing in *Rash* remotely suggests that secured creditors can be given *less* than foreclosure value. To the contrary, *Rash* emphasized that its reading of §506(a) *protected* secured creditors, since a higher market valuation would help "offset the[] risk[]" that if the debtor retains the collateral and then defaults, the secured creditor

now in foreclosure, while the $8.5 million stream of payments has a *present* value of only $3.9 million.

may receive "'less … than in a prompt foreclosure.'" *Id.* at 958, 960, 962-963; Pet. 10-12, 21-24.

Indeed, respondent's basic notion that "the very purpose of the plan is to prevent a foreclosure sale" (Opp. 12) has it exactly backwards. Chapter 11 mandates that foreclosure value is a secured creditor's minimum entitlement *because* the plan deprives the creditor of its right to foreclose. The Code's purpose in staying foreclosure is not to give secured creditors less, but to give the bankruptcy estate (and thus creditors) more, by maintaining the business as a going-concern and realizing a "reorganization surplus" over foreclosure value. The fundamental principle embodied in Chapter 11's secured-creditor protections is that a secured creditor who is not paid in full may not be deprived of its right to foreclose and get "at least the property" securing its claim, except by a "substitute of the most indubitable equivalence." *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). Where that right is not enforced in kind, it is respected in substance with the economic equivalent: deferred payments with a present value equal to the "value" of the collateral. §1129(b)(2)(A)(i)(II); Pet. 5-10, 24-28.

Respondent argues this "value" can be less than foreclosure value because *another* cramdown alternative—clause (iii)—requires the "indubitable equivalent of a foreclosure sale." Opp. 26. That proves just the opposite. The cramdown provision protects secured creditors by guaranteeing treatment under one of three economically equivalent alternatives. §1129(b)(2)(A)(i)-(iii). That foreclosure value is unquestionably the minimum required under the "indubitable equivalent" alternative (and also—by definition—the sale/credit-bidding alternative) demonstrates that Congress intended no less when the debtor chooses to keep the collateral. Indeed, *RadLAX* rejected a nearly identical argument that a secured creditor could be given less protection under one cramdown alternative than that required by another. *RadLAX Gateway Hotel* v. *Amalgamated Bank*, 566 U.S. 639, 643-647 & n.2 (2012).

Respondent's argument that reorganization should benefit all parties—and that it could therefore pay First Southern less so junior creditors could recover more—is also meritless. Opp. 22-23. It is settled law—and this Court recently reaffirmed in unequivocal terms—that the Code does not permit a debtor to take value from a senior creditor to give it to junior creditors. §1129(b)(2); *Czyzewski* v. *Jevic Holding Corp.*, 137 S. Ct. 973, 983-987 (2017).

Finally, respondent points to §1129(a)(7)(A), which requires a plan to pay creditors at least what they would receive in a Chapter 7 liquidation. Respondent argues that First Southern could have obtained foreclosure value by invoking §1129(a)(7)(A), but supposedly "waived" this right because §1129(a)(7)(A) does not apply to secured creditors who elect to be treated as fully secured under §1111(b). §1129(a)(7)(B). Accordingly, respondent argues, First Southern was entitled only to the purportedly lower "replacement value" under the cramdown provision. §1129(b)(2)(A).

That is wrong. *Both* provisions—§1129(a)(7)(A) *and* the cramdown provision in §1129(b)(2)(A)—require that the secured creditor be paid at least foreclosure value. Where they differ is in the treatment of *unsecured deficiency claims*.

To take an example: In Chapter 7, if the collateral of a secured creditor owed $10 million is sold for $7 million, the creditor will receive the full $7 million. It will also have an unsecured deficiency claim for the remaining \$3 million. If the estate has sufficient unencumbered value to pay unsecured creditors 50% of their claims, the creditor will receive another \$1.5 million, resulting in a total Chapter 7 distribution of \$8.5 million.

In Chapter 11, the creditor may choose to have its entire claim treated as secured under §1111(b). If it does so, it must be paid the full \$10 million and must retain its lien until it is paid in full, but the debtor may pay the \$10 million in deferred payments having a present value equal to the value of its collateral—\$7 million. §1129(b)(2)(A)(i). The benefit of invoking §1111(b) is that, if the collateral's value increases after plan confirmation, the secured creditor can potentially realize some of that appreciation. For instance, if the collateral were sold for \$12 million after plan confirmation, the creditor's lien would allow it to collect the full \$10 million immediately. In return for this benefit, however, a secured creditor who invokes §1111(b) waives its right to any unsecured deficiency claim. In this example, therefore, the creditor's total (present-value) distribution in Chapter 11 is \$7 million.

It makes perfect sense that §1129(a)(7)(A) is unavailable to a creditor who chooses to be treated as fully secured under §1111(b). Otherwise, the secured creditor could defeat confirmation by arguing that it would receive more in a Chapter 7 liquidation than under the Chapter 11 plan—in this example, \$8.5 million (\$7 million for its secured claim and \$1.5 million for its unsecured deficiency claim). That result would be inconsistent with the basic purpose of §1111(b), which allows a creditor to be treated as fully secured only if it relinquishes its unsecured deficiency claim. *See, e.g.*, 7 *Collier on Bankruptcy* ¶1111.03[5] (16th ed.).

Chapter 11 does not force secured creditors to choose between foreclosure value and something less; it forces them to choose between an unsecured deficiency claim and the prospect of benefiting from the collateral's potential appreciation after bankruptcy. Here, First Southern chose the latter, but by doing so it was in no way giving up its right to a secured creditor's basic entitlement—the foreclosure value of its collateral.

III. THE QUESTION PRESENTED IS IMPORTANT, AND THIS CASE IS A PERFECT VEHICLE FOR RESOLVING IT

Respondent contends this case does not warrant review because it presents "unique" circumstances in which the collateral's value as the debtor proposes to use it is lower, not higher, than foreclosure value. Opp. 18. But as discussed, courts have regularly confronted that circumstance since *Rash* and have divided on the proper outcome. Pet. 16-19. And, as the amici's submissions underscore, the issue is significant. Law Professors' and Bankruptcy Judges' Amici Br. 4 (question's "systemic importance … will affect the Chapter 11 process and conduct of secured lending throughout the United States"); Arizona Bankers Ass'n Amicus Br. 19-20 (Ninth Circuit's decision "does not serve the housing market, the HUD system, or in the long run, debtors in bankruptcy as a whole"); *id.* 5-19 (explaining impact on HUD). The question here—whether secured creditors can receive less in bankruptcy than out of it—could hardly be more fundamental to Chapter 11 practice. And it is no less important to the broader credit markets, which depend on clear and uniform bankruptcy rules when underwriting and pricing loans.

Nor is there any "vehicle problem" (Opp. 27-32). If this Court grants review, it will not need to address "equitable mootness," a doctrine this Court has never adopted and whose validity has been repeatedly questioned. *See In re One2One Commc'ns*, 805 F.3d 428, 439-446 (3d Cir. 2015) (Krause, J., concurring). Contrary to respondent's suggestion (at 29), equitable mootness is not Article III mootness. *See In re Transwest Resort Props.*, 801 F.3d 1161, 1167 (9th Cir. 2015). It is a judge-made prudential doctrine under which appellate courts abstain from hearing appeals from plan confirmation when they deem it inequitable to grant relief. Pet. 19. As a prudential doctrine bearing only on the remedy, it need not be resolved before the merits. *In re Metromedia Fiber Network*, 416 F.3d 136, 144 (2d Cir. 2005). It can be addressed on remand.

In any event, there is no colorable equitable mootness argument here. Respondent contends that the appeal is equitably moot because parties to the bankruptcy proceedings have made investments in reliance on the order confirming the plan. But purported "reliance" on a nonfinal order by a party with notice of the appeal cannot possibly justify denying relief to an appellant with a meritorious claim. Indeed, binding Ninth Circuit precedent so holds; the panel relied on that precedent in rejecting respondent's equitable-mootness claim; and the en banc court never questioned that holding. *Transwest*, 801 F.3d at 1169-1170; Pet. App. 10a, 19a n.5, 33a-38a, 48a n.1. There is no bar to this Court's review.

CONCLUSION

The petition should be granted.

Respectfully submitted.

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