

Chapman Client Alert

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Current Issues Relevant to Our Clients

Not Everything You Bargained For? Ninth Circuit Holds that a Secured Creditor Holding a Non-Recourse Mortgage is Barred from Asserting a Deficiency Claim Following the Foreclosure of the Collateral

11 U.S.C. § 1111(b)(1)(A) provides that a creditor holding a non-recourse lien on real property possesses a claim against a debtor's bankruptcy estate upon the filing of the bankruptcy petition. The purpose of this provision is to give some protection to non-recourse secured creditors from the risk of their collateral being undervalued by the bankruptcy court in a section 506(a) valuation. Secured creditors holding recourse claims have some protection against that risk, because an undervaluation would give them a larger deficiency claim, and the undersecured creditor could then vote its deficiency claim against and object to a proposed plan if it is not "fair and equitable" (for example, if the plan either (a) does not propose to make distributions with a present value of at least the amount of their unsecured deficiency claim or (b) proposes to make any distributions to junior classes or allow prepetition equity interests to remain in place). Section 1111(b)(1)(A) gives secured creditors holding non-recourse claims access to this same protection.

But what happens to the secured creditor's non-recourse claim when the property securing the loan has been sold via foreclosure? Can the creditor still utilize Section 1111(b) of the bankruptcy code to assert a claim against the debtor's bankruptcy estate? The U.S. Court of Appeals for the Ninth Circuit recently answered with a resounding no in *In re Salamon*.¹

In *Salamon*, buyer purchased a piece of real property (the "Property") from seller that already had two senior liens recorded against it. To fund the purchase, rather than paying cash at closing, buyer executed two promissory notes in favor of seller (the "Notes"), the terms of which required buyer to make monthly payments to an entity designated by seller, who would then make monthly payments to the senior lienholders.

Seller subsequently filed a chapter 11 bankruptcy petition, and, two years thereafter, buyer filed a bankruptcy petition. The trustee of seller's bankruptcy estate filed a proof of claim in the buyer's bankruptcy case for the two liens secured by the Property. The bankruptcy court later approved a stipulation between buyer and one of the senior lienholders that lifted the automatic stay and allowed the senior lienholder to foreclose on the Property. The Property was later sold through the foreclosure process.

After the Property was sold, the trustee of seller's bankruptcy estate received a check for the balance of the foreclosure proceeds, which satisfied one of the Notes but left a deficiency on the other. The trustee of seller's estate then filed an amended proof of claim in the buyer's bankruptcy case in the amount of the deficiency. Seller filed a motion for an order to disallow the amended claim, claiming that because the Property was no longer a part of the buyer's estate a recourse lien could not exist. The bankruptcy court granted the motion, finding that seller's non-recourse claim could not be transformed into a recourse claim under section 1111(b).

On appeal, the Ninth Circuit affirmed, holding that § 1111(b)'s requirement for a creditor to hold a "claim secured by a lien on the property of the estate" means that if a creditor's claim ceases to be secured by a lien on property of the estate, the creditor can no longer "transform" a non-recourse claim into a recourse claim.

Analyzing the plain language of § 1111(b), the court found that the statute "cannot apply if the lien does not exist." Because the Property was sold at a foreclosure sale during the course of buyer's bankruptcy case, which extinguished all liens on the Property, there was no basis for seller to make a claim against buyer's bankruptcy estate. The court noted that the seller was left with "what he bargained for" in the non-bankruptcy context. That is, the senior creditor's foreclosure of the

Property extinguished seller's junior liens and left seller without recourse to pursue a deficiency judgment against buyer. Allowing seller to assert a deficiency claim against buyer would have improperly afforded him more rights in bankruptcy than he would otherwise have under California law. In closing, the court also mentioned that seller could have objected to the senior lienholder's lifting of the automatic stay to permit the foreclosure sale if it was concerned that seller's rights would not be adequately protected, but failed to do so.

In light of the Ninth Circuit's holding in *Salamon*, holders of non-recourse junior liens should be cautioned that they cannot rely on § 1111(b) if the collateral securing the indebtedness is sold during the pendency of the borrower's bankruptcy case.

For More Information

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¹ *In re Salamon*, 15-60031, 2017 WL 1404194 (9th Cir. Apr. 20, 2017).

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