'Let The Lender Beware!": The Surrender Of Commercial Real Estate Collateral In Chapter 11 'Dirt For Debt' Bankruptcy Plans

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Over the last several years, lenders have experienced an increasing number of defaults on loans secured by commercial real estate. More defaults are likely in the near future as loans made at the height of the real estate and economic "bubble" reach maturity but are financially "underwater" and no longer eligible for new or extended credit, even if they have never been in default.

Faced with mounting losses, and perhaps even foreclosure, many borrowers with "underwater" loans are turning to bankruptcy in an attempt to achieve a structured reorganization in order to salvage whatever they can. In a bankruptcy reorganization pursuant to Chapter 11 of the United States Bankruptcy Code ("Code"), the debtors typically negotiate with their creditors and attempt to reach a mutually agreeable plan of reorganization. Oftentimes these negotiations are unsuccessful, as the debtor and creditors are unable to agree on how the creditors' claims should be treated.

In these situations, the debtors may attempt to "confirm" their plans of reorganization over the objections of their creditors. A growing trend for debtors that have no ability or incentive to keep property is to propose to surrender all or part of the commercial real estate to the secured lender in satisfaction of the lender's claims.

These so-called "dirt for debt" or "partial dirt for debt" plans raise a number of issues for lenders and can result in lengthy plan confirmation battles. After all, lenders are not in the business of holding, developing, marketing, or selling real estate . They are financial institutions, not developers, that negotiated for payment from revenue and, only in the dreaded event of a foreclosure, the right to quickly reduce their collateral to payment with the right to sue for the remaining deficiency, if any. Through dirt for debt plans, debtors often seek to alter or eliminate the lender's rights without adequate compensation.

The Bankruptcy Code

The Code imposes numerous requirements that must be met before Chapter 11 reorganization plans can be confirmed, and the debtor bears the burden of proof on each requirement. For instance, the plan must provide creditors with at least as much compensation as the creditors would receive in a bankruptcy pursuant to Chapter 7 of the Code where all of the debtor's non-exempt assets are either liquidated by the bankruptcy trustee or immediately surrendered to creditors holding liens.

If a creditor rejects a debtor's proposed plan, then the debtor must demonstrate that the plan is "fair and equitable" as to that creditor. The debtor bears the burden of introducing evidence of its current financial situation, assets, and liabilities sufficient to satisfy the bankruptcy court that the proposed plan will provide the creditor with at least as much compensation as it would receive in a liquidation.

"Fair and Equitable"

The debtor's proposed plan must be "fair and equitable" with respect to each class of lenders. One way a plan may satisfy the "fair and equitable" requirement is by providing the lender with the "indubitable equivalent" of its claim. To make a determination that a creditor will be provided with the indubitable equivalent of its claim, the court must have no doubt that the lender will receive consideration equal in value or amount to its claim.

A Question of Value

Although lenders routinely accepted real property as security for their loans prior to the "Great Recession," they generally did so with the express understanding and comfortable assumption that, in the event of a default, they could foreclose on the collateral and quickly reduce their claim to a cash payment. Three generations of lenders (and everyone else) had come to the irrefutable conclusion that the value of real estate only increased over time!

But now, in the "new normal," a secured lender acquiring its collateral through a dirt for debt plan has little option but to market and sell the collateral at considerable risk.

The issue in dirt for debt cases ultimately boils down to the value of the collateral the debtor proposes to surrender. The debtor must either surrender all collateral to a secured lender or demonstrate that the portion of the collateral being surrendered will fully compensate the lender for the value of its claim. The "indubitable equivalent" standard considers whether the lender's proposed treatment under the plan is completely compensatory and also the likelihood the lender will receive payment.

Of course, by surrendering collateral, the debtor shifts all risk of loss to the secured lender. For example:

- The lender will be required to incur holding, sales, development, and marketing costs, yet will not receive any proceeds unless and until it is able to sell the collateral at some uncertain future date.
- The amount of cash the lender can expect to receive will be largely speculative.
- Depending on the particular real estate market, there may be substantial delays and risks associated with the lender's attempted sale of the collateral.
- The market may be saturated with more desirable properties, with insufficient buyers (and lack of available financing) to absorb that surplus within a reasonable time.
- The lender may end up marketing the collateral for sale in direct competition with the debtor who continues to market and sell properties it has retained.

It is obvious that these risks are exacerbated where the real estate market in question is depressed and is saturated with more attractive properties, and also where the debtor proposes to retain a portion of the collateral to sell and market in direct competition with the secured lender.

Type of Valuation Required

The Code requires consideration of a debtor's proposed disposition or use of the property regardless of the Chapter of the Code under which the bankruptcy petition was filed. For example, when the debtor opts to avoid foreclosure and liquidation and retain the property in the plan, a "replacement-value" standard is appropriate in order to fairly compensate the secured lender for the deprivation of its immediate value and for the lender's exposure to the attendant risks of the plan (e.g., the risk of the debtor's future default and the risk of collateral depreciation).

Bankruptcy courts struggling with partial dirt for debt plans have found that the assets proposed to be surrendered to secured lenders should be valued conservatively and that those values should be scrutinized carefully. Unfortunately, conservative valuations are difficult, if not impossible, in an uncertain and troubled real estate market where considerable doubt exists as to the value of the property to be surrendered. In such a market, a dirt for debt plan rarely offers the creditor the "indubitable equivalent" of its claim unless the appraised value of the property, demonstrated by competent proof, far exceeds the amount of the debt to be paid.

Factors to be considered in a conservative approach to valuation include:

- Development costs;
- Completion costs;

- The sell-out period needed in order to convert the value of the property to cash;
- The holding costs including, but not limited to, accruing taxes, costs of insurance, maintenance costs, entitlement compliance costs, and stormwater and erosion control maintenance;
- Absorption rates specific to the collateral and the location;
- Competition with similar development property;
- Disposition costs associated with a bulk sale; and,
- Any other factor that would detract from the value of the collateral.

These considerations are necessary to produce a conservative valuation that accounts for the heightened risk of error inherent in valuations of this nature and in order to properly protect the secured lender from the risks associated with dirt for debt plans.

Conclusion

"Dirt for debt" cases force secured lenders to: (i) incur considerable risks and costs in holding and marketing their collateral over a prolonged period of time in the hope that they can sell the collateral for an amount equal to the present value of their secured claims; and/or (ii) take a substantial loss upon a bulk sale of the collateral in an effort to produce an immediate, but partial, cash payment on their claim.

Dirt for debt plans typically, but often in today's saturated market unreasonably, predict that the secured lender will be able to accomplish what the debtor could not: sell the collateral in a weak, oversaturated market for an amount sufficient to fairly compensate the lender. As a result, secured lenders faced with proposed dirt for debt bankruptcy plans should be proactive in seeking an appropriate collateral valuation that accurately reflects the risks and burdens associated with the plan.

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