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Reconciling “Dirt-for-Debt” Plans with “Indubitable Equivalent” Standard

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The indubitable equivalent requirement for confirmation of a chapter 11 plan is found in §1129(b)(2), and its satisfaction is a necessary prerequisite to finding that a proposed plan provides for the “fair and equitable” treatment of a particular secured creditor. The upshot of an indubitable equivalence finding is that a plan, even though it does not provide a secured creditor with full payment of its claim or with all of its collateral, does nevertheless provide that creditor with the *value* of its secured claim. Value, of course, is decisive in these circumstances.



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Bankruptcy attorneys know that judicial valuation is an absolute necessity under the Bankruptcy Code, and that evidence can almost always support a reasonable estimate of value. The current instability in real estate markets, however, is making valuation of real property collateral an uncertain exercise.

One context in which the indubitable-equivalent standard and the increasingly inexact nature of real property valuation collide head on is in a “dirt for debt” chapter 11 plan. As developers and other holders of vast amounts of real estate find themselves looking to chapter 11 for relief from the current deflationary real estate market, dirt for debt plans are becoming more common as debtors have fewer

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means to implement a chapter 11 plan—and for good reason. These plans, if confirmed, allow debtors to hand over less than all of a secured creditor's collateral while satisfying the entire secured claim. In the mid- to late 90s, this was fine, as real estate values were stable and a bankruptcy court could make a reasonable finding that a portion of a creditor's collateral *did* provide the creditor with the indubitable equivalent of its claim. However, with real estate values now steadily decreasing, and with our ability to ascertain value severely enfeebled, such findings are all but impossible.

debtor contends that the conveyance will satisfy the mortgagee's secured claim in full. Five, the debtor seeks to retain the remainder of the collateral free and clear of the mortgagee's interest.”¹ A dirt-for-debt plan is not facially invalid.²

Indubitable Equivalence



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The question of whether a chapter 11 plan may be confirmed over the objection of a secured creditor depends on whether the plan provides for “fair and equitable” treatment of that secured creditor's claim. 11 U.S.C. §1129(b)(1). In the dirt-for-debt context, the “fair and equitable” issue turns on whether the secured creditor is deemed to receive the “indubitable equivalent” of its secured claim. 11 U.S.C. §1129(b)(2)(A)(iii).³

Feature

Dirt for Debt

A dirt-for-debt plan is one in which a chapter 11 debtor attempts to convey secured collateral to a secured creditor in full satisfaction of the creditor's claim. “Such plans share five generic characteristics. One, the debtor contends that the mortgagee is oversecured. Two, the debtor proposes to force the mortgagee to accept a conveyance of property comprising less than 100 percent of the mortgagee's collateral. Three, the debtor relies on the bankruptcy court's valuation of the collateral in order to determine the amount of collateral to convey. Four, the

A conveyance by a debtor of all of a secured creditor's collateral to the creditor provides the creditor with the indubitable equivalent of its claim. As famously stated by the Fifth Circuit Court of Appeals in *Sandy Ridge Development Corp. v. Louisiana National Bank*, 881 F.2d 1346 (5th Cir. 1989), “common sense tells us that property is the indubitable equivalent

¹ Alfred S. Lurey and Brett J. Berlin, “When Can Less Than All of a Secured Creditor's Collateral Serve as the Indubitable Equivalent of the Creditor's Secured Claim?,” 28 *Cumb. L. Rev.* 333 (1998).

² See *In re Atlanta Southern Bus. Park Ltd.*, 173 B.R. 444, 449 (Bankr. N.D. Ga. 1994) (“A plan that includes the partial return of collateral may be confirmable under certain circumstances. One circumstance occurs where...the creditor is oversecured and the value of the surrendered collateral is equivalent to the amount of the creditor's claim.”).

³ See, e.g., *In re Atlanta Southern Bus. Park Ltd.*, 173 B.R. at 448-52 (engaging in four-part analysis designed to determine whether debtor's dirt-for-debt plan is confirmable).

of itself.”⁴ Notwithstanding, dirt-for-debt plans are characterized by an attempt to convey less than all of the creditor’s collateral, while retaining valuable collateral free of the creditor’s lien.⁵

Valuation by the Court

Where a debtor proposes to retain some amount of the creditor’s collateral while satisfying the creditor’s entire secured claim by conveying only a portion of the collateral to the creditor, questions of valuation become critical to an assessment of whether the secured creditor is receiving the indubitable equivalent of its claim under the plan. A secured creditor involved in such an assessment should advise the court early on that the genesis for the indubitable-equivalence standard, a 1935 opinion by Learned Hand, stressed that the indubitable equivalence must be “completely compensatory.”⁶ There are two primary approaches to valuation in the dirt-for-debt context.⁷

Sensitive to Potential for Error

The first approach to valuation in the dirt-for-debt context emphasizes the risk for error in such a valuation. Several courts have denied confirmation of dirt-for-debt plans due to serious concerns associated with the possibility of placing the entire risk of an erroneous valuation on the secured creditor. In *In re Arnold & Baker Farms*, 85 F.3d 1415 (9th Cir. 1996), the Ninth Circuit was unwilling to confirm a dirt-for-debt plan even though the bankruptcy court’s valuation of the offered collateral exceeded the mortgagee’s secured claim by nearly \$300,000. The court recognized the prevailing unfavorable market conditions and noted that under the plan the secured creditor was “forced to assume the risk of receiving less [than the amount of its claim] on the sale without being able to look to the remaining undistributed collateral for security.”⁸ In a similar decision, *In re Martindale*, 125 B.R. 32 (Bankr. D. Idaho 1991), the bankruptcy court focused on the uncertainty posed by an unstable market:

Perhaps at a different time in a different real estate market a plan proposing to surrender mortgaged land to the mortgagee in return for satisfaction of the debt may be confirmable. However, in an uncertain market it is doubtful that such a plan 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.

Id. at 38.

The *Martindale* court found that “stringent standards of equivalence are required with respect to non-cash treatment.”⁹ The court in *In re Walat Farms*, 70 B.R. 330 (Bankr. E.D. Mich. 1987), referred to as “the preeminent judicial commentary on the effect of valuation risks on confirmation of asset payment plans,”¹⁰ also fretted over market conditions:

No matter how hot the market for real estate may become in the future, the market for farm real estate here and now is not such which would permit us to hold that the value of the land being offered is the indubitable equivalent of [the secured creditor’s] claim.

Id. at 334.

The *Walat Farms* court noted that “since we are in a deflationary market environment, the longer it takes to sell the property, the less likely it is that the surrender of the land will be the equivalent of the claim.”¹¹ The court viewed the word “indubitable” to mean something that is “too evident to be doubted.”¹²

Willing to Accept Margin of Error

The second approach to the valuation question within the dirt-for-debt context recognizes that “valuation of assets is often necessary to define and protect the rights of the parties and is an ‘integral part of the confirmation process under Chapter 11.’”¹³

In re May, 174 B.R. 832 (Bankr. S.D. Ga. 1994), involved a plan proposing to convey a portion of a creditor’s collateral that provided the creditor, after a judicial determination of value, with only a 1.5 percent margin or error.¹⁴ Stated differently, the value set by the court exceeded the creditor’s claim by only 1.5 percent. The court confirmed the plan and noted that “risk is present in any case in which a court is required...to make a...determination of value” and that it could not “be the guarantor of the values it sets during the course of a bankruptcy case.”¹⁵

In *In re Atlanta Southern Bus. Park Ltd.* the court was faced with the issue of whether valuation should be determined as of the confirmation date or at a later date when the secured creditor was ultimately able to sell the collateral.¹⁶ The court rejected the secured creditor’s argument that the sale date controls, pointing out that “when valuation is for the purpose of plan confirmation, the value must be determined as of the date the plan is confirmed...[and] [n]othing in the Code requires the Court to treat a valuation in an indubitable equivalent situation any differently.” *Id.* at 450. The court was willing to concede that valuation in this context needs to be conservative.¹⁷ As justification for a conservative valuation process, the court noted that a dirt-for-debt plan shifts the risk of loss to the secured creditor and eliminates the secured creditor’s accrual of interest.¹⁸ The court also conceded that “valuation is not an exact science, and the chance for error always exists.”¹⁹

Three Valuation Methods

Real property appraisers have referred to three valuation methods, or a combination thereof, to arrive at market value estimates: the cost approach, the sales comparison approach and the income capitalization method. Broadly speaking, the cost approach considers “[t]he current cost of reproducing or replacing the improvements, minus the loss in value from depreciation, plus site value.”²⁰ When deducing the cost required to reproduce an existing structure, the appraiser will consider direct costs, indirect costs and even an entrepreneurial profit.²¹ To arrive at the accrued depreciation, the appraiser may allocate the sales price between the land and the improvements, and then deduct the portion allocated to the improvements from the estimated reproduction cost.²² If the portion of the sales price allocated to the improvements is less than the amount required to reproduce them, that means that there is accrued depreciation.²³ This amount is deducted from the reproduction cost, and then that amount is added to the value of the site.²⁴ The resulting sum is the value of the fee-simple interest as figured under the cost approach.

¹⁶ *Id.* at 449.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* (quoting *In re Simons*, 113 B.R. 942, 947 (Bankr. W.D. Tex. 1990).

²¹ Appraisal Institute, *The Appraisal of Real Estate* 71 (10th ed. 1992).

[hereinafter *Appraisal of Real Estate*].

²² *Id.* at 313.

²³ *Id.*

²⁴ *Id.*

⁴ *Id.* at 1350.

⁵ *Lurey*, *supra* note 1, at 342.

⁶ *Metropolitan Life Insurance Co. v. Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

⁷ *Lurey*, *supra* note 1, at 347-48.

⁸ *Id.* at 1422.

⁹ *Id.* at 39.

¹⁰ *Lurey*, *supra* note 1, at 351.

¹¹ *Id.* at 337, n.8.

¹² *Id.* at 335 (citing *Webster’s Ninth New Collegiate Dictionary* (1985)).

¹³ *In re Park Forest Development Corp.*, 197 B.R. 388, 396 (Bankr. N.D. Ga. 1996) (quoting *Sandy Ridge Development Corp. v. Louisiana National Bank*, 881 F.2d at 1354).

¹⁴ *Id.* at 836.

¹⁵ *Id.* at 839-40.

When the sales-comparison approach is employed, “market value is estimated by comparing the subject property to similar properties that have recently sold, are listed for sale, or are under contract (*i.e.*, recently drawn up purchase offers accompanied by a cash or equivalent deposit).”²⁵ One underlying premise for the sales comparison approach “is that the market value of a property is directly related to the prices of comparable, competitive properties.”²⁶

“The income capitalization approach to value consists of methods, techniques, and mathematical procedures that an appraiser uses to analyze a property’s capacity to generate benefits...and convert these benefits into an indication of present value.”²⁷ This approach is predicated on the idea that a property’s capacity to generate income is a critical analytical component when considering that property’s value. That is only one component, and appraisers use combinations of the income-capitalization methods in certain facets of both the cost approach and the sales-comparison approach.²⁸

Current Market Frustrates Valuation Efforts

In order for the sales-comparison method to provide a reliable estimate of value, an appraiser must examine recent sales of similar properties.²⁹ One commentator has pointed out that when the real estate market is distressed, most real estate owners choose to hold on to their property until the market rebounds.³⁰ This problem is compounded in today’s environment, where the corresponding credit crunch prevents would-be buyers from obtaining financing.³¹ The few sales that do occur in such a market take place under duress.³² Consequently, the free-flow of real estate transactions necessary for the sales-comparison method to function properly simply does not exist.

The income-capitalization method “turns on the appraiser’s ability to forecast the property’s future net income flows.”³³ In a distressed economy, this too becomes much more difficult to do. If a tenant breaches a lease, in a healthy economy, a landlord can reasonably expect to mitigate the resulting loss by re-letting the space, assuming that the landlord’s price and

premises are in line with market conditions. Under the income capitalization method, this expectation fits in well because the appraiser does not have to account for an extended (and uncertain) vacancy period, or for a severe (and ultimately unpredictable) reduction in rent in order to fill the space. The opposite is true for the workability of the income-capitalization method in a distressed market. As the author noted while writing in the midst of a previous real estate downturn, “current conditions in most commercial markets are plagued with so much uncertainty that it is virtually impossible to reliably forecast future income during the property’s projected holding period.”³⁴

The cost approach would seem to be the most reliable in a sagging market because costs are more easily ascertainable. However, the cost approach is of limited value in situations such as the current market, and it is mostly “used to estimate market value of proposed construction, special-purpose properties and other properties that are not frequently exchanged in the market.”³⁵

Dirt-for-Debt Plans in Today’s Market?

A distressed real estate market creates great uncertainty in the valuation of real property, which is cause for concern when faced with a dirt-for-debt plan today. The indubitable-equivalent standard requires that secured creditors receive the full value of their secured claims or a chapter 11 plan is not confirmable. The standard was derived from Learned Hand’s statement that the indubitable equivalence must be “completely compensatory.”³⁶ When a debtor offers a secured creditor anything less than all of its collateral, with the promise that the offered collateral will make the creditor whole, accepting this promise places all of the risk on the creditor. In a distressed and uncertain real estate market, this risk is perhaps more than the indubitable-equivalent requirement can stand. ■

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²⁵ *Id.* at 367.

²⁶ *Id.*

²⁷ *Id.* at 409.

²⁸ *Id.*

²⁹ Alex E. Sadler, “The Inherent Ambiguity of Commercial Real Estate Values,” 13 *Va. Tax Rev.* 787, 804 (Spring 1994).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.* at 805.

³⁴ *Id.*

³⁵ *Appraisal of Real Estate*, *supra* note 18, at 316.

³⁶ *Metropolitan Life Insurance Company*, 75 F.2d at 942.