Partial "Dirt-for-Debt" Plans in Chapter 11: the "Indubitable Equivalence" Debate

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One consequence of the depressed real estate market has been numerous Chapter 11 bankruptcy cases wherein the debtor seeks confirmation of a "dirt-for-debt" plan. In such a plan, instead of paying the secured creditor the value of the real property securing the debt through restructured loan terms, the debtor proposes to convey part or all of the real property securing the debt to the creditor in full satisfaction of its secured claim. Not surprisingly, dirt-for-debt plans often are met with substantial opposition from the affected secured creditor, and a contested hearing seeking to cram the plan down over the creditor's objection ensues.

Partial dirt-for-debt plans, wherein only a portion of the real property securing the debt would be conveyed to the secured creditor in full satisfaction of the debt, raise particular concerns for the parties and the court. The core issue with a partial dirt-for-debt plan is whether it is "fair and equitable" under the Bankruptcy Code to force the secured creditor to accept title to part of its collateral and release the remaining collateral when there is no certainty that the property conveyed to the creditor will turn out to be worth as much as the debt upon a subsequent sale. Will the property to be conveyed to the creditor enable the creditor to realize the "indubitable equivalent" of its claim, as the Code requires? The risk of loss to creditors is especially pronounced in today's uncertain real estate market.

I. The Divide Among Jurisdictions

Nationally, courts are split on the level of scrutiny they apply to partial dirt-for-debt plans. Some jurisdictions have adopted a strict approach, refusing to confirm a partial dirt-for-debt plan unless it is abundantly clear that the property to be conveyed is worth as much as the secured claim, plus an ample "equity cushion" to spare. These courts have emphasized the inherent risk for error in collateral valuation and potential unfairness in placing the burden of this risk solely on the creditor. Unfavorable market conditions have also played a key role in the decisions by these courts. In one leading case from the 9th Circuit, the court was unwilling to confirm a partial dirt-for-debt plan even though evidence established that the property value exceeded the debt by $300,000. The court cited a declining real estate market and reasoned that, even with the equity cushion, it would be unfair to force the creditor to take on the risk of a decline in value while permanently denying the creditor recourse against the remaining collateral.

Other jurisdictions have confirmed partial dirt-for-debt plans much more readily. These courts are willing to accept a small margin of error between the amount of the secured claim and the value of the proffered collateral, as determined by the court. In a pair of 1994 cases from the Southern District of Georgia, for example, partial dirt-for-debt plans were confirmed upon a determination that the surrendered collateral was roughly equivalent in value to the secured claim, with a negligible equity cushion.

The split among jurisdictions in the treatment of partial dirt-for-debt plans essentially comes down to differing interpretations of the "indubitable equivalence" standard in the Bankruptcy Code. Under the Code, a Chapter 11 plan may be considered "fair and equitable" as to a secured creditor if the creditor will receive the "indubitable equivalent" of its claim. This standard represents one of the three so-called "cram-down" options under the Code, and it provides the legal basis for a partial dirt-for-debt proposal. Where courts seem to diverge is in the standard of proof they require to show that the property offered is equivalent to the debt. Jurisdictions

following a stricter approach have required proof of value by "clear and convincing evidence" or a similar high standard. Other jurisdictions have required the lesser "preponderance of the evidence" standard, which is the more typical standard of proof in civil cases.

II. The Eastern District of North Carolina

The Bankruptcy Court for the Eastern District of North Carolina has not formally adopted a standard of proof in the indubitable equivalence context, but the recent case of In re Bannerman Holdings LLC (2010) may signal a trend toward more accommodation of partial dirt-for-debt proposals. In Bannerman, the debtor proposed to convey to the secured creditor eleven of the fifteen condominium units subject to the creditor's lien, as well as a parking lot, all in full satisfaction of the debt. Under the plan, the creditor would have to release its deed of trust on the remaining four condominium units. According to the valuation accepted by the court, the property to be conveyed to the creditor was worth only 2.9% more than the creditor's secured claim. The plan was confirmed over the creditor's objection.

Given the court's willingness to accept a small margin of valuation error and its decision not to formally adopt the "clear and convincing evidence" standard or proof, Bannerman falls more in line with the decisions accepting partial dirt-for-debt plans with little or no equity cushion and a lower standard of proof.

It is important to note that courts on both sides of the indubitable equivalence debate seem to agree that the value of collateral should be discounted to reflect the lender's holding and disposal costs. Bannerman followed E.D.N.C. precedent and discounted the value of the offered collateral by 10% for liquidation costs and also applied a 12% discount rate to reflect the time value of the funds tied up in the property. Still, these discounts – while creditor-friendly – are yet another variable subject to error in the valuation process.

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At a time when the real estate market may continue in general decline, and when, inarguably, real estate valuation is imprecise, secured creditors would be wise to factor the risk presented by partial dirt-for-debt plans into their credit analysis, and proceed with workout negotiations with troubled borrowers with this possibility in mind.

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