Eat My Dirt!
Dirt-for-debt Swaps

Written by:
Daniel A. Austin
McGuire Woods LLP; Pittsburgh
daustin@mcguirewoods.com

The scene is a classic one for small and mid-size chapter 11 cases: An oversecured creditor refuses to do a deal that would give it a portion of its collateral in return for a release on the remaining collateral, even where the offered portion meets or exceeds the loan value. This is particularly common where the collateral is real estate, such as in a “single-asset” bankruptcy case. Also common is a situation in which a non-consenting undersecured creditor is offered its collateral in return for a credit against its debt, and cash payments for any deficiency.

Usually, the reason given for refusal to accept an asset-for-debt swap is that the creditor does not believe the offered collateral is actually worth what the debtor claims. An added worry for the creditor may be the cost and difficulty of selling the collateral. Whatever the reason, if a debtor is convinced the collateral offered is actually worth the entire loan balance, or at least a substantial part of it, and is willing to adduce expert testimony to that effect, the Bankruptcy Code provides a way to compel the secured creditor to accept the offer in what is known as “eat my dirt,” or “dirt for debt.”

Eat My Dirt, Please

A. Section 1129(b)(2)(A)(iii). Section 1129(b)(2)(A)(iii) provides that a plan of reorganization is “fair and equitable” to a class of secured claims if it provides, inter alia, “for the realization of such holders of the indubitably equivalent of such claims” (emphasis added). This permits a dirt-for-debt satisfaction of secured claims. In a dirt-for-debt reorganization plan, an undersecured creditor may be compelled to accept the surrender of its secured collateral or other assets in satisfaction of all or part of its claim. If the creditor is undersecured, it must give a credit against the value of surrendered assets. If the creditor is oversecured, it may be compelled to accept the partial surrender of its collateral in full satisfaction of its debt.

B. Case law developments. Assume a case where the creditor is oversecured. A number of courts have supported the right of a debtor to tender part of the secured collateral in return for a credit against the secured claim. In In re Matter of Atlanta Southern Business Park Ltd., 173 B.R. 444, 449 (Bankr. N.D. Ga. 1994), the court overruled the objection of the secured lender to the debtor’s plan to satisfy the secured creditor’s claim by delivering cash and conveying a portion of the secured real property to the creditor. The court ruled that [a] plan that includes the partial return of collateral may be confirmable under certain circumstances. One circumstance occurs where, as here, the creditor is oversecured and the value of the surrendered collateral is equivalent to the amount of the creditor’s claim. Therefore, the court concludes that the proposed partial deed back of NationsBank’s collateral is not automatically fatal to the debtor’s plan under the indubitably equivalent approach (citations omitted).

Having decided that it is possible for the debtor to deed back a portion of NationsBank’s collateral in satisfaction of its claim, the court must now focus on the valuation question.

The court confirmed the plan, finding that the cash and surrendered property was the “indubitably equivalent” of its secured claim under the plan. Id. at 453. In In re Park Forest Development Corp., 197 B.R. 388 (Bankr. N.D. Ga. 1996), the court held that a secured creditor receives the “indubitably equivalent” of its secured claim when it receives all the property to which its claim attaches. However, where the creditor receives all of its collateral, a valuation hearing will be necessary to see if debtors will be deeding all or part of the collateral, and thus findings on value are required...” 197 B.R. at 395. In short, the court in In re Park Forest did not take issue with the doctrine of dirt for debt, but rather, its focus was on valuation to determine the extent of collateral to be returned in satisfaction of debt.

The dirt-for-debt doctrine can also be used where the creditor is undersecured. The court in In re Elm Creek Joint Venture, 93 B.R. 105, 111 (Bankr. W.D. Tex. 1988), overruled the objection by a secured creditor to a reorganization plan where the plan called for the creditor to receive certain lots upon which it had a pre-petition lien, and in addition, cash payment of any deficiency under plan, with a deed in trust against the remaining property to secure payment of the cash payments. Similarly, the court in In the Matter of Charles W. Hock Jr., 169 B.R. 236 (Bankr. S.D. Ga. 1994), accepted testimony to determine that the secured lenders’ collateral was worth $341,000, leaving a deficiency of $20,411.69. The court noted that:

a debtor’s abandonment of the property to the secured creditor in full satisfaction of its secured claim...is sufficient to provide the creditor with the “indubitably equivalent” of its secured claim as required under 11 U.S.C. §1129(b)(2)(A). 169 B.R. 239.

The court confirmed the debtor’s plan, which proposed to surrender the real property to the secured creditor and to pay the deficiency in full over time. Id. at 240.

C. Valuation. For most courts, the doctrine of dirt for debt is sufficiently well established that the more particular focus is on the valuation of the surrendered collateral. “Conservative valuation” is the watchword.1 In the case of In the Matter of May, 174 B.R. 832 (Bankr. S.D. Ga. 1994), the debtor had executed and delivered a note secured by a lien against 14 duplex units. The plan proposed to surrender 11 units to the creditor in full satisfaction of the secured claim. The lender objected, arguing that it was per se entitled to all the units. The court had no problem with the dirt-for-debt provisions of the plan:

Thus, having previously concluded that the surrender of all of an undersecured creditor’s collateral provides that creditor with the “indubitably equivalent” of the secured portion of its claim under §1129(b)(2)(A)(iii), the question in this case is whether this principle is properly extended to a proposal to surrender only a portion of the collateral to an oversecured creditor in full satisfaction of its claim. For the reasons that follow, I conclude that such a proposal can provide an oversecured creditor with the “indubitably equivalent” of its claim. 174 B.R. at 837.

Once the court had held that “a debtor need only prove that its proposal evidences a creditor with the “indubitably equivalent” of its claim by a preponderance of the evidence,” 174 B.R. at 840, the more

1 See In re Park Forest Development Corp., supra, 197 B.R. at 397 (“valuation of real estate in a [dirt-for-debt] context should be very conservative and allow the secured creditor an ample margin for error.”)

continued on page 48
difficult issue in May was the valuation of units proposed to be tendered by the debtor. Based on the evidence presented, the court held that the debtor’s valuation of the units was too low; it therefore permitted the debtor to amend its plan to surrender 13 of 14 units, thus providing the lender with the “indubitable equivalent” of its claim and satisfying the “fair and equitable” requirement of 11 U.S.C. §1129. See, also, In re Simmons, 113 B.R. 942, 946 (Bankr. W.D. Tex. 1990) (plan confirmed where debtor surrendered 131 of 690 acres of secured real property for a credit, and paid the remaining lien balance in installments).

There is a split in the circuits as to whether valuation is a question of law or fact. Compare In re Arnold & Baker Farms, 85 F.3d 1415, 1421 (9th Cir. 1997), where the court held that the issue of indubitable equivalence is a question of law because it requires analysis of the meaning of the statutory language, with the decision in Woods v. Pine Mountain Ltd., (In re Pine Mountain), 80 B.R. 171,172 (9th Cir. BAP 1987):

Whether a plan provides a secured creditor with the indubitable equivalent of its claim is a mixed question of law and fact. Although the facts underlying such determination are reviewed under the clearly erroneous standard, the question of whether the legal standard has been satisfied is reviewed de novo.

The Ninth Circuit rule appears to be a minority view. For example, in Matter of James Wilson Assoc., 965 F.2d 160, 172 (7th Cir. 1992), the court held that “indubitable equivalence” is a question of fact reviewed for clear error. Most courts outside the Ninth Circuit address valuation as a factual matter, not a legal one. See, e.g., In re Elm Creek Joint Venture, supra., 93 B.R. 105 at 111-112 (in “indubitable value” cases, “courts are called upon to consider and weigh the evidence and make findings of fact as to values...”).

**Conclusion**

Dirt-for-debt can be a powerful tool in the debtor’s arsenal. Secured creditors receive the indisputable value of their claim, and the debtor gets a modification of its debt. But the most important aspect of dirt-for-debt may actually be its utility in avoiding bankruptcy. A creditor that knows that it may be compelled to accept dirt-for-debt in bankruptcy pursuant to 11 U.S.C. §1129(b)(2)(A)(iii) may therefore be amenable to accepting the transaction outside bankruptcy. In certain cases, this may mean the difference between filing a bankruptcy petition or establishing a workout outside of bankruptcy.

**Toxins-Are-Us**

from page 25

available actions for contribution for CERCLA violations because, although not explicit in CERCLA, the right was at least implied therein.

**Most Courts Agree**

Although few published decisions “parsed the language of §113(f)(1),” numerous courts post-SARA have permitted plaintiffs to sue for contribution without even addressing whether the plaintiff was itself sued under CERCLA. The fact that the issue has seen so little ink was itself impressive, opined the majority:

Given the enormous monetary exposure and the volume of litigation surrounding CERCLA mandates, one must assume that talented attorneys have had sufficient incentive and opportunity to explore statutory lacunae such as those created by a cramped reading of §113(f)(1). Yet all that existed before this case arose are isolated dicta. The absence of direct precedent is like the dog that didn’t bark. Furthermore, as the court noted at the outset of its opinion, the district court, the panel and the en banc dissent were all out of step with the many post-SARA cases that permitted PRPs to seek contribution even though the plaintiff had not itself been sued under CERCLA.

**Policy**

In the court’s view, a contrary reading of §113(f)(1) would result in disincentives for PRPs to promptly engage in cleanup activities. It would “slow...the reallocation of cleanup costs for less culpable PRPs to more culpable PRPs...disguise[e] the voluntary expenditure of PRP funds on cleanup activities, [and] diminish...the incentives for PRPs voluntarily to report contamination to state agencies.”

The dissent’s suggestion that PRPs could always sue for contribution under state laws was an unsupportable assumption, as not all states’ environmental statutes provide for contribution. Moreover, Congress evidently believed that pollution was a matter of federal concern, and that national—thereby uniform—response was required. It would be contrary to that underlying objective to require that state law fill an interstice that simply does not exist.

**Value & Cents**

from page 33

time of the second downgrade (i.e., following the first downgrade) was -82 percent. In other words, by the time of the first downgrade, nearly half of the equity value had already been lost, while four-fifths of the value was lost by the time of the second downgrade. Moreover, in the two days surrounding these two respective downgrades, the rate of return was -3.6 and -12.7 percent, both statistically significant declines. There were also a number of upgrades in analysts’ recommendations in the two years prior to bankruptcy. The first upgrade for a stock by a brokerage firm in the two-year period prior to bankruptcy, although statistically significant, was less pronounced (+1.3 percent). The second upgrade (i.e., following an upgrade by the same brokerage firm) was not statistically significant. The median cumulative returns from two years prior to bankruptcy at the time of the first and second upgrades were -22.1 and -25.9 percent. In other words, even in the case of upgrades, the equity values had declined by the time of the upgrades. Unlike the large difference in equity values between the first and second downgrades, there was relatively little movement between the first and second upgrades. Therefore, the stocks proceeded to decline in value following the second downgrade.