SINGLE ASSET PROPOSALS

The preparation of the discussion sections for these proposals is the individual work of Senior Adviser Stephen A. Case and the members of the Small Business Working Group, John A. Gose, Jeffery J. Hartley and James I. Shepard, with the staff assistance of Jennifer C. Frasier. The proposals were adopted by the Commission based on a five to three vote.

A significant number of Chapter 11 cases involves a partnership or corporation whose sole significant asset is an office building, apartment complex, warehouse, or similar real property. In the typical case, the sole significant creditor is the mortgage holder. When the rental value of the property declines, or the debtor suffers an increase in vacancies, the debtor is no longer able to pay debt service. The mortgage goes into default, the debtor and the lender fail to agree upon an out-of-court workout, and the debtor files Chapter 11 to stave off foreclosure.

All persons who appeared before the Commission's working group on single-asset realty ("SARE") matters conceded that some use of Chapter 11 in these cases was abusive and unjustified. However, these persons differed significantly on whether the problem was very serious, on the one hand, or trivial, on the other hand.

Two concerns are voiced most frequently by those who contend that abuse is rampant and must be stamped out[1678]. First, the automatic stay enables the debtor to prevent foreclosure for an extended period of time without filing a plan or making postpetition payments. This gives the debtor substantial leverage over the secured

[1678] Some even question whether SARE debtors should be excluded from Chapter 11. *See, e.g.*, Robert M. Zinman, No Chapter 11 For Single Asset Real Estate, No "New Value" for Single Asset Real Estate, Am. Bankr. Inst. Winter Leadership Conf. (Dec. 5-7, 1996)(unpublished article on file with the American Bankruptcy Institute and the National Bankruptcy Review Commission); Alan Robin & James Lipscomb, *Real Estate Bankruptcies and the Bankruptcy Process*, REAL PROP. PROB. & TR. J (Spring 1997).

lender by imposing the principal costs of delay on that creditor. Second, SARE debtors sometimes attempt to use the provisions of Chapter 11 to keep overencumbered property without either paying the mortgage in full or obtaining the assent of a majority of creditors. These concerns are heightened because, many contend, SARE cases fulfill few of the recognized goals of Chapter 11. Reorganization is not generally necessary to preserve jobs and going-concern value in SARE cases. Whether the debtor keeps the real property or the secured creditor takes it back, the property will be operated in the same manner, creating the same jobs and economic activity. Opponents of the status quo contended that too many SARE cases involved individual equity owners, often functioning through syndicates such as partnerships, faced as a result of foreclosure large liabilities to pay cash tax on completion of the sale even though no cash proceeds thereof were paid to the equity. (This results from the operation of federal and state income tax laws on certain investments in real estate). Anecdotal examples were cited to the Commission's working group of extremely drawn out, expensively litigated SARE cases where tax avoidance/tax postponement strategies were the only conceivable explanation for the behavior of the debtor. The most extreme types of cases which were complained about involved efforts by debtors to confirm so-called "lien-stripping, new-value" plans. In these plans, the debtor's pre-bankruptcy owners ask the court to fix a value for the property which is usually much less than the unpaid principal amount of the secured debt and then to retain ownership by infusing new capital into the debtor.

A number of published articles and persons who appeared before the Working Group defended availability of Chapter 11, as presently constituted, for SARE cases[1679]. These spokespersons contend, as noted above, that there is no greater incidence of abuse in the SARE area than in other areas and that increasingly wise and thoughtful case management by bankruptcy judges, U.S. Trustees and Bankruptcy Administrators was bringing the problems under control without need for significant statutory reform. These commentators repeatedly asserted that whatever the problems with SARE cases might or might not be, the SARE debtor did not deserve more restriction in how it could function in Chapter 11 than any other debtor.

All individuals expressing views to the Commission shared the belief that in recent years, the incidence of cases where tax-shelter-preservation motivations predominated had declined significantly. Also, there seemed to be a consensus that the courts, the U.S. Trustees and the Bankruptcy Administrators had gotten much wiser about moving more swiftly against abusive single-asset realty cases.

[1679] *See, e.g.,* L.E. Creel, III & Weldon L. Moore, III, Unjustified Criticism of Single Asset Real Estate Cases in Bankruptcy, Am. Bankr. Inst. Winter Leadership Conf. (Dec. 5-7, 1996)(unpublished article on file with the American Bankruptcy Institute and the National Bankruptcy Review Commission

Nevertheless, in spite of some indication of some favorable trends, problems alleged to arise from SARE cases continue to demand the careful attention of judges and makers of public policy. Congress recently addressed the concern that SARE debtors enjoy the benefit of the automatic stay for too long. In 1994, Congress enacted section 362(d)(3), which entitles secured creditors relief from stay, unless within 90 days after the order for relief the SARE debtor: (1) files a confirmable plan, (2) commences postpetition mortgage payments, or (3) obtains an extension of the 90-day plan-or-payment deadline. The effect of section 362(d)(3) is limited, however, by the fact that it does not apply to cases in which the secured debt exceeds $4 million.

Court decisions have established limitations on when a SARE debtor may keep overencumbered property without paying a mortgage debt in full. Whether a SARE debtor can confirm a lien-stripping plan generally turns on whether an impaired class has accepted the plan, and whether the plan satisfies the new-value exception to the absolute priority rule. The Courts of Appeals have made it increasingly difficult for the debtor to create an impaired accepting class, by restricting the debtor's ability to divide unsecured claims into more than one class.[1680] The drawback in this approach is that reliance on classification rules does not ensure that reasonable lien-stripping plans are confirmed and that unreasonable lien-stripping plans are not confirmed.

The Commission's working group on small business, partnership and single-asset real estate, conducted several discussions regarding SARE cases, during which it received comments from many attorneys, lenders, and judges. A consensus emerged within the working group from those discussions that the incidence of abuse in the past and danger of additional abuse in the future from SARE cases was very significant and requires tightening up in the statute. The Commission rejected the extreme view, advocated by some, that SARE debtors should be excluded from Chapter 11 altogether. However, the Commission's Recommendations provide for additional steps be taken to reduce cost and delay, and for incorporation of clear, objective standards regarding use of the so-called "new-value exception" in SARE cases.

[1680] *See, e.g., In re* Barakat, 99 F.3d 1520, 1526 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1312, *reh'g denied*, 117 S. Ct. 1725 (1997); *In re* Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d 647, 649 (8th Cir. 1992); *In re* Bryson Properties, XVIII, 961 F.2d 496, 502 (4th Cir.), *cert. denied*, 506 U.S. 866 (1992); *In re* Greystone III Joint Venture, 995 F.2d 1274, 1281 (5th Cir. 1991), *cert denied*, 506 U.S. 821 (1992); *In re* Boston Post Road Ltd. Partnership, 21 F.3d 477, 483 (2d Cir. 1994) *cert. denied*, 513 U.S. 1109 (1995).

RECOMMENDATIONS

2.6.1 ***Change the Present Statutory Definition of "Single Asset Real Estate" in two ways.***

First, the $4 million debt limit should be eliminated from the definition of "single asset real estate" debtor subject to section 362(d)(3).

Second, the definition of "single asset real estate" should be more carefully worded to exclude cases in which the real property is used by a debtor in an active business.

The definition, as proposed, incorporating both concepts, would read as follows:

undeveloped real property or other real property constituting a single property or project other than residential real property with fewer than 4 residential units on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities substantially all of which are concurrently Chapter 11 debtors, other than the business of operating the real property and activities incidental thereto.

2.6.2 ***Amend Code Section 362(d)(3) in Three Particulars***

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).

2.6.3 *Require Substantial Equity in order to Confirm a Lien-Stripping Plan Using the New Value Exception*

In cases where the secured creditor has not made the election under section 1111(b)(1)(a)(i), a plan must satisfy the following requirements to be confirmed under the new-value exception following rejection by a class that includes the unsecured portion of a claim secured by real property: (1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of debt secured by the property is no more than 80 percent of the court-determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable requirements of section 1129 of the Code, and (ii) satisfy then-prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed-charge coverage and loan documentation; and (3) the new value contribution must be treated as an equity interest that is not convertible to or exchangeable for debt.

DISCUSSION

2.6.1 ***Change the Present Statutory Definition of "Single Asset Real Estate" in two ways.***

> **First, the $4 million debt limit should be eliminated from the definition of "single asset real estate" debtor subject to section 362(d)(3).**
>
> **Second, the definition of "single asset real estate" should be more carefully worded to exclude cases in which the real property is used by a debtor in an active business.**

The definition, as proposed, incorporating both concepts, would read as follows:

> **undeveloped real property or other real property constituting a single property or project other than residential real property with fewer than 4 residential units on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities substantially all of which are concurrently Chapter 11 debtors, other than the business of operating the real property and activities incidental thereto**.

Comments. Under current law, "single asset real estate is defined as:

> real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having

> aggregate, noncontingent, liquidated secured debts in an amount no more than $4,000,000.[1681]

Four Million Dollar Cap Issues. The most significant aspect of the proposed amendment is the elimination of the four million dollar cap. The Working Group determined the cap should be eliminated because the reasons supporting the 90 day plan-or-payment deadline apply to the typical large SARE case as well as to the typical small SARE case.[1682] The time needed to formulate a plan is similar in large and small SARE cases, because the basic task in each instance is usually financial restructuring rather than business restructuring. The focus of the plan in SARE causes of all sizes is typically on a single secured creditor. The harm caused by delay is also similar in large and small SARE cases. The debtor's failure promptly to file a plan or commence interest payments imposes the cost and risk of reorganization on the secured creditor to the same extent in SARE cases of all sizes. Finally, reorganization provides limited social benefit in SARE cases of all sizes. Unsecured trade creditors are typically a very small percentage of total debt in large SARE cases as well as small ones. Although preservation of jobs and going-concern value may be an issue in some SARE cases, it is not typically an issue in either large or small SARE cases. In those unusual cases in which enforcement of the ninety-day deadline would cause injustice, the Bankruptcy Code affords sufficient flexibility to courts to extend the deadline as appropriate.

The Commission considered and rejected raising the debt limit rather than eliminating it. Except perhaps in very large cases,[1683] the amount of secured debt is not a reliable indicator of complexity and the need for more time. Only in a minority of large SARE cases is the ninety-day deadline too short. Yet the debt limit removes the wholesome discipline of section 362(d)(3) from *all* cases with secured debt exceeding four million dollars on the basis that a *few* such cases may require additional time. In other words, the general rule for large SARE cases (no plan or payment deadline) is derived from the needs of the unusual case.

If the rationale for eliminating the four million dollar cap were to be expressed in two sentences, they would be these:

[1681] A bill which is currently pending before the House of Representatives would increase the cap to $15 million dollars. See H.R. 764, § 2 (2)(B), 105th Cong., 1st Sess. (1997). Section 2(2)(B) of H.R. 764 is based on H.R. 73, the "Single Asset Bankruptcy Reform Act," introduced by Rep. Knollenberg on January 7, 1997.

[1682] PROPOSED AMENDMENTS TO THE UNITED STATES BANKRUPTCY CODE: HEARINGS BEFORE THE SUBCOMM. ON COMM. AND ADMIN. LAW, 105th CONG., 1st Sess. (April 30, 1997) (testimony of Donald R. Ennis, noting that the average commercial loan at risk in the single asset context is ten million dollars).

[1683] E.g., where the secured debt exceeds fifty million dollars.

(1) The ninety-day plan-or-payment deadline is an appropriate general rule for SARE cases of all sizes.

(2) Unusual cases should be addressed through the court's power to extend the deadline, not by creating a lax general rule for all large cases.

Active-Business Issues. The proposed definition of the SARE debtor is designed to include real estate investors, and to exclude debtors who use real estate in an active business, such as a wholly owned subsidiary that holds a building used as a factory by the parent, or a television broadcast tower held in a separate entity owned by the FCC licensee, but only when the parent or the licensee was also a debtor in a bankruptcy case. Whether the debtor uses real property in an active business should be viewed in terms of economic substance rather than the form of ownership. Thus, where a debtor conducting an active business holds title to the real property used in that business through a separate entity, the entity holding the real property should not be considered a SARE debtor.

In other words, a basic idea embedded in the Proposal is that SARE *not* include members of a consolidated group of debtors operating a substantial non-realty business in the real estate. A prime motive in proposing this requirement is that lenders in workouts will not be motivated to demand that operational companies, such as manufacturing companies, drop all their factory buildings into single-asset subsidiaries for the purpose of mandating fast-track treatment of these subsidiaries as single-asset realty entities if the workout fails and Chapter 11 becomes necessary. Not only would the transaction costs of this procedure be excessive, but should Chapter 11 eventuate, the additional stress of fast-track treatment for the so-called SARE entities in the consolidated group might endanger fulfillment of two of the prime goals of Chapter 11, namely, preservation of jobs and going-concern values.

It is necessary to define carefully the relationship the real estate debtor must have to the operating debtor to come within the operating business exception to the definition of SARE. The Commission has opted in favor of the undefined term "group of commonly controlled entities of which the debtor is a member" because the existing definition of "affiliate" in the Code would be too loose. The definition of "affiliate" in Section 101 uses a 20% ownership threshold, which might sweep out of the defined concept of SARE too many situations in which the affiliated entity was not so closely related to the debtor that the relationship, alone, should be sufficient grounds to exempt the debtor from the definition of SARE. The concept is to provide special treatment for stand-alone realty entities but not to impose that treatment on an entity which is only one part of a larger enterprise in bankruptcy. The following examples illustrate what the Commission has in mind.

1. Debtor is a limited liability company owned by a group of lawyers, doctors, and dentists which owns an office building held for rental. Debtor is an

SARE. This would be true even if the debtor provides its own cleaning, maintenance, snow removal, and landscape services, because these are activities incidental to the operation of the property.

2. Debtor is a wholly owned subsidiary of a Fortune 500 manufacturing company which owns a manufacturing facility operated by the parent. The debtor and its parent are both Chapter 11 debtors. The debtor is not an SARE. This is because the debtor is a member of a commonly controlled group in Chapter 11 which conducts a substantial business on the debtor's property other than a business incidental to the operation of the property.

3. Debtor is a limited partnership owned by a group of business executives which owns a strip shopping center with twenty-three stores, none of which stores is operated by the debtor. Debtor is an SARE.

4. Debtor is the same limited partnership owned by the same group of business executives which owns the same strip shopping center with twenty-three stores. However, in this example, the smallest of the store spaces is operated as a frozen-yogurt stand by the debtor. Debtor is an SARE, even though it operates a business other than an activity incidental to real estate because the frozen-yogurt stand is not "substantial."

5. Debtor is a corporation owning a regional shopping mall. Debtor is majority owned by an enterprise which also operates a nationwide chain of 147 ladies-apparel stores, one of which is on the debtor's premises. The debtor is not an SARE, because the business being operated by the debtor's group is "substantial."

Elimination of Other Ambiguities. The present definition contains several ambiguities. The phrase "which generates substantially all of the gross income of a debtor" has led at least one court to question whether the definition includes raw land.[1684] It is the intention of this Proposal that the SARE definition includes raw land. It is also unclear whether under the $4 million debt limit refers to the face amount of the secured claim or to the lesser of the face amount or the value of the collateral.[1685] Eliminating the debt limit will moot this question.

[1684] In re Oceanside Mission Associates, 192 B.R. 232, 234 (Bankr. S.D. Cal. 1996).

[1685] *Compare In re* Pensignorkay, Inc., 204 B.R. 676 (Bankr. E.D. Pa. 1997) (holding that the cap should be calculated by reference to the value of the collateral) *with In re* Oceanside Mission Associates, 192 B.R. 232 (Bankr. S.D. Ca. 1996) (holding that the four-million-dollar cap should be calculated by reference to the total value of the secured creditor's nonbankruptcy claim).

2.6.2 *Amend Code Section 362(d)(3) in Three Particulars*

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).

The Commission suggests that three additional minor amendments be made to the language of section 362(d)(3). First, the statute should make clear that the payments required may be made from rents generated from the property. Second, the statute should be amended to provide that the interest rate from which the payments are calculated be the nondefault contract rate, rather than the "current fair market rate" as now specified. This change will provide greater certainty and reduce litigation. Third, the statute should be amended to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines that the debtor is subject to section 362(d)(3). If a debtor does not timely comply with section 362(d)(3) based on its contention that it is not an SARE debtor, and it is later determined that section 362(d)(3) does apply, relief from stay must be granted even if the debtor is ready to make payments or file a plan promptly. This trap would be eliminated by the suggested amendment.

Congress adopted section 362(d)(3) for the express purpose of reducing delay and potential abuse in SARE cases.[1686] Section 362(d)(3) requires the SARE debtor within 90 days after the order for relief to: (1) file a confirmable plan; (2) commence postpetition mortgage payments; or (3) obtain an extension of the 90-day plan-or-payment deadline. If the SARE debtor fails to perform any of these three options, secured creditors are entitled to relief from the automatic stay.[1687] Subject

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[1686] 3 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 362.07[5][b] (1996) (citing S. Rep. No. 168, 103d Cong., 1st Sess. (1993) ("This amendment will ensure that the automatic stay provision is not abused, while giving the debtor an opportunity to create a workable plan of reorganization."); 140 Cong. Rec. 10, 764 (daily ed. October 4, 1994), reprinted in App. Pt. 9(b) (statements of Rep. Brooks, chairperson of the House Judiciary Committee):

> Without bankruptcy reform, companies, creditors, and debtors alike will continue to be place on endless hold until their rights and obligations are adjudicated under the present system--and that slows down ventures, new extensions of credit and new investments.

[1687] Section 362(d)(3) provides that the court shall grant relief from the automatic stay:

to the provisions of the Commission Small Business Proposal, the Commission believes that section 362(d)(3) establishes a sound approach to SARE cases.[1688]

Rationale for the Ninety-Day Plan Deadline. SARE cases, both large and small, typically fit the following fact pattern. The debtor's investment is highly leveraged, *i.e.*, mortgage debt represents a high percentage of the value of the real property. Rental income has declined, so that the debtor is no longer able to pay all operating expenses, taxes, and mortgage debt from the rental income. The decline in rental income typically results from: (1) a general decline in the relevant rental market; (2) overbuilding; (3) vacancy caused by loss of a major tenant; or (4) vacancy and decline in rental value caused by mismanagement, poor maintenance, or both.

In this typical SARE case, ninety days is generally sufficient time for the debtor to file a feasible plan of reorganization, regardless of the amount of mortgage debt involved. First, the plan in a SARE case involves financial restructuring, not operational restructuring of the business. The debtor whose case usually involves business restructuring may need to open or close a branch or division. The debtor may then need to operate the restructured business for some time, to see how profitable it will be, before the debtor can propose a plan. In contrast, the financial restructuring involved in SARE cases is generally accomplished by reducing creditors' claims and/or by infusing new capital to cover the difference between rental income and the amount needed to pay expenses and debt service. In addition, the typical SARE debtor has only one significant creditor, the first mortgage holder. Trade debt is generally *de minimis,* and paid in full under the plan. Thus, the typical

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(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period)--

> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

[1688] The Small Business Proposal, adopted by the Commission in May 1977, defines "small business" to include all single-asset realty debtors. As a consequence, the 150-day-confirmation, financial reporting, U.S.-Trustee-supervision and other provisions of the Proposal would apply in SARE cases. To coordinate section 362(d)(3) with the Small Business Proposal, it would be necessary to amend section 362(d)(3) to provide that extensions of the ninety-day period thereunder would have to be obtained pursuant to the section which sets forth burden-of-proof standards proposed for extensions of small business debtors.

SARE case is in substance a two-party dispute, the primary focus of which is to restructure the terms of the debtor's secured debt. In this respect, the typical SARE case is very different from the typical manufacturing case, in which there may be a significant number of jobs at stake, and which may involve a significant amount of trade debt, unsecured bond debt, and numerous secured creditors, each secured by different collateral.

It should also be noted that filing a plan within the ninety-day period is not the debtor's only option. The SARE debtor need not file a plan if it either commences making interest payments to the mortgage holder within ninety days, or seeks an extension from the ninety-day deadline by showing cause of why more time is needed to either file a plan or commence payments. Thus, section 362(d)(3) carefully balances the interest of the secured creditor for speedy resolution of the Chapter 11 proceeding and the SARE debtor's needs for adequate time to attempt to reorganize.

Rationale for Requiring Payments if Plan not Filed withing Ninety Days. Section 362(d)(3) provides that if an SARE debtor does not file a plan within ninety days or obtain an extension of that deadline, the debtor must commence making monthly interest payments or the secured creditor is entitled to relief from the automatic stay. The Commission believes that this requirement is appropriate for the following reasons.[1689]

If the debtor does not promptly file a plan or commence payments, continuation of the automatic stay places the primary cost and risk of reorganization on the secured creditor. In SARE cases in which the secured debt exceeds the value of the debtor's real property, the debtor and unsecured creditors have no present economic interest in the property. There is value only for the secured creditor. If the debtor is permitted to hold the property for an extended period without making payments and the value of the property declines further, it is the return to the secured creditor that is diminished. Moreover, the secured creditor is deprived of the use of property in which only it has a present economic interest without payment for that use. Judge Lisa Hill Fenning has succinctly described this situation as follows:

> [T]he plans proposed in most of these [single-asset] cases attempt to buy a few years' delay in foreclosure in the hope that the real estate market will improve, shifting the risk of failure to the secured creditor, while trying to preserve the upside potential for the equity holders.[1690]

[1689] This requirement would not apply to small-business debtors which are not SARE debtors.

[1690] The Honorable Lisa H. Fenning, *The Future of Chapter 11: One View From the Bench*, Advanced Bankruptcy Workshop 1993 (650 PLI/COM. L. AND PRAC. COURSE HANDBOOK SERIES 317

Imposing the cost and risks of delay on the secured creditor for more than three months are not justified because SARE cases often serve few recognized goals of Chapter 11. First, confirmation of a plan provides minimal benefit to unsecured creditors. Unsecured trade debt is typically paid after the property is foreclosed, either by the purchaser, who wants to maintain the same services to the property, or by the general partners of the debtor, who remain liable for partnership debts.[1691] Second, the bankruptcy does not serve the purpose of eliminating the destructive race among unsecured creditors. There is typically only one significant asset, the real property, and that is generally fully encumbered by the first mortgage. Third, the debtor often has no equity in the property to preserve. In such cases, the debtor is not trying to preserve a present economic interest, but rather is attempting to retain the property in the hope that its value will increase in the future. Fourth, loss of jobs and going-concern value are generally not at stake in single-asset real estate cases. In the usual case, if a debtor loses the property to a new owner, the new owner operates the property in the same general manner as the debtor, thus preserving the same number of jobs and economic activity in the community.

Doubts about the social utility of reorganization in SARE cases deepen when one considers the public interest in proper building maintenance. It is not unusual for a financially strapped SARE debtor to maintain its property poorly because the debtor applies available cash flow to debt service, operating expenses, and taxes. Capital improvements, replacements, and even routine maintenance may therefore be deferred.[1692] Inadequately maintained properties may also contribute to the decline in value of surrounding property and a related decline in the tax base.[1693] Confirmation of a plan does not necessarily remove the impediments to proper upkeep. After confirmation, the debtor is often left with secured debt equal to the entire value of the property.[1694] This high debt-to-equity ratio means debt service is high relative to operating income. Moreover, equity holders may not have sufficient incentive to put new money into the property for maintenance, because they have no current equity to protect. In this respect, transfer of the property to a new owner

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at 331).

[1691] J. Ayer, *Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case*, 44 S.C.L. Rev. 863, 868-70 (1993).

[1692] E.g., Shannon C. Bogle, *Bonner Mall and Single-Asset Real Estate Cases in Chapter 11: Are the 1994 Amendments Enough?*, 69 S. CAL. L. REV. 2163 (1996); Alan Robin & James Lipscomb, *Real Estate Bankruptcies and the Bankruptcy*, REAL PROP. PROB. & TR. J (Spring 1997).

[1693] *See id.*

[1694] *But see infra* pp. 624-79. As described below, the Commission proposes to condition confirmation of a new value plans proposed by SARE debtors on the debtors' infusion of sufficient cash to yield a market-rate loan-to-value ratio.

after foreclosure may lead to better maintenance. The new purchaser is likely to have a more conventional debt-to-equity ratio and, as a result, has both the incentive and the cash flow to property maintain the property.

It should also be noted that the payments that the debtor is required to make under section 362(d)(3) are smaller than the payments the debtor would be required to make pursuant to a plan of reorganization. Section 362(d)(3) requires the debtor to make payments, if any at all, only on a principal amount not to exceed the value of the collateral. Under a plan, the debtor will also have to make payments to unsecured creditors, pay administrative and other priority claims in full, and provide for the payment of the principal balance of the secured claim. Generally a debtor that can reorganize should be capable of paying interest on the current value of the property from rental income.

2.6.3 *Require Substantial Equity in order to Confirm a Lien-Stripping Plan Using the New Value Exception*

In cases where the secured creditor has not made the election under section 1111(b)(1)(a)(i), a plan must satisfy the following requirements to be confirmed under the new-value exception following rejection by a class that includes the unsecured portion of a claim secured by real property: (1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of debt secured by the property is no more than 80 percent of the court-determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable requirements of section 1129 of the Code, and (ii) satisfy then-prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed-charge coverage and loan documentation; and (3) the new value contribution must be treated as an equity interest that is not convertible to or exchangeable for debt.

To further reduce cost and delay in SARE cases, the Commission recommends that the requirements for confirmation of "new value exception" plans be clarified.

Under current law, some courts allow pre-petition equity holders to retain property under a plan of reorganization, over the objection of creditors and even though creditors are not paid in full, by infusing "new value" into the reorganized business. This concept is known as the new value exception to the absolute priority

rule.[1695] The new-value exception is invoked most frequently in SARE cases in which the mortgage debt exceeds the value of the real property. The new value exception is used in such cases to enable the debtor to keep the property without paying the mortgage debt in full.

The principal problem with the new-value exception is that its elements are not precisely defined. Under current case law, the new-value exception contains five requirements. The new-value contribution must be: (1) new; (2) in money or money's worth; (3) substantial; (4) necessary; and (5) reasonably equivalent to the interest retained.[1696] While court decisions provide reasonably precise definitions for the "new" and "money or money's worth" requirements, case law does not come close to providing clear rules for the other three requirements.[1697] Cases addressing the "**substantial**" requirement are split over whether substantiality is to be measured in absolute terms or relative to unsecured claims. Cases addressing the "**necessary**" requirement are split over whether the contribution must be necessary to operations or whether it may be used to pay preconfirmation creditors. It is also unsettled whether old equity must be the sole available source of new capital.[1698] Regarding the "**reasonably equivalent**" requirement, it is unclear whether indirect benefits to equity holders, such as expected future salary and deferral of taxes, must be taken into account. Courts also differ as to whether the equity interest must be put up for auction.[1699] A recent survey concludes that "the courts have offered few insights regarding the methodology of satisfying this requirement."[1700]

The Commission proposes a clear, objective standard for new-value plans in SARE cases. The new-value exception would be satisfied if, and only if, the secured

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[1695] It is an open question whether the new-value exception exists under the 1978 Code. The Supreme Court granted certiorari in a case in which the Ninth Circuit held that the new-value exception does exist, even though there was no conflict among the circuits. The court later dismissed the appeal as moot when the parties settled the appeal. In re Bonner Mall Partnership, 2 F.3d 899, 908 (9th Cir. 1993), cert. granted, 510 U.S. 1039, 114 S. Ct. 681, case dismissed as moot, 513 U.S. 118, 115 S. Ct. 386 (1994). On September 19, 1996, the Commission adopted a Proposal to codify the new value exception. *See* Recommendation 2.4.15 ***Absolute Priority and Exclusivity.***

[1696] In re Bonner Mall Partnership. 2 F.3d 899, 908 (9th Cir. 1993), cert. granted, 510 U.S. 1030. 114 S.Ct. 681, case dismissed as moot, 513 U.S. 118, 115 S. Ct. 386 (1994).

[1697] The lack of clarity in the case law regarding the other three requirements is set forth in J. Ronald Trost, *et al.*, *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, (1996).

[1698] Id. at 1336-37.

[1699] Id. at 1346-47.

[1700] Id. at 1348.

portion of the loan was paid down to 80 percent of the value of the property. This would permit the debtor to "strip off" liens to the extent that they exceed the current value of the property, while providing the secured creditors conventional terms on the remaining portion of the lien. The Proposal improves the balance of equities between debtors and secured creditors in SARE cases, and reduces litigation over what constitutes sufficient "new value."

Rationale Supporting a Loan-to-Value Test. The loan-to-value test for new plans improves upon current law in three ways: It more equitably balances the interests of debtors and secured creditors; it increases the likelihood of success of the reorganized debtor; and it reduces litigation.

The loan-to-value standard fairly balances the interests of debtors and creditors. The debtor would be able to reorganize overencumbered property in Chapter 11 over the objection of its secured creditor by reducing the mortgage debt to the current value of the property and retaining the property through a new-value contribution. This new value contribution would provide the secured creditor with a conventional layer of equity beneath its mortgage loan. Without this layer of equity, the secured lender bears all the risks of any future decline in value, while the debtor enjoys all the benefits of any future appreciation. With a conventional layer of equity, the debtor enjoys the benefits and bears the burdens of ownership. From the lender's perspective, it would be as if the property were sold to a creditworthy purchaser for a price equal to a court-determined value.[1701] The loan-to-value proposal would not give additional leverage to holders of junior liens that are completely unsecured. This is so because the protections apply to the treatment of the secured portion of the debt only.

Requiring the debtor to reduce the principal balance of its secured note by twenty percent would also leave the debtor with a sound capital structure coming out of confirmation. A new-value plan in which the secured debt equals 100 percent of the value of the property is a virtual recipe for future default and poor maintenance.[1702] In such cases, too much of the debtor's net income must be spent on mortgage debt service, leaving the debtor too little for maintenance and reserves. Requiring the debtor to maintain an 80 percent loan-to-value ratio decreases the amount of net income that must be spent on debt service, greatly increasing the likelihood that the debtor will properly maintain the property and will fully perform its obligations under the plan. Requiring the equity holders to make this down

[1701] The restructured loan could also likely be classified as a performing loan, reducing regulatory problems for the lender.

[1702] As explained on pages 673-74 *supra*, in the text the main concern of the public in SARE cases is that the affected apartment building or other real property be property maintained.

payment will also give those equity holders a greater incentive to put in additional new money as needed, because they will have a current economic interest in the property to protect.

Finally, the Proposal should reduce or simplify litigation in several respects. First, by more precisely defining the requirements of the new-value exception, it should reduce litigation over whether those requirements have been met in a particular case. Second, the loan-to-value requirement would relieve courts from having to determine the market rate of interest on one hundred percent loan-to-value loans – loans which do not exist in the marketplace. Third, the Proposal should reduce litigation over classification of claims and artificial impairment of classes in SARE cases.[1703] Fourth, clarifying the rules for debtors who seek to reorganize overencumbered real estate in Chapter 11 may increase the number of out-of-court workouts.

The proposed loan-to-value test is not a departure from the present new-value exception, but rather applies the five elements of the existing new-value exception to the unique circumstances of SARE cases:

1. "New" and "money or money's worth." The Proposal requires the contribution to be in cash paid on the effective date of the plan from a source other than the property of the estate. In this respect it is identical to the present new-value exception.

2. "Necessary." The payment required under the Proposal is "necessary" in that it is precisely calculated to further the likelihood of success of the reorganized SARE debtor. As explained above, the required equity cushion is designed to leave the reorganized debtor with a capital structure that will enhance its ability to maintain the property and fully perform its obligations under the plan.

3. "Substantial" and "reasonably equivalent to the interest retained." The primary concern raised by lien-stripping plans is that the secured creditor bears all risk of future decline in the value of the property, while the debtor enjoys the benefits of all future appreciation. Thus, although the equity interest in the reorganized debtor may have no value in an accounting sense, it has a substantial practical value, because it affords the debtor's equity holders an opportunity to recover future profits without putting their assets at risk, and because foreclosure

[1703] The Commission believes that none of the existing restrictions on confirmation of lien-stripping plans should be modified in SARE cases unless the loan-to-value test for new-value plans is adopted. These existing limitations include the impaired accepting class requirement of Section 1129(a)(10), case law precluding separate classification of the mortgage holder's unsecured deficiency claim and case law regarding artificial impairment of claims. The Commission also believes that the new-value exemption should not be recognized in SARE cases without the loan-to-value test.

often has substantial adverse tax consequences for equity holders. The size of the new-value contribution required under the Proposal is calculated to allocate more equitably the benefits and risks of reorganization. The debtor's equity holders, who reap the entire benefit of any future appreciation, are required to bear an appropriate share of the risk of any future decline in value by supplying the same equity cushion an outside purchaser would have to put up.

The new-value exception is never easy to satisfy, because it requires equity holders to make a "substantial" contribution of capital. Undoubtedly, the equity holders in many cases would not be able, or willing, to contribute sufficient new cash to pay down the secured debt as required under the Proposal. It is doubtful, however, that cases in which equity holders propose a smaller contribution would be confirmed under current law either.[1704] The big difference between current law and the proposed loan-to-value test is that the Proposal creates an objective test that will lead to faster, less expensive resolution of SARE cases.

There must be some restriction on how the debtor treats the new-value contribution. It would completely undermine the logic of the Proposal, for instance, to permit the debtor to treat the new contribution as a senior lien on the real property. A more realistic danger is that the contribution might be treated as equity convertible to debt on a par with unsecured claims to be paid under the plan. In that instance the new-value contribution might not have the hoped-for effect of enhancing the capital structure of the debtor and the feasibility of the plan. The Proposal provides that the contribution be equity that is not convertible to debt without consent of the secured lender.

The loan-to-value requirements would not apply when the secured creditor makes the section 1111(b) election. When a creditor makes the election, its entire claim is treated as secured. The absolute priority rule and the new-value exception apply only to unsecured claims.

Annex A, attached hereto, presents accounting entries illustrating how the loan-to-value test for the new-value exception would work in various hypothetical cases.

*Credit-Bid Approach to New-Value Exception.*The Commission received many comments stating that the real property should be put up for auction, and the secured creditor permitted to credit bid its note, when an SARE debtor proposes to confirm a plan under the new-value exception.[1705] The Commission considered this

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[1704] See The Honorable Thomas E. Carlson, *Memorandum to the Small Business Working Group Regarding the Loan-to-Value Approach to the New Value Exception* (June 5, 1997) (noting that courts confirm new-value plans in only eleven percent of reported cases).

[1705] Joel B. Zweibel, O'Melveny & Meyers LLP, *Letter to the Small Business Working Group Regarding Single Asset Real Estate Proposal Numbers 10-12* (Sept. 8, 1997); John D.

approach carefully, but declined to adopt it, out of concern that it might prevent a debtor from ever confirming a new-value plan over the objection of a secured creditor. At the same time, however, the Commission acknowledges that the credit-bid approach has advantages, and suggests that Congress give this approach serious review. Attached as Annex B is a copy of a memorandum received by the Commission that explains the credit-bid approach in detail.[1706]

Cleavenger, The Principal Financial Group, *Letter to the National Bankruptcy Review Commission Regarding Single Asset Real Estate* (Aug. 9, 1997); Dean A. Rogeness, MassMutual Ins. Co., *Letter to the National Bankruptcy Review Commission Regarding Single Asset Real Estate* (Sept. 9, 1997); Dain C. Donelson & The Honorable Robert D. Martin, *Memorandum to the Small Business Working Group Regarding Proposed New-Value Exception--Single Asset Real Estate Entities Alternative Proposal/Additional Analysis* (Sept. 9, 1997).

In addition, three commentators who supported to loan-to-value approach stated they would also support a credit-bid approach. J.S. Hollyfield, sole practitioner, *Letter to the National Bankruptcy Review Commission*; Alan J. Robin, Metropolitan Life Ins. Co., *Letter to John Gose, Esq.* (Sept. 5, 1997); Prof. Robert M. Zinman, *Memorandum to the National Bankruptcy Review Commission, Small Business Working Group Regarding Single Asset Real Estate* (Sept. 9, 1997).

[1706] Dain C. Donelson & The Honorable Robert D. Martin, *Memorandum to the Small Business Working Group Regarding Proposed New-Value Exception--Single Asset Real Estate Entities Alternative Proposal/Additional Analysis* (Sept. 9, 1997)

Professor Kenneth N. Klee of the University of California at Los Angeles School of Law submitted the Alternative Proposals set forth below after the Commission voted on the previous Single Asset Real Estate Proposals. The Commission did not have the opportunity to vote on Professor Klee's Proposals. The Small Business Working Group did consider a number of the concepts embodied in the proposals but rejected them.

While there has been no Commission vote on the Alternative Proposals discussed below, they have the support of five Commissioners who were not members of the Small Business Working Group. They view it as a well-reasoned alternative and hope that it will receive careful consideration by Congress.

ALTERNATIVE SINGLE ASSET PROPOSALS

A significant number of Chapter 11 cases involve a partnership or corporation whose sole significant asset is an office building, apartment complex, warehouse, or similar real property. In the typical case, the sole significant creditor is the mortgage holder. When the rental value of the property declines, or the debtor suffers an increase in vacancies, the debtor is no longer able to pay debt service. The mortgage goes into default, the debtor and the lender fail to agree upon an out-of-court workout, and the debtor files Chapter 11 to stave off foreclosure.

Although use of Chapter 11 in some of these cases is abusive and unjustified, in other cases, access to Chapter 11 serves legitimate reorganization objectives. Moreover, as Judge Samuel Bufford testified before the working group, there is something to be learned from the depression when ownership of United States real estate was concentrated in the hands of American banks. Therefore, the Commission's objective should be to fine-tune Chapter 11 to weed out the abusive cases without precluding reorganization of the non-abusive cases.

Two concerns are voiced most frequently by those who contend that abuse is rampant and must be stamped out[1707]. First, the automatic stay enables the debtor to

[1707] Some even question whether SARE debtors should be excluded from Chapter 11. *E.g.*,

prevent foreclosure for an extended period of time without filing a plan or making postpetition payments. This gives the debtor substantial leverage over the secured lender by imposing the principal costs of delay on that creditor. Second, SARE debtors sometimes attempt to use the provisions of Chapter 11 to keep overencumbered property without either paying the mortgage in full or obtaining the assent of a majority of creditors. These concerns are heightened because, some contend, SARE cases fulfill few of the recognized goals of Chapter 11. They contend that reorganization is not generally necessary to preserve jobs and going-concern value in SARE cases. Whether the debtor keeps the real property or the secured creditor takes it back, they believe that the property will be operated in the same manner, creating the same jobs and economic activity. Opponents of this view contend that lenders do not always operate properties after foreclosure. Anecdotal evidence of foreclosing banks boarding-up buildings in Texas during the 1980's supports this view. Jobs can be lost.

Several published articles and persons who appeared before the Working Group defended availability of Chapter 11, as presently constituted, for SARE cases[1708]. These spokespersons contend, as noted above, that there is no greater incidence of abuse in the SARE area than in other areas and that increasingly wise and thoughtful case management by bankruptcy judges, U.S. Trustees and Bankruptcy Administrators was bringing the problems under control without need for significant statutory reform. These commentators repeatedly asserted that whatever the problems with SARE cases might or might not be, the SARE debtor did not deserve more restriction in how it could function in Chapter 11 than any other debtor.

All individuals expressing views to the Commission shared the belief that in recent years, the incidence of cases where tax-shelter-preservation motivations predominated had declined significantly. Also, there seemed to be a consensus that the courts, the U.S. Trustees and the Bankruptcy Administrators had gotten much wiser about moving more swiftly against abusive single-asset realty cases.

Nevertheless, in spite of some indication of some favorable trends, problems alleged to arise from SARE cases continue to demand the careful attention of judges and makers of public policy. Congress recently addressed the concern that SARE debtors enjoy the benefit of the automatic stay for too long. In 1994, Congress

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Robert M. Zinman, *No Chapter 11 For Single Asset Real Estate, No "New Value" for Single Asset Real Estate*, AM. BANKR. INST. WINTER LEADERSHIP CONF. (Dec. 5-7, 1996)(unpublished article on file with the American Bankruptcy Institute and the National Bankruptcy Review Commission); Alan Robin & James Lipscomb, *Real Estate Bankruptcies and the Bankruptcy Process*, REAL PROP. PROB. & TR. J (Spring 1997).

[1708] *See, e.g.,* L.E. Creel, III & Weldon L. Moore, III, *Unjustified Criticism of Single Asset Real Estate Cases in Bankruptcy*, AM. BANKR. INST. WINTER LEADERSHIP CONF. (Dec. 5-7, 1996)(unpublished article).

enacted section 362(d)(3), which entitles secured creditors relief from stay, unless within 90 days after the order for relief the SARE debtor: (1) files a confirmable plan, (2) commences postpetition mortgage payments, or (3) obtains an extension of the 90-day plan-or-payment deadline. The effect of section 362(d)(3) is limited, however, by the fact that it does not apply to cases in which the secured debt exceeds $4 million. During the 105th Congress, as noted below, the House Committee on the Judiciary reported out H.R. 764 which would increase the $4 million limit to $15 million. Congress will determine whether $4 million, $15 million, or something in between is an appropriate cap for these cases.

Court decisions have established limitations on when an SARE debtor may keep overencumbered property without paying a mortgage debt in full. Whether an SARE debtor can confirm a lien-stripping plan generally turns on whether an impaired class has accepted the plan, and whether the plan satisfies the new-value exception to the absolute priority rule. The Courts of Appeals have made it increasingly difficult for the debtor to create an impaired accepting class, by restricting the debtor's ability to divide unsecured claims into more than one class.[1709] The drawback in this approach is that reliance on classification rules does not ensure that reasonable lien-stripping plans are confirmed and that unreasonable lien-stripping plans are not confirmed.

The Commission's working group on small business, partnership and single-asset real estate, conducted several discussions regarding SARE cases, during which it received comments from many attorneys, lenders, and judges. A consensus emerged within the working group from those discussions that the incidence of abuse in the past and danger of additional abuse in the future from SARE cases was very significant and requires tightening up in the statute. The Commission rejected the extreme view, advocated by some, that SARE debtors should be excluded from Chapter 11 altogether. However, the Working Group's Recommendations provide for additional steps be taken to reduce cost and delay, and for incorporation of clear, objective standards regarding use of the so-called "new-value exception" in SARE cases.

Set forth below are Alternative Proposals that should be considered by Congress as a variation on the Single Asset Real Estate proposals made by The Small Business Working Group. The proposal is a conservative approach in light of the lack

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[1709] *See, e.g.*, *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996). *cert. denied*, 117 S. Ct. 1312, 137 L. Ed. 2d 475, *reh'g denied*, 117 S. Ct. 1725 (1997); *In re Lumber Exch. Bldg. Ltd. Partnership*, 968 F.2d 647, 649 (8th Cir. 1992); *In re Bryson Properties, XVIII*, 961 F.2d 496, 502 (4th Cir.) *cert denied*, 506 U.S. 866, 11 S.Ct. 191, 121 L.Ed.2d 134 (1992); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1281 (5th Cir. 1991), *cert denied*, 506 U.S. 821, 113 S. Ct. 72, 121 L. Ed. 2d 37 (1992). *In re Boston Post Road Ltd. Partnership*, 21 F.3d 477, 483 (2d Cir. 1994) *cert. denied*, 513 U.S. 1109, 115 S. Ct. 897, 130 L. Ed. 2d 782 (1995).

of empirical data in this important area. The Alternative Proposals make different recommendations to reduce cost and delay by providing a streamlined definition of SARE cases and leaving the development of the "new-value exception" to court decisions.

The Alternative Proposals are designed to embrace the consensus of the Working Group "that SARE debtors should not be excluded from chapter 11, but that additional steps be taken to reduce cost and delay." The proposals do not use the Working Group approach of employing objective standards into the single asset real estate cases, either in the definition or in the confirmation standards. While clear standards are generally to be applauded, they work well only when people generally agree that they are appropriate, both as a matter of principle and as an empirical matter. In SARE cases, there is no such consensus, which means that any recommendation incorporating objective standards is bound to be controversial. A controversial proposal will offer little guidance to Congress, setting up another round of contentious hearings that to little to forward the debate in the absence of empirical data.

The kind of rigid standard recommended by the Working Group for incorporation into the new-value exception to the fair and equitable rule--requiring a 20% cash equity infusion--may make sense in some cases, but may wreak havoc in others, forcing businesses to close only because a technical financial rule, that seemed sensible in the abstract, makes no sense in a specific case. Moreover, tinkering with the fair and equitable rule in the absence of concrete data could have detrimental spill-over effects in non-SARE cases as well as in countless out of court workout agreements.

Similarly, the Working Group's definition for SARE cases would permit sophisticated lenders to condition all significant real estate loans by requiring borrowers to drop real estate collateral down into a single-purpose subsidiary which would qualify for SARE treatment in the event of default. This would enable lenders to opt into section 362(d)(3) even though in essence the loan is made to a viable business, and, in some cases, it would prevent the operating company from reorganizing.

RECOMMENDATIONS

2.6.1A *Change the Present Statutory Definition of "Single Asset Real Estate" in two ways.*

First, the $4 million debt limit should be raised to $15 million in the definition of "single asset real estate" debtor subject to section 362(d)(3).

Second, the definition of "single asset real estate" should be more carefully worded to exclude cases in which the real property is used by a debtor or related company in an active business.

The definition, as proposed, incorporating both concepts, would read as follows:

undeveloped real property or other real property constituting a single property or project, other than residential real property with fewer than 4 residential units, on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a member of a commonly controlled group of companies of which the debtor is a member, other than the business of operating the real property and activities incidental thereto having aggregate, noncontingent, liquidated secured debts in an amount no more than $15,000,000.

2.6.1B *Congress should fund a study to compare results in SARE cases with those in single asset real estate cases in which the secured debt exceeds $15 million*

2.6.2A *Amend Code Section 362(d)(3) in Three Particulars*

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).

2.6.3A *An SARE debtor should be able to confirm a lien-stripping under the new- value exception to the absolute priority rule*

Codification of the new-value exception should apply in all Chapter 11 cases, including SARE cases. The Commission's proposal to terminate plan exclusivity when the plan proponent seeks to confirm a new-value plan under section 1129(b)(2)(B)(ii) should also apply in SARE cases.

DISCUSSION

2.6.1A *Change the Present Statutory Definition of "Single Asset Real Estate" in two ways*

First, the $4 million debt limit should be raised to $15 million in the definition of "single asset real estate" debtor subject to section 362(d)(3).

Second, the definition of "single asset real estate" should be more carefully worded to exclude cases in which the real property is used by a debtor or related company in an active business.

The definition, as proposed, incorporating both concepts, would read as follows:

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2.6.1B *Congress should fund a study to compare results in SARE cases with those in single asset real estate cases in which the secured debt exceeds $15 million*

Comments. Under current law, "single asset real estate" is defined as:

> real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having

> aggregate, noncontingent, liquidated secured debts in an amount no more than $4,000,000.[1710]

Four Million Dollar Cap Issues.

Section 362(d)(3) establishes a sound approach to small SARE cases where non payment of taxes and neglect of the property is highly likely. The $4 million cap should be raised to include other SARE cases in which the level of cash flow is likely to lead to deferred maintenance and non-payment of property taxes. But the cap should not be eliminated or raised to a level where projects that can be rehabilitated will be liquidated in foreclosure sales and jobs will be lost. The recommendation of the Working Group to repeal the $4 million cap is rejected, however, as too radical in light of the dearth of empirical data. The only available experiences suggest that most projects with large debt levels have ample cash flow to maintain tax and maintenance payments. These large projects are not subject to the same policy constraints or "abuses" as the smaller projects. Moreover, many of these projects involve jobs that will be lost if the reorganization process is forced down a fast track. Furthermore, large projects are more likely to have complex debt structures that would preclude application of the fast track of section 362(d)(3). More resources are devoted to developing cash flow models and appraisals than in the smaller cases. The implications of rigid refinance rules and fast-track negotiations would have other, unanticipated effects. For example, the possibility of claims trading to enhance liquidity in large projects and to increase both the leverage and return for the creditors would be all but eliminated. Rather than increase litigation in these cases by forcing the debtor to file motions to extend the section 362(d)(3) period, the proposal leaves large projects in the regular chapter 11 track where the debtor and creditors can focus their efforts on plan negotiation.

To say that a line is difficult to draw is not to say that a line should not be drawn. In order to enable further study, the proposal raises the cap to $15 million as a measured first step. In fact, such a study should be made even if Congress decides to retain the $4 million cap or raise it to an amount less than $15 million. Proposal 2.6.1B asks Congress to gather data in SARE cases under $15 million and to compare the results with single asset real estate cases over $15 million that will not be subject to section 362(d)(3). After the data are analyzed, further refinements may be made.

[1710] A bill which is currently pending before the House of Representatives would increase the cap to $15 million dollars. See H.R. 764, § 2 (2)(B), 105th Cong., 1st Sess. (1997). Section 2(2)(B) of H.R. 764 is based on H.R. 73, the "Single Asset Bankruptcy Reform Act," introduced by Rep. Knollenberg on January 7, 1997. The bill was ordered reported, as amended, by the House Judiciary Committee on July 16, 1997. The amended bill imposes a $15 million cap on the definition of "single asset real estate" in section 101(51B) of title 11.

Active-Business Issues. The Alternative proposed definition of the SARE debtor is designed to include real estate investors, and to exclude debtors who use real estate in an active business, such as a wholly owned subsidiary that holds a building used as a factory by the parent, or a television broadcast tower held in a separate entity owned by the FCC licensee, whether or not the parent or the licensee is also a debtor in a bankruptcy case. Whether the debtor uses real property in an active business should be viewed in terms of economic substance rather than the form of ownership. Thus, where a debtor conducting an active business holds title to the real property used in that business through a separate entity, the entity holding the real property should not be considered an SARE debtor. In other words, a basic idea embedded in the Alternative Proposals is that SARE *not* include members of a consolidated group of debtors operating a substantial non-realty business in the real estate.

It is necessary to define carefully the relationship the real estate debtor must have to the operating debtor to come within the operating business exception to the definition of SARE. The Commission has opted in favor of the undefined term "group of commonly controlled entities of which the debtor is a member" because the existing definition of "affiliate" in the Code would be too loose. The definition of "affiliate" in Section 101 uses a 20% ownership threshold, which might sweep out of the defined concept of SARE too many situations in which the affiliated entity was not so closely related to the debtor that the relationship, alone, should be a sufficient basis to exempt the debtor from the definition of SARE. The Alternative Proposals embrace these concepts, but reject the Working Group's requirement that substantially all members of the commonly controlled group be Chapter 11 debtors.

The Alternative Proposals amend the definition of SARE to include real estate investors, but to exclude debtors who use real estate in an active business, such as a hotel or casino. Moreover, the definition is expanded to exclude groups where one member owns the real estate and another operates a business on the real estate. There is no requirement that the member operating the business be a title 11 debtor as long as the owner or lessee of the property is a chapter 11 debtor. The concept of a commonly controlled group is broader than the definition of "affiliate" in section 101(2) of the Bankruptcy Code.

By focusing on the commonly controlled group, the Alternative Proposals remove incentives for lenders to require real estate borrowers to form single purpose subsidiaries into which real property must be dropped down as a condition to financing. By contrast, the Working Group's proposals probably would encourage single purpose subsidiary financing by excluding such a subsidiary from the definition of SARE only if substantially all other members of the commonly controlled group were chapter 11 debtors. Financially sound commonly controlled companies operating on the real property would not file chapter 11 petitions.

Only the real estate subsidiary would be a debtor. As a result, under the Working Group proposals, the real estate subsidiary would be on the SARE fast track even though a viable business was being operated on the property. If the lender forecloses in the SARE case, the loss of the real estate could threaten the viability of the remaining business. This is a huge realignment of power toward the lender in single asset real estate cases that has not been justified either by principle or empirical necessity.

The following examples illustrate what the Alternative Proposals have in mind. The result in Example 2 differs from that proposed by the Working Group.

1. Debtor is a limited liability company owned by a group of lawyers, doctors, and dentists which owns an office building held for rental. Debtor is an SARE. This would be true even if the debtor provides its own cleaning, maintenance, snow removal, and landscape services, because these are activities incidental to the operation of the property.

2. Debtor is a wholly owned subsidiary of a Fortune 500 manufacturing company which owns a manufacturing facility operated by the parent. The debtor is a Chapter 11 debtor. The debtor is not an SARE whether or not the parent is also a Chapter 11 debtor. This is because the debtor is a member of a commonly controlled group which conducts a substantial business on the debtor's property other than a business incidental to the operation of the property.

3. Debtor is a limited partnership owned by a group of business executives which owns a strip shopping center with twenty-three stores, none of which stores is operated by the debtor. Debtor is an SARE.

4. Debtor is the same limited partnership owned by the same group of business executives which owns the same strip shopping center with twenty-three stores. However, in this example, the smallest of the store spaces is operated as a frozen-yogurt stand by the debtor. Debtor is an SARE, even though it operates a business other than an activity incidental to real estate because the frozen-yogurt stand is not "substantial."

5. Debtor is a corporation owning a regional shopping mall. Debtor is majority owned by an enterprise which also operates a nationwide chain of 147 ladies-apparel stores, one of which is on the debtor's premises. The debtor is not an SARE, because the business being operated by the debtor's group is "substantial."

Elimination of Other Ambiguities. The current definition contains several ambiguities. The phrase "which generates substantially all of the gross income of a debtor" has led at least one court to question whether the definition includes raw

land.[1711] It is the intention of this Proposal that the SARE definition includes raw land. It is also unclear whether under the $4 million debt limit refers to the face amount of the secured claim or to the lesser of the face amount or the value of the collateral.[1712] Congress should clarify that in raising the debt limit, it is the face amount of the debt and not the value of the property that is controlling. This should eliminate or reduce litigation.

2.6.2A *Amend Code Section 362(d)(3) in Three Particulars*

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).

The Alternative Proposals adopt the suggestions of the Working Group in proposal 2.6.2. It adopts the Commission's suggestion that three additional minor amendments be made to the language of section 362(d)(3). First, the statute should make clear that the payments required may be made from rents generated from the property. Second, the statute should be amended to provide that the interest rate from which the payments are calculated be the nondefault contract rate, rather than the "current fair market rate" as now specified. This change will provide greater certainty and reduce litigation. Third, the statute should be amended to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines that the debtor is subject to section 362(d)(3). If a debtor does not timely comply with section 362(d)(3) based on its contention that it is not an SARE debtor, and it is later determined that section 362(d)(3) does apply, relief from stay must be granted even if the debtor is ready to make payments or file a plan promptly. This trap would be eliminated by the suggested amendment.

[1711] *In re Oceanside Mission Assocs.*, 192 B.R. 232, 234 (Bankr. S.D. Cal. 1996).

[1712] *Compare In re Pensignorkay, Inc.*, 204 B.R. 676 (Bankr. E.D. Pa. 1997) (holding that the cap should be calculated by reference to the value of the collateral) *with In re Oceanside Mission Assocs.*, 192 B.R. 232 (Bankr. S.D. Cal. 1996) (holding that the four-million-dollar cap should be calculated by reference to the total value of the secured creditor's nonbankruptcy claim).

Congress adopted section 362(d)(3) for the express purpose of reducing delay and potential abuse in SARE cases.[1713] Section 362(d)(3) requires the SARE debtor within 90 days after the order for relief to: (1) file a confirmable plan; (2) commence postpetition mortgage payments; or (3) obtain an extension of the 90-day plan-or-payment deadline. If the SARE debtor fails to perform any of these three options, secured creditors are entitled to relief from the automatic stay.[1714] Subject to the provisions of the Commission Small Business Proposal, the Commission believes that section 362(d)(3) establishes a sound approach to SARE cases.[1715]

Rationale for the Ninety-Day Plan Deadline. Small SARE cases typically fit the following fact pattern. The debtor's investment is highly leveraged, *i.e.*, mortgage debt represents a high percentage of the value of the real property. Rental income has declined, so that the debtor is no longer able to pay all

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[1713] 3 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 362.07[5][b] (1996) (citing S. Rep. No. 168, 103d Cong., 1st Sess. (1993) ("This amendment will ensure that the automatic stay provision is not abused, while giving the debtor an opportunity to create a workable plan of reorganization."); 140 Cong. Rec. 10, 764 (daily ed. October 4, 1994), *reprinted in* App. Pt. 9(b) (statements of Rep. Brooks, chairperson of the House Judiciary Committee):

> Without bankruptcy reform, companies, creditors, and debtors alike will continue to be place on endless hold until their rights and obligations are adjudicated under the present system--and that slows down ventures, new extensions of credit and new investments.

[1714] Section 362(d)(3) provides that the court shall grant relief from the automatic stay:

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period)--

> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

[1715] The Small Business Proposal, adopted by the Commission in June 1977, defines "small business" to include all single-asset realty debtors. As a consequence, the 150-day-confirmation, financial reporting, U.S.-Trustee-supervision and other provisions of the Proposal would apply in SARE cases. To coordinate section 362(d)(3) with the Small Business Proposal, it would be necessary to amend section 362(d)(3) to provide that extensions of the ninety-day period thereunder would have to be obtained pursuant to the section which sets forth burden-of-proof standards proposed for extensions of small business debtors.

operating expenses, taxes, and mortgage debt from the rental income. The decline in rental income typically results from: (1) a general decline in the relevant rental market; (2) overbuilding; (3) vacancy caused by loss of a major tenant; or (4) vacancy and decline in rental value caused by mismanagement, poor maintenance, or both.

In this typical SARE case, ninety days is generally sufficient time for the debtor to file a feasible plan of reorganization. First, the plan in an SARE case involves financial restructuring, not operational restructuring of the business. The debtor whose case usually involves business restructuring may need to open or close a branch or division. The debtor may then need to operate the restructured business for some time, to see how profitable it will be, before the debtor can propose a plan. In contrast, the financial restructuring involved in SARE cases is generally accomplished by reducing creditors' claims and/or by infusing new capital to cover the difference between rental income and the amount needed to pay expenses and debt service. In addition, the typical SARE debtor has only one significant creditor, the first mortgage holder. Trade debt is generally *de minimis*, and paid in full under the plan. Thus, the typical SARE case is in substance a two-party dispute, the primary focus of which is to restructure the terms of the debtor's secured debt. In this respect, the typical SARE case is very different from the typical manufacturing case, in which there may be a significant number of jobs at stake, and which may involve a significant amount of trade debt, unsecured bond debt, and numerous secured creditors, each secured by different collateral.

By contrast, in larger real estate cases where the mortgage debt exceeds $15 million, debtors are better equipped to keep current on tax and maintenance payments. At the same time, the debt structure in large cases is likely to be more complex. For example, the debtor and a third party lender might be parties to an interest rate swap, a device not likely to be used in smaller cases. Moreover, based on the dollar amounts at stake, all parties will require more time to perform a financial analysis of the project than in smaller cases. The $15 million cap will give Congress the opportunity to gather data to determine whether the cap should be adjusted up or down or eliminated.

2.6.3A *An SARE debtor should be able to confirm a lien-stripping under the new-value exception to the absolute priority rule*

Codification of the new-value exception should apply in all Chapter 11 cases, including SARE cases. The Commission's proposal to terminate plan exclusivity when the plan proponent seeks to confirm a new-value plan under section 1129(b)(2)(B)(ii) should also apply in SARE cases.

Under current law, some courts allow prepetition equity holders to retain property under a plan of reorganization, over the objection of creditors and even though creditors are not paid in full, by infusing "new value" into the reorganized business. This concept is known as the new value exception to the absolute priority rule.[1716] The new-value exception is invoked most frequently in SARE cases in which the mortgage debt exceeds the value of the real property. The new value exception is used in such cases to enable the debtor to keep the property without paying the mortgage debt in full.

The principal problem with the new-value exception is that its elements are not precisely defined. Under current case law, the new-value exception contains five requirements. The new-value contribution must be: (1) new; (2) in money or money's worth; (3) substantial; (4) necessary; and (5) reasonably equivalent to the interest retained.[1717] While court decisions provide reasonably precise definitions for the "new" and "money or money's worth" requirements, case law is only beginning to provide clear guidelines for the other three requirements.[1718] Cases addressing the "**substantial**" requirement are split over whether substantiality is to be determined on a common sense basis or measured in absolute terms or relative to unsecured claims. Cases addressing the "**necessary**" requirement are split over whether the

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[1716] Both courts of appeals to decide the issue have squarely held that the new-value exception exists under the 1978 Code. *In re 203 N. LaSalle St. Partnership*, _F.3d_, 1997 U.S. App. Lexis 27008 (7th Cir. Sept. 29, 1997); *In re Bonner Mall Partnership*, 2 F.3d 899, 908 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039, 114 S. Ct. 681, *case dismissed as moot*, 513 U.S. 118, 115 S. Ct. 386 (1994). On September 19, 1996, the Commission adopted a Proposal to codify the new value exception. *See*, *Chapter 11 Working Group Proposal #1: Absolute Priority and Exclusivity.*

[1717] *In re Bonner Mall Partnership*, 2 F.3d 899, 908 (9th Cir. 1993), *cert. granted*, 510 U.S. 1030, 114 S.Ct. 681, *case dismissed as moot*, 513 U.S. 118, 115 S. Ct. 386 (1994).

[1718] The lack of clarity in the case law regarding the other three requirements is set forth in J. Ronald Trost, *et al.*, *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, (1996). But as the courts of appeals refine these concepts, clear guidelines will emerge. For example in *203 N. LaSalle St. Partnership*, note 10 *supra*, the Court of Appeals for the Seventh Circuit adopted a common sense approach in evaluating these requirements as opposed to a mathematical formula.

contribution must be necessary to operations or whether it may be used to pay preconfirmation creditors. It is also unsettled whether old equity must be the sole available source of new capital.[1719] Regarding the "**reasonably equivalent**" requirement, it is unclear whether indirect benefits to equity holders, such as expected future salary and deferral of taxes, must be taken into account. Courts also differ whether the equity interest must be put up for auction.[1720] A recent survey concludes that "the courts have offered few insights regarding the methodology of satisfying this requirement."[1721]

The Commission has adopted the recommendations of the Chapter 11 Working Group to codify the new-value exception or principle but to terminate plan exclusivity when the debtor seeks to confirm a new-value plan under section 1129(b)(2)(B)(ii) of the Bankruptcy Code. At this time, the Alternative Proposals embrace these recommendations in the context of SARE cases. The Alternative Proposals urge Congress to study the new-value exception to see if codification of all or part of the principle is appropriate. Currently, in other chapter 11 cases, the Commission recommends the conservative approach to allow the courts to further develop the new-value principle. Applications of the principle in different cases should provide Congress with rich data from which to determine whether codification of all or part of the elements of the exception is necessary or desirable.

The consensus of the Working Group to codify a loan-to-value test to measure "substantiality" is not included in the Alternative Proposals. The loan-to-value test would preclude out-of-court workout agreements in which lenders often take less than an 80% restructured first mortgage. Moreover, the loan-to-value test would discourage lenders from taking fractional equity positions in workouts, as they often currently do, because they could hold out for 20% cash or ownership of all of the equity in a chapter 11 plan. As a practical matter, the Working Group proposals would make most SARE cases impossible to confirm. Since the Commission has resolved to give SARE debtors access to chapter 11, it is only fitting that they have some reasonable opportunity to negotiate a consensual plan. The debtor's threat to confirm a non-consensual plan, even though tempered by the loss of exclusivity, gives the debtor reasonable leverage to reach a consensually negotiated plan. Confirmation of consensual plans will reduce litigation.

The Alternative Proposals reject the notion that in all SARE new-value cases the property should instead be put up to auction for the lender to credit bid its note.

[1719] *Id.* at 1336-37.

[1720] *Id.* at 1346-47.

[1721] *Id.* at 1348.

When the property is worth less than the debt, the lender's credit bid does not accurately determine the value of the property; it deliberately deviates from the market value of the property and permits a bankruptcy-endorsed foreclosure. The typical SARE case has few assets other than the real property. Therefore, the lender can afford to ignore its unsecured deficiency claim and can bid its entire debt to get the property. Indeed, if the debt is nonrecourse, the lender would have no other option in an auction. The Alternative Proposals rely instead on the market place to determine the value of the property. The competing plan process can be expected to produce a superior result by encouraging consensual workouts and providing opportunities to save businesses, and hence save jobs, for operating companies. The competing plan offers conservative changes to the current Bankruptcy Code and does not run the risk of sharply unbalancing established business relationships.

CONCLUSION

The Alternative Proposals offer a balanced, measured approach to single asset real estate reorganization cases. Congress should give serious consideration to the more conservative amendments embraced in the Alternative Proposals. After empirical data are gathered and evaluated, perhaps the time will be ripe to adopt the sweeping suggestions made by the Working Group. On the other hand, perhaps the data will yield conclusions that show the Working Group's proposals to be undesirable, and the Alternative Proposals, or some variations, to be closer to the norms that should be adopted in single asset real estate cases.

Annex A

Example of Operation of Single-Asset Real Estate Proposal As It Applies to New Value Plans

The Working Group's single-asset proposal, in so far as it applies to new-value plans, is designed to implement the requirements of *Case v. Los Angeles Lumber Products, Inc.*, 308 U.S. 106 (1939) (new value must meet certain tests, including that it be "substantial") by requiring that the terms of debt issued to secured creditors in the plan meet two minimum requirements with two statutory "floors", namely (1) that the post-confirmation loan-to-value ratio must be no more than 80% and (2) that the "cram-down" requirements of Section 1129(b) be met with respect to classes which do not accept the plan.

As explained more fully below, the proposal is designed to work whether or not the secured creditor makes the election provided for in Section 1111(b)(2) of the Bankruptcy Code. *However, the proposal does not apply when the creditor makes such election.* The example of the operation of the plan when the election is made is set forth under Heading II below solely to compare and contrast the situation where it is made with the situation where it is not. A particular purpose of this comparison is to reveal the Working Group's analysis about which entity captures future appreciation in the collateral, depending on whether the election is made.

The operation of the proposal in a simplified, hypothetical real-estate situation, where no Section 1111(b) election is made, is as follows:

I. Creditor Does Not Make Section 1111(b)(2) Election; Proposal Applies and Would Change Present Law

A. Pre-petition Balance Sheet

Debtor, a single-asset real estate entity as defined by the Working Group's proposal, owns Blackacre, which, immediately prior to the filing of its voluntary petition, is on its books for $12,000,000. The property has depreciated in value. Debtor contends the current fair-market value is $6,000,000. The mortgage holder contends the value is $8,000,000. Inability to resolve the issue defeats a pre-petition workout effort. Debtor thereupon files for chapter 11. Debtor's balance sheet, immediately prior to the filing, is as follows. The bookkeeping entries for each account in this balance sheet and all subsequent balance sheets showing the implementation of the plan appear on Exhibit 1. Each number on each balance sheet (with one or two exceptions) ties to a line item in one of the accounts. The balance

sheet entries and the line items can be connected to Exhibit 1 (or 2, as the case may be) by using the number appearing under the symbol "#".

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$ 100,000	1	Payables	$ 100,000	20
Realty	12,000,000	7	Mortgage	9,000,000	24
Tractor	65,000	10	Tractor Loan	40,788	34
		--	Total Liabilities	9,140,788	14
		--	Equity	3,024,212	16
Total Assets	$ 12,165,000	12	Total Liabilities and equity	$ 12,165,000	18

Note that, based on pre-petition book value, the financial structure is conservative: the loan-to-value ratio is 75%.

B. Interim Balance Sheet After Marking Realty to Market

Expert testimony and findings of fact by the court in the Chapter 11 process establish conclusively that the realty asset has a current fair value of $6,000,000. Under Bankruptcy Code Section 506, this (assuming no Section 1111(b) election) makes the balance sheet look like this (on an interim basis):

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$ 100,000	1	Payables	$ 100,000	20
Realty	6,000,000	7	Mortgage	9,000,000	24
Tractor	65,000	10	Tractor Loan	40,788	34
		--	Total Liabilities	9,140,788	14
			Equity	(2,975,588)	16
Total Assets	$ 6,165,000	12	Total Liabilities and equity	$ 6,165,000	18

C. Debtor Confirms Chapter 11 Plan with High Level of New Value

Debtor then develops the following chapter 11 plan. In summary, the plan distributes a total of $1,500,000 in cash plus a new secured note with a principal

amount of $4,500,000. The plan cancels $3,100,000 of debt. (The plan contains alternative treatment in case the mortgage holder makes the Section 1111(b)(2) election.) The following chart summarizes the plan treatment when no Section 1111(b)(2) election is made. This plan treatment is explained more fully in the ensuing text (the alternative treatment for the Section 1111(b)(2) election being described under Heading II below):

Claimant	Total Claim	Treatment			
		Percentage	Cash	Notes	Total Distribution
Payables	$ 100,000	--	--	--	--
Deficiency	3,000,000	--	--	--	--
Tractor loan	40,788	100%	--	$ 40,788	$ 40,788
Secured Claim	$ 6,000,000	100%	1,500,000	$ 4,500,000	$ 6,000,000

1. *Unsecured creditors:* There is no value for this class, and they receive nothing in the plan. Members of the class include both the creditors to whom the payables are owed and the unsecured deficiency claim of the secured lender.

2. *Secured claims:* The mortgage lender receives a new note with a principal amount of $4,500,000 and indisputable local-market levels for the interest rate (say, 8.5%) and maturity (say, 10 years), with appropriate amortization this new note represents a 75% loan-to-value ratio on the restated, lower, marked-to-market value of the realty) *plus* cash of $1,500,000. (The new note amount was designed to be more conservative than the required 80% to give a "cushion" against adverse fact findings at the confirmation hearing.) This means that, according to the plan proponent, the secured creditor will receive on account of the $6 million secured claim, property with a value equal to the $6 million value of the collateral. This debt paper meets both (a) the requirements of the Working Group proposal, in that it has rate, maturity and loan-to-value characteristics which meet a current market test and (b) the cramdown standards of Section 1129 because it pays the secured creditor at least the amount of the allowed secured claim (i.e., $6,000,000) in cash ($1,500,000) and market-rate, short maturity notes ($4,500,000) which have a value (i.e., fair market value of the $4.5 million note) equal to the remaining value of the mortgagee's interest in the collateral, after giving effect to the up-front payment.

The high level of cash new value is required because the Working Group's proposal that the new loan meet local-market requirements, i.e., on a building worth $6,000,000, the loan cannot exceed 80% of the value. The loan-to-value ratio used

in this numerical equation is a more conservative one than that recommended by the Commission. This calls for a $1,500,000 cash payment to the secured creditor.

3. *Tractor Loan*. The prepetition tractor loan amount due is unchanged. The holder of this loan accepts a five-year extension of maturity and step up in the interest rate of one per cent over the prepetition rate. The holder of this loan is the impaired class which accepts the plan under Code Section 1129(a)(10).

4. *Infuse New Value*. Inasmuch as cash of $1,500,000 is required for distribution under the plan, the proponent determines to infuse $2,000,000. The amount of cash exceeds the paydown requirements, because capital and cash will be needed to attract new tenants and finance tenant improvements. Also, the large amount of cash infused helps the debtor meet the feasibility requirements for confirmation of a chapter 11 plan.

D. Debtor Confirms Plan

Here is what the balance sheet of the reorganized debtor looks like, pro forma for the confirmation of the plan:

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$ 600,000	6	Mortgage	4,500,000	27
Realty	6,000,000	9	Tractor Loan	40,788	34
Tractor	65,000	11	Total Liabilities	4,540,788	15
			Equity	2,124,212	17
Total Assets	$ 6,665,000	13	Total Liabilities and equity	$ 6,665,000	19

E. Subsequent Sale

Two years after confirmation, the market improves and the debtor sells the property for $8,000,000. The use of proceeds is:

To Secured Creditor:	$ 4,500,000
To Equity:	$ 3,500,000

II. Secured Creditor Makes Section 1111(b) Election; No Change From Existing Law; Presented Solely for Comparison As To Difference in Capture of Future Appreciation

This scenario initially involves the same two balance sheets as those shown under A and B in Heading I above.

However, the treatment of the creditors changes when the secured creditor makes valid, timely Section 1111(b)(2) election. Under the proposal, no 80% ceiling on the loan-to-value ratio is required when the election is made. This example is presented for purposes of contrasting the capture of future appreciation by the equity when the election is not made with its capture by the debt when the election is made. The treatment provided for in the plan for this situation is that the electing mortgage holder must receive a payment stream with a value at least equal to the allowed secured claim (in this case $6,000,000). This is met by delivery of a non-interest bearing note for $9,144,500, payable in ten equal installments of $914,450. Using an 8.5% discount rate, this note has a present value equal to the value of the collateral, namely, $6,000,000.

Obviously, this loan does not meet the standard of 80% loan-to-value as described under Heading I above. This is because that standard does not apply when the *secured creditor* exercises its right to make the Section 1111(b)(2) election. The reasoning is that when the creditor opts for the protections of Section 1111(b), as provided to creditors in 1978, there is no need for the new protection proposed by the Working Group.

The following chart summarizes the treatment:

				Notes		
Claimant	Total Claim	Treatment	Cash	At Face	Present Value at 8.5% Discount Rate	Total Distribution at Face
Payables	$ 100,000	--	--	--	--	--
Deficiency	--	--	--	--	--	--
Tractor Loan	40,788	100%	—	$ 40,788	$ 40,788	$ 40,788
Secured Claim	$9,000,000	100%	--	$9,144,500	$6,000,000	$9,144,500

Under Section 1129(b), the secured creditor being crammed down must receive at least (i) deferred payments equal to the allowed amount of the secured claim (in this case, due to Section 1111(b)(2), $9,000,000) and (ii) with a value as at the effective date of the plan of at least as much as the value of the collateral (in this case, $6,000,000). These requirements are met, as shown above.

Here is the debtor's balance sheet, pro forma for the confirmation of the plan:

Assets			Liabilities and Equity				
Category	Amount	#	Category	At Face	#	At Present Value	#
Cash	$2,100,000	6	Mortgage Debt	$9,144,500	24	$6,000,000	
Realty			Tractor Loan				31
	6,000,000	9		40,788	31	40,788	0
Tractor	65,000	--	Total Liabilities	9,185,288	--	6,040,788	--
			Equity	(1,020,288)	15	2,124,212	37
Total Assets	$8,165,000		Total Liabilities and equity	$8,165,000		$8,165,000	--

In the above example, the $2 million cash contribution is still show, even though it was not legally required, since the secured creditor made the election. This was done primarily for simplicity of computation and comparison of the two examples. In the "real world," this contribution would not be made, and both sides of the balance sheet would deplete by $2 million.

Obviously, if the plan debt is shown at face, debtor is technically insolvent, in the balance sheet sense. Presumably, this is irrelevant to feasibility, inasmuch as the feasibility showing at the confirmation hearing presumably showed enough regular cash flow to assure that the liabilities of the enterprise will be met on a current basis. Future earnings will work the debtor over time out of the insolvency "hole" into a positive net worth. Assuming that the accounting rules (using concepts like those of

"fresh start" accounting) would permit the debt to be shown at its present value amount, the debtor could also report the debt at its present value at the confirmation date and thus avoid having to address the credit markets with a balance sheet showing a negative net worth. (The Working Group has not consulted accounting professional to determine whether this mode of presenting financial condition would be permitted under present accounting rules.) If the debt could be shown at present value, the debtor would then be required to charge earnings to accrete the carrying amount upward every year by $314,500, an annual amount which will permit the debt amount to grow over the life of the debt to the full principal amount. These accretions would be offset by the annual payments so that, at year ten, the whole liability would be amortized to zero.

Lastly, on the hypothetical of the subsequent sale of the property for $8,000,000 after two years, the secured creditor would have received one payment of $914,450, reducing the outstanding debt (at face) during year two to $8,230,050. If there were a closing, then, the use of proceeds would be as follows:

To Secured Creditor:	$8,000,000
To Equity:	$ 0

In other words, because of the making of the Section 1111(b) election, all proceeds would go to the lender. The equity would get nothing. For this reason, the equity would probably not sell the property at this point, waiting until later when the debt had been amortized to an amount less than the net proceeds of the selling price.

EXHIBIT 1 TO ANNEX A (Page 1) BOOKKEEPING ENTRIES
NO 1111(b) ELECTION

Transaction	Amount	D/C	#
Account: Cash			
Opening balance	100,000	dr	1
Infuse new value	2,000,000	dr	2
Pay sec. clm @ conf	(1,500,000)	cr	3
Pay uns df @ conf	—	cr	4
Pay uns clm @ conf	—	cr	5
Closing balance	600,000	dr	6
Account: Real Esatate			
Opening balance	12,000,000	dr	7
Write asset to mkt	(6,000,000)	cr	8
Closing balance	6,000,000	dr	9
Account: Tractor			
Opening balance	65,000	dr	10
Closing balance	65,000	dr	11
Opening total assets	12,165,000	dr	12
Closing total assets	6,665,000	dr	13
Opening total liabs.	9,140,788	cr	14
Closing total liabs.	4,540,788	cr	15
Opening equity	3,024,212	cr	16
Closing equity	2,124,212	cr	17
Opening liab. plus equity	12,165,000	cr	18
Closing liab plus equity	6,665,000	cr	19

Transaction	Amount	D/C	#
Account: Payables			
Opening balance	100,000	cr	20
Pay at consumm.	--	dr	21
Cancel @ discharge	(100,000)	dr	22
Closing balance	—	cr	23
Account: Mortgage Debt			
Opening balance	9,000,000	cr	24
Create unsec. defic.	(3,000,000)	dr	25
Pay cash at conf.	(1,500,000)	dr	26
Closing balance	4,500,000	cr	27
Account: Unsecured Portion of Mortgage			
Opening balance	3,000,000	cr	28
Pay @ consumm.	—	dr	29
Cancel @ disch.	(3,000,000)	dr	30
Closing balance	—	cr	31
Account: Tractor Loan			
Opening balance	39,000	cr	32
Perpet. acc. int.	1,788	cr	33
Total	40,788	cr	34
Account: Equity			
Opening balance	3,024,212	cr	35
Write down realty	(6,000,000)	dr	36
Infuse new value	2,000,000	cr	37
Cancel p'ables @ consummation	100,000	cr	38
Cancel unsec. portion	3,000,000	cr	39
Closing balance	2,124,212	cr	40

EXHIBIT 1 TO ANNEX A (Page 2) BOOKKEEPING ENTRIES

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$ 100,000	1	Payables	$ 100,000	20
Realty	12,000,000	7	Mortgage	9,000,000	24
Tractor	65,000	10	Tractor Loan	40,788	34
		--	Total Liabilities	9,140,788	14
		--	Equity	3,024,212	16
Total Assets	$ 12,165,000	12	Total lia. & eq.	$ 12,165,000	18

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$100,000	1	Payables	$100,000	20
Realty	6,000,000	9	Mortgage	9,000,000	24
Tractor	65,000	10	Tractor Loan	40,788	34
		--	Total Liabilities	9,140,788	14
			Equity	(2,975,788)	--
Total Assets	$6,165,000	--	Total lia. & eq.	$6,165,000	

Claimant	Total Claim	Treatment	Cash	Notes	Total Dist.
Payables	--	0%	--	--	--
Deficiency	--	0%	--	--	--
Tractor Loan	40,788	100%	--	40,788	--
Secured Claim	6,000,000	100%	1,500,000	4,500,000	6,000,000

Assets			Liabilities and Equity		
Category	Amount	#	Category	Amount	#
Cash	$600,000	6	Mortgage	$4,500,000	27
Realty	6,000,000	9	Tractor Loan	40,788	34
Tractor	65,000	11	Total Liabilities	4,540,788	15
			Equity	2,124,212	17
Total Assets	$6,665,000	13	Total lia. & eq.	$6,665,000	19

EXHIBIT 2 TO ANNEX A (Page 1) BOOKKEEPING ENTRIES
NO 1111(b) ELECTION MADE BY CREDITOR

Transaction	Amount	D/C	#
Account: Cash			
Opening balance	100,000	dr	1
Infuse new value	2,000,000	dr	2
Pay sec. clm @ conf	--	cr	3
Pay uns df @ conf	--	cr	4
Pay uns clm @ conf		cr	5
Closing balance	2,100,000	dr	6

Transaction	Amount	D/C	#
Account: Payables			
Opening balance	100,000	cr	16
Pay 0 at consumm.	--	dr	17
Cancel 100% dis	(100,000)	dr	18
Closing balance	--	cr	19

Transaction	Amount	D/C	#
Account: Real Estate			
Opening balance	12,000,000	dr	7
Write asset to mkt	(6,000,000)	cr	8
Closing balance	6,000,000	dr	9

Transaction	Amount	D/C	#
Account: Mortgage Debt (face)			
Opening balance	9,000,000	cr	20
Add Increment	144,500	dr	21
Secured claim	9,144,500	cr	22
Pay cash at conf.	—	dr	23
Closing balance (face)	9,144,500	cr	24

Transaction	Amount	D/C	#
Account: Unsecured Portion of Mortgage			
Opening balance	--	cr	25
Pay @ conf..	--	dr	26
Cancel @ conf..	--	dr	27
Closing balance	--	cr	28

Transaction	Amount	D/C	#
Account: Tractor Loan			
Opening balance	39,000	cr	29
Prepet. acc. int.	1,788	cr	30
Total	40,788	cr	31

Transaction	Amount	D/C	#
Account: Equity (At Face)			
Opening balance	3,024,212	cr	10
Write down realty	6,000,000	dr	11
Infuse new value	2,000,000	cr	12
Cancel p'ables @ consummation	100,000	cr	13
Add $144,500 debt	144,500	dr	14
Closing balance	(1,044,500)	cr	15

Transaction	Amount	D/C	#
Account: Equity (At Present Value)			
Opening balance	3,024,212	cr	32
Write down realt	6,000,000	dr	33
Infuse new value	2,000,000	cr	34
Cancel p'ables @ con	100,000	cr	35
Cancel $3 million	3,000,000	cr	36
Closing balance	2,124,212	cr	37

EXHIBIT 2 TO ANNEX A (Page 2) BOOKKEEPING ENTRIES
NO 1111(b) ELECTION MADE BY CREDITOR

				Ten-Year Note		
Claimant	**Total Claim**	**Treatment**	**Cash**	**At Face**	**At Present Value 8.5% Disc. Rate**	**Total Dist. (Face)**
Payables	100,000	0%	--	--		--
Deficiency	--	—	—			--
Tractor loan	40,788	100%		40,788	40,788	40,788
Secured Claim	9,000,000	100%	--	9,144,500	6,000,000	9,144,500

Assets			**Liabilities and Equity**				
Category	Amount	#	Category	Face Amount	#	PV Amount	#
Cash	2,100,000	6	Mortgage debt	9,144,500	24	6,000,000	
Tractor	65,000		Tractor loan	40,788	31	40,788	31
Realty	6,000,000	9	Equity	(1,020,288)	15	2,124,212	37
Total assets	8,165,000		Tot. liab. & equity	8,165,000		8,165,000	

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TO: Small Business Working Group Bankruptcy Commission

FROM: Dain C. Donelson and Judge Robert D. Martin

DATE: September 9, 1997

RE: Proposed New Value Exception - Single Asset Real Estate Entities Alternative Proposal/Additional Analysis

I. Introduction

This follow-up to the memorandum of September 5, 1997 analyzes the proposed modification to the new value exception ("NVE") as it applies to single asset real estate ("SARE") entities. Putting aside questions of whether the NVE can exist under/with the absolute priority rule and whether § 362 and the rest of the Code already provide a sufficient structure for this type of case, this memo addresses an alternative to the proposed 20% rule. In so doing, it addresses concerns about the 20% rule as articulated in the previous memorandum, discusses how this proposal deals with these issues, and attempts to address drawbacks to this new proposal.

In order to assess what system is appropriate for the NVE, it is helpful to examine what is actually happening in a NVE situation. To utilize the NVE, the estate must be insolvent or become insolvent during the bankruptcy. Otherwise, all creditors could be paid in full and the absolute priority rule would not be an issue. However, creditors in a NVE case are not paid in full. Therefore, applying the absolute priority rule, the debtor has no equity and can retain nothing on account of the prior equity interest. The debtor's only rights are those in the Code.

The question therefore becomes: What is happening in the NVE plan? It seems that the equityholders are "purchasing" an interest in a reorganized entity which essentially consists of a single piece of real estate. This is reasonable under the traditional elements of the NVE as it

requires that any interest received must be reasonably equivalent to the equityholders' contribution, and that the contribution must be both new and in money or moneys' worth.

In a NVE SARE case, therefore, it seems the debtor is actually re-purchasing the property it formerly held. The key point is that the old equity position is valueless. Therefore, any attempt to take an interest in the post-reorganization property by the former equityholders is quite similar to what occurs in a sale of property outside the ordinary course of business under § 363(b). Any sale of property under § 363(b) is subject to § 363(k), which provides that the secured creditor may bid on the property. Courts have held that this requires the allowance of credit bids.

While this analogy may seem simplistic, the key points are difficult to dispute. First, there is no equity in the property. If there were, the NVE could not be utilized. Second, the debtor is contributing money or money's worth. Third, the debtor is receiving an interest that is reasonably equivalent to the contribution in exchange for the contribution. Therefore, any attempt to utilize the NVE in a SARE case is essentially similar to a sale of property of the estate. The issue is what the best method to handle this simulated sale is in the context of a SARE chapter 11 case.

II. Proposal: Credit Bidding

A. Credit Bidding as a Viable Alternative?

One possible alternative to the 20% proposal is to use a limited "auction" system allowing the secured creditor to "bid" on the property against the debtor. Other possible alternatives include reducing or eliminating the exclusivity period in a SARE NVE case or simply leaving the Code in its current form, relying on creditors to take advantage of the opportunity to get exclusivity terminated or have the stay lifted based on the facts of the specific case.

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The reason we focus on credit bidding is that it provides more protection to creditors than the current Code, but does not take away the debtor's right to formulate a plan. In addition, by not lifting exclusivity in every NVE case, it will not be necessary for both the debtor and creditor to formulate a plan. As the key provisions of the plan will deal with financial restructuring, primarily concerned with valuation and loan terms, full-scale competing plans would seem unnecessary. Thus, in a SARE NVE case, allowing the creditor to bid if it does not accept the plan should provide sufficient protection to the creditor with the least burden.

Credit bidding would address concerns regarding valuation. The creditor could not complain about unfair valuation if given an opportunity to bid. While the allowance of credit bidding at NVE "auctions" has been argued against by some, the primary concern with such a rule is whether this would tip the scales too far in the creditor's favor. To determine whether the creditor is unduly favored, the motivations and likely behavior of the creditor must be analyzed.

B. Assumptions: Creditor Behavior

First, we assume that the creditor is not in the business of real estate investment. If it were, the creditor would not be lending to other entities but would be using its capital to purchase properties. Second, as a result of the first assumption, the creditor will not want or may not be allowed to hold the real estate for a significant period of time. Therefore, if a loan goes bad and the real estate is worth less than it was at the time the loan was made, the lender will have an incentive to limit its loss on the loan. Conversely, the creditor will have an incentive to avoid taking ownership for a significant period of time, particularly if there is no benefit in doing so.

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C. The Application

The Annex A reorganization will be used as an example. The property was originally valued at $12,000,000, subject to a mortgage of $9,000,000. The property declined in value. The debtor claimed the property was worth $6,000,000 and the creditor claimed $8,000,000.

In the example, the court valued the property at $6,000,000 and the debtor crammed down a plan. Under an alternative credit bidding system, the creditor would seem to have an incentive to bid at least the $8,000,000 it believed the property was worth, if not the full $9,000,000 of its debt. However, this is questionable if the situation is realistically evaluated.

While the creditor undoubtedly has some expertise in the valuation of properties so that it may make intelligent lending decisions, a decision to bid will not be undertaken lightly. If the creditor bids over $6,000,000 and is wrong, it will suffer a loss as it will receive less on a subsequent sale than it would have under the plan. The creditor should bid the debt (or a portion of the debt) only when it *legitimately* believes that the debtor's bid is low. However, this forces creditors to make a more critical analysis of a property than if they were merely contesting the debtor's valuation. If the lender is willing to actually bid $8,000,000 for the property the debtor values at only $6,000,000, then it is difficult for the debtor to claim a value of only $6,000,000.

Another question then arises in credit bidding situations, which is whether the creditor is really bidding. This is because the creditor will offset the loan balance with the bid price, meaning that there is no balance sheet cost until the creditor bids more than the debt. One benefit of this system is that it does not require creditor liquidity to bid. Conversely, it might be argued that the creditor would always bid as there is no "real cost" to doing so.

Again, however, it is useful to look at the creditor's motivations. If the creditor "overbids", the creditor will eventually suffer a loss on the subsequent sale. As the creditor will not be holding the property indefinitely, it must look at relatively short term sale value in making its assessment. This may give the debtor another advantage as the debtor can look at the long term possibility of appreciation. If the debtor is only looking at short term sale value, as it appears in Annex A, there is no real justification for giving the property to the debtor without exposing it to the limited market produced by letting the creditor bid on the property as well. The 20% proposal, conversely, gives the debtor the opportunity to take the property at a low value--with loan forgiveness thrown in--by convincing the court that its valuation is reasonable.

III. Benefits of the Credit Bidding Proposal

A. Valuation Issues

One of the main objections to the 20% proposal involves the necessity of court valuation in every case. Our proposal reduces the problems inherent in the speculative valuation of property by a court. The creditor can protect itself from inaccurate valuations by acting on its own valuation proposal if it is dissatisfied. By giving the creditor a limited veto power, a lowball valuation attempt by a debtor is preempted. See also section IV. C. for reasons why any creditor bid would have to be reasonable. Conversely, this also prevents posturing by a creditor in order to "drive up" a court's valuation as the creditor will have to take the property at any proposed "high" valuation. This may lead to more fruitful negotiation between the parties and may reduce court involvement. Therefore, this proposal acts as a check on possible problems in valuation.

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B. § 1111(b) Issues

This proposal also seems to alleviate the questions raised regarding the § 1111(b) election. As discussed in the previous memorandum, it seems that the primary reason for a creditor to take the election in a NVE case is to guard against a low valuation by the court. The ability to credit bid takes care of this problem. Therefore, strategic use of the § 1111(b) election as a check on valuation should not be necessary if this proposal is used instead of or in conjunction with the 20% proposal. While the presence of the § 1111(b) election may protect creditors under the 20% proposal, thereby encouraging negotiation, the potential to cramdown on the creditor at a valuation with which the creditor disagrees is too large a risk to take (and is totally unnecessary).

C. "Market Terms" Issue

A portion of the 20% proposal indicates that the portion of the new value (the 80% that is not paid at the time of confirmation) must be in the form of a loan at market terms. The credit bidding proposal would also help alleviate problems with this issue, which would lead to large amounts of litigation in order to determine what "market terms" are in any given situation.

The credit bid option would give the creditor veto power over any offensive loan terms. This gives the creditor some control over its own destiny and requires that any proposal made must be reasonable. The balance here is in the creditor's favor, but the debtor should have an incentive to push for terms that are actually in line with the current market as otherwise the debtor would be unable or unwilling to get the plan confirmed. While the 20% proposal would obviously require court validation of the loan terms in a cramdown, the credit bidding proposal would give the secured creditor the ability to avoid these litigation costs.

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IV. Potential Drawbacks

Questions may be raised regarding this proposal. Primarily, these questions would likely deal with possible creditor misbehavior during the bidding process, the possible unique value that property may have in the hands of the original equityholders, the potential that a secured creditor would bid the full amount of the debt in every NVE case and no NVE plan would ever be confirmed, and whether too much power is given to creditors under this proposal.

A. Creditor Misbehavior

An unreasonable or antagonistic creditor could bid the full amount of the debt and take the property simply to spite the debtor. It would appear that no unsecured creditors would be paid as the amount of the secured claim is exactly equal to the value of the estate. The unsecured creditors are no worse off, however, than they would be in a cramdown situation (see Annex A example). The problem with this argument is that in addition to antagonism it assumes irrationality on the part of the creditor. The creditor must do something with the property. If the creditor sells the property for less than the NVE plan was proposing, the creditor has shot itself in the foot. Therefore, it does not seem likely that creditors will act out of spite in most situations.

B. Potential "Unique Value" to the Original Equityholder

Given that unique tax advantages (or other unique ownership value) may exist which may only be realized by leaving the property in the hands of the original equityholders, the secured creditor may get the highest price for its interest in the property by a "sale" to the old equityholders. The equityholders should be willing to pay something to retain such benefits.

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To illustrate, assume that the property in Annex A held tax advantages of $500,000 in the debtor's hands. Assume further that the secured creditor values the property at $6,000,000 on the open market to a third party (the $8,000,000 figure is a bargaining posture) but thinks that the debtor should be willing to pay for the tax advantages. Therefore, the creditor determines that the property is worth $6,500,000 to the debtor. However, the debtor will not want to pay for tax breaks that no other party can use. While the debtor will not be willing to pay over $6,500,000, the creditor will not accept under $6,000,000. This provides a range of possible negotiated solutions, any of which would be reasonable. The exact outcome will depend on the bargaining strengths of the parties, as intended and currently implemented in chapter 11.

C. No Confirmed NVE Plans

It might be argued that no NVE plan would ever be confirmed under the credit bidding proposal. This does not seem to be a legitimate concern. No rational creditor would bid its debt in every NVE case. As discussed earlier, creditors are generally not in the real estate business and must do something with any property they acquire. Assuming a creditor acts rationally and in its economic self interest, the creditor will only bid the full amount of the debt if it actually believes that the debtor is underbidding. If this is not the case, then there is no reason for the creditor not to accept the debtor's proposal.

In addition, it is helpful to remember here that the creditor will undergo some transaction costs in reselling the property. Besides any carrying costs, the property will have to be marketed and sold, involving legal and other fees. Therefore, there would need to be a substantial disparity in valuation in order for it to be worthwhile for a creditor to bid (i.e., a $50,000 difference in

valuation would be insufficient to undergo the bidding and resale process).

It might also be argued that a cramdown will not be possible if this limited veto power is given to creditors. This is not necessarily true, however, and this proposal does not guarantee that courts will not have to assess the propriety of NVE plans in certain circumstances. For instance, the debtor and creditor may agree on valuation (or may be close enough that the creditor does not contest it), but may not be able to reach agreement on credit terms. While the credit bidding proposal should encourage negotiation, and the creditor would have limited veto power in any event, disputes may still exist where the creditor simply does not want to take possession of the property. Therefore, in these and other circumstances, cramdowns may still be utilized.

D. Creditor Power Under this Proposal

In reality, this proposal should do nothing but protect creditors and their legitimate interests. As discussed above, this proposal acts as a check on low valuation by the debtor and/or court, but also prevents the creditor from pushing for valuation at a price higher than it reasonably believes or is willing to take the property for itself. Additionally, a rational creditor will not simply bid the full amount of debt in each case and reasonable NVE plans will still be confirmable.

This proposal will merely serve to ensure that the values espoused by the 20% proposal and the NVE's traditional five requirements are actually met in each individual case. It would also take some of the burden off the court in NVE cases by giving power to the creditor. This should result in less court involvement, and whatever court involvement is necessary should only need to focus on genuine issues.

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V. Conclusion

The most important point to consider in assessing which NVE implementation is "the best" is that none actually improve the current Code if it is properly implemented by a court. While it could be credibly argued that the credit bidding proposal allows unilateral action by creditors through a veto power on any proposed plan, the 20% proposal gives just such unilateral power to debtors through the use of cramdowns if the initial valuation obstacle is met. Such unilateral action, whether on the part of debtor or creditor, is not the point of the reorganization process. The parties should be encouraged to negotiate and settle their own disputes.

The primary advantage of the credit bidding proposal is that it provides a check on valuation and prevents "unfair" cramdowns. Under the 20% proposal, the creditor has an incentive to push for the highest valuation possible, yet assumes little or no risk by taking such a position. The debtor, meanwhile, has every incentive to push for the lowest valuation possible, as a finding of low value would allow the debtor to cramdown a NVE plan, thereby keeping its property and achieving significant loan forgiveness.

In comparison, the creditor's ability to push for a high valuation is tempered in a credit bidding scenario. The risk of taking the property ensures that creditor valuation proposals are reasonable. It could be argued that the creditor's incentives do not change significantly as compared to the 20% proposal because a high valuation in such a case would require the creditor to take the property because the debtor would be unable to confirm a plan. However, it seems more likely that a creditor under the 20% proposal would argue for a higher valuation than it legitimately felt justified in order to counter the debtor's low proposal.

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Whatever system (if any) is adopted, it should encourage realistic valuation proposals by the parties and serious negotiations between the parties. The 20% proposal does not provide these incentives. It provides the debtor with the incentive to gamble on a low valuation by the court whenever a property begins to lose value, which encourages a strategic response by the creditor. The credit bidding proposal is designed to provide checks on each of the parties during the valuation and reorganization process in order to ensure that valuation is reasonable and to hopefully minimize unnecessary court involvement.