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Real Estate Bankruptcies

Next Wave Features Underwater Assets, Complex Structures

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With increased vacancy rates, falling rents, and billions of dollars of near-term real estate loan maturities, turnaround professionals may be working increasingly on restructuring real estate assets. This article addresses a few issues for which turnaround professionals may need to be prepared. Some are old, some are new, but many share a common theme — most real estate assets will be underwater in this wave of bankruptcy cases. Added layers of debt and more complex capital and transaction structures will add new twists to an otherwise old problem typically seen in real estate turnarounds.

This article employs the following case study. A real estate developer owns a 500-unit apartment complex in the southeast United States. Adjacent to the apartments is vacant land on which the developer wants to build a luxury condominium project. Both the apartments and vacant land are secured by a $100 million first mortgage and an $80 million second mortgage. The owners have $10 million in equity into the project. The estimated fair market value of the apartments is $90 million. The vacant land has negligible value with nothing on it but growing weeds and haphazard flowers that have bloomed, which the developer sees as a sign of better times to come.

Case 1: Priming DIP Loan

The issue: A new money lender will lend only if it receives a senior-secured, first-priority priming debtor-in-possession (DIP) loan.

In this case study, both the first and second mortgage holders clearly are undersecured, or underwater, with regard to the apartments, the value of which is less than the secured debt at both levels. The first-lien lender is undersecured by $10 million because its secured claim of $90 million attaches to the apartment collateral, and there remains a $10 million unsecured deficiency claim. The second mortgage is completely undersecured.

However, the debtor would like to develop the vacant land in hopes of creating value and paying its creditors. Both existing lenders have refused to lend any more money. However, the debtor has found a lender willing to loan $50 million to construct luxury condos on the vacant land under terms it finds acceptable.

> It is plausible that a fully built project is better than a half-built one and will significantly increase value for existing lenders — even with the new priming loan.

In appropriate circumstances, Bankruptcy Code Section 364(d) allows a debtor to obtain a DIP loan that "primes" existing secured creditors. While priming fights traditionally have been avoided because of their expensive and divisive nature, instances of these battles may increase in the next wave of cases, either because existing senior lenders have no more funds to lend or because they simply choose not to invest more into a project.

Under Section 364(d), a Bankruptcy Court may authorize a priming DIP loan if the debtor successfully demonstrates: 1) that it is unable to obtain such credit otherwise, and (2) that the interests of the current lien holders will be adequately protected from the diminution of their collateral if the priming lien is granted. How does one "adequately protect" exiting lenders?

Section 361 provides three ways to adequately protect a party's interest:

1. A cash payment or periodic cash payments to the extent of a diminution in the value of an entity's interest in such property
2. An additional or replacement lien to the extent that the party's interest declines in value as a result of the debtor's actions
3. Such other relief as will result in the realization of the "indubitable equivalent" of an entity's interest in property

These options are not exclusive and the concept of adequate protection is flexible, depending on the facts of a case. However, in the context of a real estate case, the adequate protection inquiry likely will come down to a few key issues:

- *For what is the loan to be used?* That is, is the purpose of the loan to pay down existing debt in some fashion and/or to provide operating capital to finish a half-built or partially built project?
- *How much will the real estate be worth after the loan is obtained?*

Obviously, a debtor who simply tries to layer another level of debt onto a building with relatively fixed cash flows will have difficulty obtaining a priming loan. However, this article's case study would require a more detailed inquiry. If the debtor uses the new funds to build on the vacant land, is the loan sufficient to construct the luxury condominiums? Is there likely to be a market for new luxury condominiums in the near future? If the condos are built, how much additional value is created for the entire project if the loan is obtained and put to its best use? Will an "equity cushion" be created for the existing lender? This last question is central to the priming fight.

A debtor that can show that, if given a $50 million DIP loan, it can build out an asset with greater than $50 million in value can argue that the existing lenders will be adequately protected. The debtor would need to present solid valuation and project feasibility evidence before most judges would approve a priming. However, that is not an impossible case to make and, in fact, is being done successfully in the current economic environment. It is plausible that a fully built project is better than a half-built one and will significantly increase value for existing lenders — even with the new priming loan. This fight likely boils down to a battle of real estate experts before a bankruptcy judge.

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For example, in *In re 495 Central Park Avenue Corp.*, 136 B.R. 626 (Bankr. S.D.N.Y. 1992), the debtor sought to obtain financing from a third party that would prime the secured position of its first-lien lender. In determining whether the existing first-lien lender was adequately protected by the priming loan, the court said that it "must consider whether the value of the debtor's property will increase as a result of the renovations funded by the proposed financing."

Although appraisers for the two sides disagreed on what the value of the property would be following the infusion of additional funds, the court found that "there is no question that the property would be improved by the proposed renovations and that an increase in value will result. In effect, a substitution occurs in that the money spent for improvements will be transferred into value. This value will serve as adequate protection for [the existing lender's] secured claim."

Another court from the same district has observed that the "most important question… is whether the interest of the secured creditor whose lien is to be primed is being unjustifiably jeopardized." *In re Mosello*, 195 B.R. 277, 289 (Bankr. S.D.N.Y. 1996). In this article's hypothetical case, a judge who concluded that there is no market for newly built luxury condos or that the existing lender's collateral position would be jeopardized by what the judge perceived as a developer's wishful thinking would not approve the loan. Thus, the "equity cushion" argument alone may not be sufficient to win approval.

However, perhaps the hypothetical debtor's chances increase if it uses $20 million of its DIP loan to fund a reserve to pay down the senior lender and uses the balance to build the condos. Or, perhaps the DIP lender agrees to a less onerous waterfall of proceeds from the sale of new units so that the exiting lenders can be repaid through some portion of net sale proceeds from the condo sales.

Priming is a powerful tool that exists only in bankruptcy cases. Debtors may need to explore this option either to finish projects or as a negotiating tool to bring existing lenders to the table.

Case 2: Equity's 'New Value Plan'

The issue: How can creditors or other investors protect themselves when an existing owner tries to invest new value into a real estate project to retain an ownership interest?

The absolute priority rule in Bankruptcy Code Section 1129(b) provides that a plan of reorganization cannot be confirmed over the objection of a class of unsecured claims unless the plan provides either of the following: a) all members of the class are to receive or retain property that has a value as of the effective date of the plan equal to the allowed amount of their claims, or b) no class of claims or interests that is junior to the class will receive or retain any property on account of their claims or interests.

> Because the Supreme Court did not offer guidance on how new value equity auctions are to be properly conducted, these concepts are ripe for turnaround professionals to explore.

Because equity interests are junior to claims held by unsecured creditors, equity cannot retain its ownership interests in a debtor, absent the consent of unsecured creditors, unless the unsecured creditors will receive payment in full. There exists, however, an exception to the absolute priority rule known as the "new value" exception. It allows equity holders to retain their ownership interests even though creditors do not receive full payment of their claims, provided that the new capital contributed to the reorganized debtor is an amount reasonably equivalent to the equity's retained interest in the debtor.

The new value plan is often the last refuge of an owner seeking to retain ownership. The equity holder agrees to contribute new value, generally cash, to retain its equity in the reorganized debtor. It is generally conceded that the new value exception requires that the equity holders' infusion of capital be:

1. Substantial
2. New
3. Reasonably equivalent to the interest being retained
4. In the form of "money or money's worth" that constitutes more than a promise by the equity holders to make future payments
5. Necessary to a reorganization

In 1999, the U.S. Supreme Court examined new value and held that a debtor's prebankruptcy equity holders may not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. See *Bank of America National Trust and Savings Association v. 203 N. LaSalle Street P.ship*.

The Supreme Court held in that case that new value offered exclusively to prepetition owners violated the Bankruptcy Code's absolute priority rule. The court's concern that old equity might not be paying top dollar for the equity interest that it retained or received in the reorganized debtor was based on old equity's "exclusive opportunity" to buy the equity. It was this exclusive opportunity to buy (and to set the price) that was the "property" that was being received "on account of" the former equity interest.

Accordingly, the court held that a new value plan could be considered only when either the right to buy the new equity was subject to a market test or open auction, or after the termination of the exclusivity period — during which only the debtor can propose a plan — thereby effectively auctioning off the underlying property by creating an opportunity for creditors to propose their own plan of reorganization. Proposed creditor plans often provide for the property to be surrendered to the secured creditors.

This raises several issues to consider:

- Assuming an equity owner decided to allow its equity to be exposed to a market test, how does a turnaround professional go about doing this? Should the auction be held in connection with the plan confirmation hearing or at some earlier point in time? Do bid procedure elements that are regularly employed in Section 363 asset sales, such as marketing by a banker, apply to equity sales?
- Can the secured creditor credit bid its claims? (Some courts have said they cannot because the secured creditor does not have a lien on the equity of the reorganized debtor).
- While an invitation for competing bids may appear to be in line with the Supreme Court's holding in *203 N. La Salle*, creditors and other parties in interest may contend that this will actually chill the process because management — which obviously will be involved in the auction process — has a strategic advantage.

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Case 3: Bifurcating Lenders' Claims

The issue: How do the lenders avoid being wiped out if a debtor files a plan seeking to bifurcate both lenders' claims into secured and unsecured deficiency claims, and how can they preserve upside value in the future?

Bankruptcy Code Section 1111(b) enables a secured creditor to avoid being "stripped down" and treated as an undersecured secured creditor with a deficiency claim. While this code section is complex and much of it is beyond the scope of this article, a powerful procedure this section contemplates is allowing a partially secured creditor to elect to be treated as "fully secured." A Section 1111(b)(2) election may be an optimal option for a secured lender in the current economic environment — when real estate values are depressed but will likely appreciate. Electing to be fully secured under Section 1111(b)(2) provides the potential to benefit from upside appreciation of value, and it avoids valuation disputes before a court.

For the hypothetical scenario, what if the debtor files a Chapter 11 plan that treats the senior lender as having an $80 million secured claim and a $20 million unsecured deficiency claim? The debtor would term out the secured portion over time at a market rate of interest and would likely pay the unsecured deficiency claim at pennies on the dollar. By making the 1111(b)(2) election, however, the first-lien lender would have a $100 million secured claim. Despite that, the debtor would be required only to offer a payment stream equal to at least the value of the holder's "allowed claim" — in this case, $80 million. As one court observed, the payment stream need only have a present value of at least the value of the collateral.

Thus, while the payments would equal the same amount of the non-electing creditors ($80 million in the hypothetical), the sum of the payments must be in an amount equal to at least the secured creditors total claim, or $100 million in the hypothetical. See *Collier on Bankruptcy* 1111.03[4] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) citing *First Fed. Of California v. Weinstein (In re Weinstein)*, 227 B.R. 284, 294 (B.A.P. 9th Cir 1998).

Consequently, an election under Section 1111(b)(2) allows a secured creditor to maintain its lien on its collateral, irrespective of the valuation of the collateral at the time of confirmation. In a depressed real estate market, creditors should think hard about the Section 1111(b)(2) election to save upside value. It may be interesting to see vastly out-of-the-money second lien creditors make such elections. That alone may force a debtor to sell its assets to avoid the impact of such an election.

There are a few issues and rules for lenders to consider before making a Section 1111(b)(2) election:

- In a multi-participant lender group, which is common in many recent financings, the class must make the election by voting half in number of creditors in the class and two-thirds in amount of claims
- The election does not apply in a situation in which a debtor sells its assets via a Section 363 sale or under the plan [see 1111(b)(1)(A)(ii)]
- The electing undersecured creditor loses the right to vote with regard to the previously unsecured claim. This could impact whether a plan is confirmable because in many cases, a secured lender's unsecured deficiency claim gives it a significant blocking position in the confirmation process.
- The election must be made before the conclusion of the hearing on the disclosure statement, unless the court extends the deadline

Issues Ahead

Turnaround professionals may be busy restructuring underwater real estate projects. Both old and new techniques and issues will be tested, and new strategies will be developed to confront problems inherent in half-built projects and other projects that were financed during the credit boom. CR

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