

Cramdown Litigation: Considering COVID in Valuing Real Estate in Chapter 11 Cases

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By Timothy P. Duggan

Valuation of real estate in Chapter 11 cases is challenging to begin with, and adding the effect of COVID-19 to the equation will make litigating valuation issues much more complicated. Although it is clear COVID-19 has affected most facets of our economy, quantifying the impact on real estate will lead to increased valuation hearings and motions in limine challenging the data relied upon by appraisers and their ultimate opinions of value. Also, COVID-19 did not have the same effect on all assets classes, with industrial properties doing much better as the demand for warehouse space increased, while lodging took a substantial hit with soaring hotel vacancy rates. It is likely that the lifting of various COVID-19 moratoriums and the expiration of forbearance agreements will cause a spike in Chapter 11 filings, leading to epic cramdown battles between debtors and secured creditors.

Generally, real estate is valued at its highest and best use with appraisers conducting a four-part test to determine a use that is legally permissible, physically possible,

financially feasible, and maximally productive. However, under the Bankruptcy Code, when a debtor intends to retain property and pay the secured creditor over time, the property is valued based upon the debtor's intended use of the property, which is not always the highest and best use of the property. 11 U.S.C. §506(a). In addition, the property is to be valued using the "replacement value" standard, which is the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition. With these fundamental concepts in mind, we can turn to valuing real estate in the era of COVID-19.

Property is generally valued using the sales comparison approach, income approach, and/or cost approach. COVID-19 adjustments to each appraisal approach will vary. For example, most types of commercial properties are valued with a focus on the income approach (either income / direct capitalization method or discounted cash flow method). Under the income capitalization approach, the appraiser starts with the gross revenue of a property, deducts vacan-



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cies and an allowance for collection losses to arrive at net income, and deducts certain expenses to arrive at the net operating income. Once the net operating income is determined, it is divided by a capitalization rate (similar to a rate of return) to arrive at a value. If COVID-19 had a direct impact on any of these line items, the overall value of the property could change. However, the availability of reliable data generally lags behind real-time market results, adding another challenge for appraisers. Nevertheless, cases have been decided over the past year providing some guidance on valuation issues.

In the case of *In re Kisner Group*, 2020 WL 7633854 (Bankr. D. Az. Dec. 18, 2020), the debtor filed a Chapter 11 plan seeking to cramdown a mortgagee's secured claim from \$7,5043,234 to \$5,748,000.

The lender's claim was secured by first mortgages against a Holiday Inn and a Comfort Inn, including a lien on all personal property owned by the hotels. In order to have the valuation issue decided before the confirmation hearing, the debtor filed a motion to determine the value of the collateral with the parties agreeing to use Oct. 7, 2020, as the valuation date. The bankruptcy court scheduled a plenary hearing and heard testimony over two days. Relevant to this article is the court's analysis of the income approach used by the parties' appraisers, with a focus on how the general market conditions (i.e., competition from other hotels) and COVID-19 impacted hotel revenue and capitalization rates.

Each appraiser relied upon the actual performance of the hotels in question and an accepted industry study (STARR Report) which reports each hotel's average daily room rates and hotel occupancies. In *Kisner*, the two hotels in question were experiencing operating problems in 2018 and 2019 (the two years leading up to the COVID-19 pandemic in 2020) which were caused by a large increase in hotel rooms in the local community without corresponding demand. This was followed by the decimation of hotel revenues caused by the COVID-19 pandemic in 2020. There were several differences in each appraiser's analysis that the court evaluated. One issue relevant to this article was the court's evaluation of the appraisers' use of projected net operating income based upon projected increases in hotel occupancy rates and average daily rates for the rooms and how COVID-19 was addressed in

the forecast. The lender's appraiser believed occupancy rates and daily average room rates would stabilize in 3 years by 2024, an opinion the court rejected believing 4 to 5 years was more realistic:

This Court finds the Comfort Inn's performance has been severely harmed by dramatically increased competition in the Bloomington hotel market. This fact is reflected in the financial performance from 2018 to 2019 producing a RevPar decrease of over 30%. Then, in 2020 the Comfort Inn's problems really began with the onset of the COVID-19 pandemic. Bloomington is a college town. Many students have left Bloomington to return home to advance their education online. Sporting events and other college gatherings have come to a standstill for most of 2020 and this will likely continue well into 2021. At the Valuation Date, there was still no sign of a vaccine and many were predicting an increase in COVID-19 cases as winter approached. By no means were occupancy rates or ADR rates stabilized. The Court finds that ADR and occupancy stabilization will not likely occur for 4 to 5 years. The Court cannot accept what it perceives to be Shah's overly rosy projections.

The bankruptcy court also commented on the capitalization rates used by both appraisers. In the end, the court gave more weight to the testimony of the debtor's appraiser because of his well-supported COVID-19 adjustments to the net operating income, and determined the combined value of the hotels was \$5,748,000. It is important to note that this case was decided before a vaccine was approved and there was more uncertainty in the economy.

Also, the debtor's appraiser provided substantial support for the hotel's operating results by analyzing the subject properties' actual operating results, local issues impacting hotel revenue (like it being a college town where school classes were made remote and sporting events were cancelled), and industry reports.

In the case of *In re Museum of American Jewish History*, 2020 Bankr. LEXIS 3427 (Bankr. E.D.Pa. Dec. 4, 2020), the bankruptcy court had to decide the value of a museum in Philadelphia which was built in 2010. Similar to the debtor in *Kisner*, the Museum filed a motion to fix the value of the property prior to the confirmation hearing since the debtor alleged the property was worth \$10,150,000 while the lender alleged the property was worth \$66,000,000. The court held a six-day plenary hearing and heard testimony from six expert witnesses and two fact witnesses. The debtor offered the testimony of three experts, one appraiser and two real estate experts, valuing the property as a mixed-use office development or multi-tenant office building.

Although the debtor's experts spent time discussing the effect of COVID-19 on the office market, the debtor's experts did not offer any testimony on the value of the property for the debtor's intended use—operating as a museum. During the hearing, the debtor's appraiser admitted he was not told to value the property based upon anything other than its "highest and best use" (i.e., he ignored Bankruptcy Code 506(a)). The lender offered the testimony of three appraisers, one of whom had appraised the property twice pre-petition and valued the property at its highest and best

use (office building) since there was no pending Chapter 11 case (case filed 2020) and Bankruptcy Code §506(a) did not apply. The appraiser updated the valuation and made numerous adjustments for the effects of COVID-19, but as discussed below, the value was still as an office (see decision for a discussion of the COVID-19 adjustments that counsel should consider when valuing office properties).

The lender also produced an appraiser who valued the property as a museum, using the sales comparison approach and cost approach. However, since the “results of the sales comparison approach were inconclusive because the comparable sales yielded insufficient data on which to calculate a value for the Property,” the appraiser did not put any weight on his sales comparison analysis. The appraiser relied on the cost approach, which values a property based on the sum of current depreciated replacement or reproduction cost of the property, together with land value and an appropriate incentive or profit figure, where applicable.

One of the more challenging aspects of the cost approach is determining the total amount of depreciation or obsolescence (physical, functional and/or external depreciation / obsolescence accrued to the improvements). In this case, although the parties appeared to agree that the impact of COVID-19 could be considered a form of external obsolescence, the lender’s appraiser made no adjustment for COVID-19 resulting in an objection from the debtor’s counsel. The

court overruled the objection, finding there was no evidence to support the allegation that the lender’s appraiser was required to make a COVID-19 adjustment and, if one was required to be made, there was no evidence as to how to calculate any additional depreciation caused by COVID-19. In the end, since the lender’s appraiser was the only one who valued the property based upon the debtor’s intended use as a museum and the court was satisfied that the data used for the cost approach was reasonable, the court determined a property value of \$66,000,000.

Another instructive case is one that was decided in 2021 by the United States Bankruptcy Court for the District of Connecticut, where the bankruptcy judge discussed the impact of COVID-19 on the capitalization rate where two appraisers used the income approach to value a leasehold interest (ground lease) for a restaurant. In *re Chip’s Southington*, 2021 WL 5313546 (Bankr. C. Conn. Nov. 13, 2021). The debtor’s appraiser used a 9% capitalization rate “to reflect a more risky investment environment for potential investors in light of COVID-19’s impact on the restaurant industry,” relying on industry studies and the debtor’s actual operating income. The lender used a 7% discount rate, finding that COVID-19 had no real impact on the rental income. It is important to note that the lower the discount rate, the higher the value. The bankruptcy court found that the “current challenges to the hospitality/restaurant industry call for a

higher discount rate” and gave more weight to the debtor’s appraiser’s testimony noting:

At trial, the Court took judicial notice of generally known facts regarding COVID-19, including reports from the Connecticut Restaurant Association that the prognosis for the industry was uncertain and that, as of August 2021, at least 600 restaurants had failed in Connecticut. See ECF 362 (Court’s Order after hearing taking judicial notice of the COVID-19 pandemic and related executive orders). The local restaurant industry, by virtue of its current failure rates, demonstrates increased vacancies in such properties and calls for a risk adjustment consistent with revenue losses and escalating costs of goods and labor.

Although the COVID-19 adjustment analysis in each case is not detailed, the cases do provide some guidance on what courts are looking at when allowing COVID-19 adjustments. To avoid a net opinion challenge to opinions based upon a COVID-19 adjustment, the appraiser must set forth the data he or she relied upon to support the opinion—the whys and wherefores of the opinion. Also, as we move further into 2022, more market data will be available, and we may start to see certain markets take small steps toward stabilization.

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