

Fall 2004

## Treatment of Real Property Liens in Bankruptcy Cases, 38 J. Marshall L. Rev. 171 (2004)

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### Recommended Citation

Gerald F. Munitz, Treatment of Real Property Liens in Bankruptcy Cases, 38 J. Marshall L. Rev. 171 (2004)

<https://repository.law.uic.edu/lawreview/vol38/iss1/9>

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# TREATMENT OF REAL PROPERTY LIENS IN BANKRUPTCY CASES

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## I. INTRODUCTION

The focus of this Article is the treatment of real property liens in cases under the United States Bankruptcy Code (the "Code"). Topics discussed are (i) the concept of adequate protection, (ii) treatment of postpetition rents as "cash collateral," (iii) the estate's ability to obtain credit including the priming of existing liens, (iv) the special provision of § 1111(b) pertaining to an undersecured creditor in a chapter 11 case, and (v) the treatment of a lien on real estate under the "cram down" power.

Bankruptcy law is said to be arcane and counter-intuitive. Only in bankruptcy can perfected senior liens become junior liens and a matured mortgage involuntarily restructured into a deferred balloon payment obligation. In the hope that the bankruptcy process and its treatment of real property liens will be better understood, this Article will present an overview of the bankruptcy power and the structure of the Code.

## II. UNITED STATES BANKRUPTCY LAW IS A FEDERAL QUESTION

### A. *Constitutional Basis*

#### 1. *The Bankruptcy Power*

The United States Constitution delegates to Congress the exclusive power to establish "uniform Laws on the subject of Bankruptcies. . . ."<sup>1</sup> *Continental Illinois National Bank & Trust Co. of Chicago v. Chicago, Rock Island and Pacific Railroad Co.* ("*Rock Island*") defined "subject of bankruptcies" as "nothing less than 'the subject of the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his

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1. U.S. CONST. art. I, § 8, cl. 4. See generally, Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995).

and their relief.”<sup>2</sup> *Rock Island* relied upon *In re Klein*<sup>3</sup>, which held the bankruptcy power:

[E]xtends to all cases where the law causes to be distributed, the property of the debtor among his creditors; this is its least limit. Its greatest is a discharge of the debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject—distribution and discharge—are in the competency and discretion of congress.<sup>4</sup>

*Rock Island* also held that “bankruptcy” and “insolvency” are convertible terms. The court stated that “while attempts have been made to formulate a distinction between bankruptcy and insolvency, it long has been settled that, within the meaning of the constitutional provision, the terms are convertible.”<sup>5</sup>

## 2. Federal Supremacy and the Contracts Clause

When Congress enacts bankruptcy legislation, that power is “paramount and transcends and supersedes all inconsistent state laws.”<sup>6</sup> However, *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*<sup>7</sup> sustained a state statute permitting a municipality in a court supervised proceeding, with the consent of eighty-five percent of affected bondholders, to extend the maturity of the city’s unsecured bonds but prohibiting the state from reducing the unpaid principal.<sup>8</sup> While the grant of a discharge in bankruptcy or its equivalent, the confirmation of a plan, have the effect of abridging the debtor’s contractual obligations, this result does not conflict with the Constitution’s “Contracts Clause”<sup>9</sup> because that clause only prohibits the states from impairing obligations under existing contracts. The restriction does not apply to Congress because doing so would be inconsistent with Congress’s bankruptcy power to discharge obligations in existence at the date of enactment of a bankruptcy statute.

*First National Bank of Chicago v. Prima Co.*<sup>10</sup> discussed the applicability of the bankruptcy power to both existing and future contracts.<sup>11</sup>

2. *Id.* at 673.

3. 42 U.S. (1 How.) 277 (1843)

4. *Id.* at 718.

5. *Rock Island*, 294 U.S. at 667-68.

6. *Chi. Junction R.R. v. Sprague (In re Chi. Rapid Transit Co.)*, 129 F.2d 1, 4 (7th Cir. 1942), *cert. denied*, 317 U.S. 683 (1942); *Int’l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929).

7. 316 U.S. 502 (1942).

8. *Id.* at 502, 512-14. *Cf. Sherwood Partners, Inc. v. Lycos, Inc.*, No. 03-55247, 2005 U.S. App. LEXIS 490, at \*21 (9th Cir. Jan. 12, 2005) (holding a state statute was preempted by the Code).

9. U.S. CONST. art. I, § 10, cl. 1.

10. 88 F.2d 785 (7th Cir. 1937).

11. *Id.* at 788.

All parties to a contract are, of necessity, aware of the existence of, and subject to, the power of Congress to legislate on the subject of bankruptcies. They were and are chargeable with knowledge that their rights and remedies, in case the debtor becomes insolvent and is adjudicated a bankrupt, are affected by existing bankruptcy laws and all future lawful bankruptcy legislation which might be enacted.<sup>12</sup>

Another unavoidable conclusion is that all contracts are made with the knowledge that existing bankruptcy laws may be amended.<sup>13</sup> However, always to be remembered with respect to the exercise of the bankruptcy power is that, like the other substantive powers of Congress, it is subject to constitutional restraints, such as the Fifth and Eleventh Amendments.<sup>14</sup>

### 3. *Historical Perspective and Interpretation of Bankruptcy Power*

In 1898, Congress enacted a comprehensive bankruptcy statute named the Bankruptcy Act.<sup>15</sup> Subsequently, the Chandler Act Amendments of 1938 added Chapters X, XI, XII, and XIII to the Act.<sup>16</sup> Recognizing the need to adapt bankruptcy law to present financial and commercial activities, in 1970, Congress created the Commission on the Bankruptcy Laws of the United States to recommend changes to the substantive and procedural law of bankruptcy. The Commission filed a two-part report in 1973. Part Two was a draft statute which, with significant amendments, became the Bankruptcy Reform Act of 1978.<sup>17</sup>

In an effort to meet new conditions resulting from commercial activity growth, the tendency of bankruptcy laws and of judicial interpretation of those laws has been uniformly in the direction of progressive liberalization.<sup>18</sup> But all expansions of the bankruptcy power were not readily accepted. A month after deciding *Rock Island*, the Supreme Court struck down the first Frazier-Lemke Act<sup>19</sup> as unconstitutional in *Louisville Joint Stock Land Bank v. Radford*.<sup>20</sup> The following year the Court voided the first municipal

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12. *Id.*

13. *Id.*

14. U.S. CONST. amends. V, XI. See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589 (1935); *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44, 54 (1996); *Schlossberg v. Maryland (In re Creative Goldsmiths of Wash. D.C., Inc.)*, 119 F.3d 1140, 1147 (4th Cir. 1997); *Tenn. Student Assistance Corp. v. Hood*, 124 S. Ct. 1905, 1909, 1914 (2004).

15. Bankruptcy Act, ch. 541, 30 Stat. 544 (1898).

16. Chandler Act (Bankruptcy Act, Amendments of 1938) ch. 575, 52 Stat. 840 (1938) (codified as amended at 11 U.S.C. § 101 *et seq.*).

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

18. See *Rock Island*, 294 U.S. at 671.

19. Frazier-Lemke Farm-Mortgage Act, Pub. L. No. 73-486, 48 Stat. 1289 (1934).

20. *Radford*, 295 U.S. at 555.

debt adjustment law in *Ashton v. Cameron County Water Dist. No. 1*.<sup>21</sup> The constitutional infirmity in both cases was not that the subject legislation exceeded the scope of the bankruptcy power, but rather that the bankruptcy power had to yield to other constitutional demands, i.e., the Fifth, Tenth, and Eleventh Amendments, along with state sovereignty.<sup>22</sup> Scholars still debate whether successor statutes sustained in *Wright v. Union Central Life Insurance Co.*<sup>23</sup> and *United States v. Bekins*<sup>24</sup> actually corrected the perceived defects or only reflected the intervening change in the composition of the Supreme Court.

### B. The Bankruptcy Code of 1978

#### 1. Background and Statutory Construction

The Code was developed during the period 1970-1978 and enacted on November 6, 1978 with an effective date of October 1, 1979.<sup>25</sup> Updated with periodic amendments, the most significant changes came in 1984, 1986, 1994, and 2000. The cardinal canon of statutory construction used in interpreting the Code, as with other federal legislation, is the "plain meaning rule." Basically, Congress "says in a statute what it means and means in a statute what is says there."<sup>26</sup> The plain meaning rule, i.e., the words Congress used, will control unless it produces a patently absurd result or contravenes clear legislative history.<sup>27</sup>

A second rule of statutory construction is the "clean slate rule." As noted, a pervasive bankruptcy statute has been in continuous effect for more than 100 years. *Dewsnup v. Timm*<sup>28</sup> observed:

When Congress amends the bankruptcy laws, it does not write 'on a clean slate.' . . . Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history. . . . Of course, where the language is unambiguous, silence in the legislative history cannot be controlling.<sup>29</sup>

Another rule followed in construing the Code is that if

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21. *Ashton v. Cameron County Water Dist. No. 1*, 298 U.S. 513, 542 (1936).

22. *Id.*; *Radford*, 295 U.S. at 589.

23. *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940).

24. *United States v. Bekins*, 304 U.S. 27 (1938).

25. Bankruptcy Reform Act of 1978, 92 Stat. 2549.

26. *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 254 (1992); *Hartford Underwriters v. Union Planters*, 530 U.S. 1, 10 (2000).

27. *In re Catapult Entm't, Inc.*, 165 F.3d 747, 753 (9th Cir. 1999).

28. 502 U.S. 410 (1992).

29. *Id.* at 419-20.

Congress knows how to say something and chooses not to do so, its silence is controlling.<sup>30</sup>

## 2. *Structure of the Code*

The Code contains the following eight Arabic-numbered chapters, with chapters 7, 9, 11, 12, and 13 each being referred to as a “relief” chapter:

Chapter 1	General Provisions
Chapter 3	Case Administration
Chapter 5	Creditors, Debtor and the Estate
Chapter 7	Liquidation
Chapter 9	Adjustment of Debts of a Municipality
Chapter 11	Reorganization
Chapter 12	Adjustment of Debts of a Family Farmer with Regular Annual Income
Chapter 13	Adjustment of Debts of an Individual with Regular Income

All cases may be voluntarily commenced. Cases brought under chapters 7 and 11 may also be involuntarily commenced.<sup>31</sup> The eligibility of an entity to be a debtor in a case is contained in Code § 109(b)-(g).<sup>32</sup>

Code § 103 specifies which chapters of the Code apply to the cases. Relevant to this Article are the following applications:

(a) Chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title.<sup>33</sup>

(g) Subchapters I, II and III of chapter 11 of this title apply only in a case under such chapter.<sup>34</sup>

(i) Chapter 13 of this title applies only in a case under such chapter.<sup>35</sup>

(j) Chapter 12 of this title applies only in a case under such chapter.<sup>36</sup>

In a chapter 9 case, the chapters and sections of the Code applicable to the case are specified in § 103(f) and § 901. Among the sections adopted by § 901 are §§ 364(d), 506, 552, 1111(b) and

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30. *Nat'l Labor Relations Bd. v. Bildisco & Bildisco*, 465 U.S. 513, 522-23 (1984); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-41 (1989).

31. 11 U.S.C. § 303 (2000).

32. *Id.* § 109(b)-(g).

33. *Id.* § 103(a).

34. *Id.* § 103 (g).

35. *Id.* § 103 (i).

36. *Id.* § 103(j).

1129(b)(1).

### III. SPECIAL TREATMENT FOR REAL ESTATE CASES AND LIENS

There is a general principle that liens pass through bankruptcy unaffected. But as discussed in *Matter of Penrod*,<sup>37</sup> the principle cannot be taken literally. While the secured creditor does not, by participating in the bankruptcy case by filing a claim, surrender his lien,<sup>38</sup> the lien is subject to challenge and may be impaired in a plan or reorganization. In *Penrod*, a lienholder filed a claim but did not object to the confirmed plan's not classifying his lien. The precise question presented was whether a pre-existing lien survives a reorganization where the plan or order confirming the plan does not mention the lien. The Seventh Circuit ruled that the lien was extinguished relying upon § 1141(c) which provides that "except as provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor." The lesson to be learned is that the lienholder must follow the case to the point of insuring that the plan, or a sale of property under § 363, does not extinguish the lien.

Set forth below are sections of the Code that provide special treatment for real estate cases and liens on real property:

Code Section	Summary of Provision
101(51)(B)	Defines the term "single asset real estate," including the requirement that the debtor's noncontingent, liquidated secured debt not exceed \$4 million. See IV.D, V.D, <i>infra</i> .
101(53)	Defines "statutory lien" as a lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien.
362(b)(3)	Exempts from the operation of the automatic stay of § 362(a), any act to perfect, or to maintain or continue the perfection of, an interest in property that is not a voidable transfer under §§ 544, 545 and 549 or is filed within the time periods prescribed by § 546(b) and § 547(e)(2)(A).

37. 50 F.3d 459, 462 (7th Cir. 1995).

38. *In re Sax*, 796 F.2d 994, 997-98 (7th Cir. 1986); *Matter of Met-L-Wood Corp.*, 861 F.2d 1012, 1017-18 (7th Cir. 1988).

Code Section	Summary of Provision
362(b)(8)	Exempts from the operation of the automatic stay, the commencement of any action by the Secretary of Housing and Urban Development to foreclose a mortgage or deed of trust in any case in which the mortgage or deed of trust held by the Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations or property, consisting of five or more living units.
362(b)(9)(D)	Exempts from the operation of the automatic stay, the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment (but any tax lien that would otherwise attach to property of the estate by reason of such an assessment shall not take effect unless such tax is a debt of the debtor that will not be discharged in the case and such property or its proceeds are transferred out of the estate to, or otherwise revested in, the debtor).
362(b)(18)	Exempts from the operation of the automatic stay, the creation or perfection of a statutory lien for an ad valorem property tax imposed by the District of Columbia, or a political subdivision of a State, if such tax comes due after the filing of the petition.
362(d)(3)	Deals with relief from the automatic stay of an act against single asset real estate.
363(g)	Authorizes trustee to sell property free and clear of any vested or contingent right in the nature of dower or curtesy.
363(i)	Recognizes right of the debtor's spouse or a co-owner of property of the estate to purchase property at the price at which a sale is to consummated to a third party, i.e., creates a right of first refusal.
502(b)(3)	Disallows a claim for a tax assessed against property of the estate to the extent such claim exceeds the value of the interest of the estate in such property.
506(d)	Preserves the validity of a lien where the underlying claim was (1) disallowed only under §§ 502(b)(5) or 502(e), or (2) such claim was not an allowed secured claim due only to the failure of the secured creditor to file a proof of claim under § 501.



Code Section	Summary of Provision
546(b)	See comment to § 362(b)(3), <i>supra</i> .
547(e)(1)(A)	For purposes of preference law, a transfer of an interest in property other than fixtures, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee.
547(e)(2)(A)	See comments to § 362(b)(3) and § 547(e)(1)(A), <i>supra</i> .
549(c)	<p>The trustee may not avoid a post-petition transfer of real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such property, against whom applicable law permits such transfer to be perfected, could not acquire an interest that is superior to the interest of such good faith purchaser.</p> <p>A good faith purchaser without knowledge of the commencement of the case and for less than present fair equivalent value has a lien on the property transferred to the extent of any present value given, unless a copy or notice of the petition was so filed before such transfer was so perfected.</p>
722	The debtor's right of redemption in a chapter 7 case does not pertain to real property.
1123(b)(5)	The rights of a holder of a secured claim secured only by a security interest in real property that is the debtor's principal residence may not be impaired by a chapter 11 plan. An individual debtor, however, may cure any default pursuant to § 1123(a)(5)(G). Interest on interest will only be allowed if provided for in the agreement and applicable nonbankruptcy law. See § 1123(d).

Code Section	Summary of Provision
1322(b)(2)	The rights of a holder of a secured claim secured only by a security interest in real property that is the debtor's principal residence may not be impaired by a chapter 13 plan. The plan may, however, cure a default pursuant to § 1322(b)(3). Interest on interest will only be allowed if provided for in the agreement and applicable nonbankruptcy law. See § 1322(e).
1322(b)(5)	Notwithstanding § 1322(b)(2), a plan may provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on which the last payment is due after the date on which the final payment under the plan is due.
1322(c)	Notwithstanding subsection 1322(b)(2), and applicable non-bankruptcy law (1) a default with respect to a lien on the debtor's principal residence may be cured under paragraph (3) or (5) of subsection (b) until such residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law, and (2) in a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to § 1325(a)(5).

#### IV. DEFINITIONS OF CLAIM, CREDITOR, LIEN, SECURITY INTEREST, AND SINGLE ASSET REAL ESTATE

##### A. "Claim" Is Defined to Mean:

(a) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(b) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent,

matured, unmatured, disputed, undisputed, secured, or unsecured.<sup>39</sup>

### *B. Creditor*

A "creditor" is an "entity that has a claim against the debtor that arose at the time of or before [the entry of] the order for relief in the bankruptcy case concerning the debtor."<sup>40</sup>

Also to be noted is the following distinction: Assume a lender makes an unsecured loan to a corporation, which loan is guaranteed by the corporate president and is secured by a mortgage on the president's home. The lender would only be an unsecured creditor in the corporation's bankruptcy case. It would be a secured creditor in the president's bankruptcy case because of its mortgage on his or her home. If the guarantee was not secured with the president's property, the lender would only be an unsecured creditor in the president's bankruptcy case.

### *C. Consensual, Judicial and Statutory Liens*

"Lien" is the broadest term in bankruptcy law affecting secured creditors. A lien means a "charge against or interest in property [of the estate] to secure payment of a debt or performance of an obligation."<sup>41</sup> Lien encompasses both a "judicial lien," security interests arising under "a security agreement," and statutory liens. A judicial lien is one obtained by judgment, levy, sequestration or other legal or equitable process or proceeding.<sup>42</sup> A security agreement is a consensual lien, a lien created by agreement.<sup>43</sup> Under bankruptcy law, a real estate mortgage is a security interest.

The Code defines a statutory lien as a lien arising solely by force of a statute or specified circumstances or conditions, or lien of distress for rent, whether or not statutory. Section 545 of the Code avoids statutory liens that are disguised priorities and conflict with the priorities established by § 507(a) of the Code. Statutory liens may be avoided if they are first effective upon the commencement of a bankruptcy case or similar event stated in § 545(1), is not perfected or enforceable as of the commencement of a bankruptcy case against a bona fide purchaser, whether or not such purchaser exists, is for rent, or is a lien of distress for rent. A statutory lien for an ad valorem property tax is not affected by § 545 but is subject to disallowance under § 502(b)(3) if the tax claim exceeds the value of the interest of the estate in the property. By way of example, if a debtor owned Blackacre having

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39. 11 U.S.C. § 101(5).

40. *Id.* § 101(10).

41. *Id.* § 101(37).

42. *Id.* § 101(36).

43. *Id.* § 101(51).

a value of \$100,000 but unavoidable mortgages and judicial liens against Blackacre totaled \$125,000, the tax lien is entitled to the status accorded it under applicable nonbankruptcy law but is not a claim against the debtor's estate.

#### D. Single Asset Real Estate

In response to pressure from real property lenders, the Code defines "single asset real estate" to mean:

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.<sup>44</sup>

The phrase "single asset real estate" only appears in Code § 362(d)(3) regarding relief from the automatic stay.

Pursuant to § 102(2), the phrase "claim against the debtor includes a claim against property of the debtor", a nonrecourse claim. As discussed in Section VIII *infra*, pursuant to § 1111(b)(1)(A), an undersecured creditor automatically obtains the right of recourse against a debtor retaining ownership of the collateral with respect to the unsecured portion of its claim, whether or not such creditor has a recourse claim under applicable nonbankruptcy law. Conversely, under specified conditions, § 1111(b)(2) permits the creditor to waive the "split" effected by § 1111(b)(1) and remain a secured creditor for the full amount of its claim.

### V. THE CONCEPT OF ADEQUATE PROTECTION

#### A. Introduction and Purpose

Among the concepts introduced by the Code was that of "adequate protection" of the interests of secured creditors.<sup>45</sup> A lien is a property right. Adequate protection is designed to reconcile the tension between the prohibition against the taking of property established by the Fifth Amendment to the United States Constitution and the need in a bankruptcy case to impair the rights and remedies of a secured creditor.<sup>46</sup>

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44. *Id.* § 101(51B). See *In re Kkemko, Inc.* 181 B.R. 47, 48 (Bankr. S.D. Ohio 1995).

45. The interests of a co-owner of property of the estate and of an entity having a right of setoff are also entitled to adequate protection. A secured creditor's right to adequate protection in a chapter 12 case is governed by 11 U.S.C. § 1205.

46. See *Wright*, 311 U.S. at 278-79 (stating that the Bankruptcy Act

While the concept of "adequate protection" is not defined in the Code, the generally accepted definition views adequate protection as that protection necessary to preserve the value of a lien at the commencement of the case throughout the administration of the case.

The most important message of the Code with respect to the treatment of an entity with an interest in property of the estate or in the possession of the estate is that its remedies may be suspended, even abrogated, and its right of recourse to collateral may be terminated as it is consumed in the business, as long as the value of its secured position is adequately protected. . . . However, courts are divided on the question of whether the value to be protected is the value of the interest as of the date of the request for protection or as of the commencement of the case.<sup>47</sup>

Adequate protection is not self-executing. The secured creditor must establish the value of its secured claim to entitle such value to adequate protection. The "strict rule" is that adequate protection entitlement only arises from and after the request for relief.<sup>48</sup> The "liberal rule" is that, if otherwise timely requested, the adequate protection entitlement can be made retroactive to the commencement of the case.<sup>49</sup> The failure to request adequate protection, however, does not affect the validity of an otherwise perfected lien.

It is essential to note that the interest entitled to protection is the value of the lien. A creditor holding a valid lien on collateral worth \$15,000 securing a \$10,000 claim is entitled to have \$10,000 in value protected against decrease, i.e., the amount required to make the creditor whole. If collateral having a value of \$8,000 secures a \$10,000 claim, the creditor is only entitled to protection of the \$8,000 value (i.e., its secured claim as determined under § 506(a)).

### *B. Valuation of Collateral and § 506(a)*

Section 506(a) provides for the determination of a creditor's secured status as a function of the "value" of the creditor's interest in the property. The level of adequate protection to which the creditor is entitled will be based upon this valuation. The

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rehabilitates distressed debtors while safeguarding the rights of secured creditors); *Rock Island*, 294 U.S. at 680-81 (declaring that Congress has authority to pass legislation pertinent to bankruptcies even if it impairs the obligation of private contracts).

47. 2 COLLIER ON BANKRUPTCY ¶ 361.01, at 361-6 (15th ed. 1991). See also *In re Beker Indus. Corp.*, 58 B.R. 725, 736 (Bankr. S.D.N.Y. 1986) ("adequate protection' is not defined in the Code except by the implications of the examples. . . . Its application is left to the vagaries of each case.").

48. See generally *In re Kennedy*, 177 B.R. 967 (Bankr. S.D. Ala. 1995).

49. See generally *In re Longbine*, 256 B.R. 470 (Bankr. S.D. Tex. 2000).

procedure for determining the value of security is contained in Bankruptcy Rule 3012. This Rule permits the valuation to be made on motion of any party in interest, after notice and a hearing, to the secured creditor and any other entity the court may direct.<sup>50</sup> A final hearing conducted under Bankruptcy Rule 4001 would be a hearing in compliance with Bankruptcy Rule 3012. Value is a factual matter, and the party appealing a valuation finding will bear the heavy burden of showing that the trial court's finding was clearly erroneous.<sup>51</sup>

The difference between requesting a "plain" valuation of collateral under Rule 3012 and requesting relief from the automatic stay should be noted. There is no restriction on the number of times a creditor can request relief from the automatic stay. There is a continuing controversy as to how many valuations a creditor is entitled to. The "strict rule" is two, one for purposes of adequate protection and the second, if necessary, for purposes of plan confirmation.<sup>52</sup> The "liberal rule" would permit multiple valuations for cause shown.<sup>53</sup>

### C. *Commercially Reasonable Standard of Valuation*

Many courts, in valuing collateral pursuant to § 506(a), have applied the "commercially reasonable" standard of in *In re American Kitchen Foods, Inc.*<sup>54</sup>

Where collateral is used or produced . . . by a going business which offers reasonable prospects that it can continue, the value of the collateral is equatable with the net recovery realizable from its disposition as near as may be in the ordinary course of the business.

Consistency in collateral valuation obviously does not mean that collateral will be assigned the same value throughout the proceedings as at their commencement, but merely that the most *commercially reasonable* disposition practicable in the circumstances should be the standard universally applicable in all cases and at every phase of each case.<sup>55</sup>

The last sentence of § 506(a) provides that a valuation made for one purpose, for example in an adequate protection hearing will not be given res judicata effect in other valuation aspects of

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50. FED. R. BANKR. P. 3012

51. FED. R. BANKR. P. 8013.

52. *See generally In re Addison Props. Ltd.*, 185 B.R. 766 (Bankr. N.D. Ill. 1995).

53. *See generally In re The Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990).

54. *Chem. Bank & First Penn. Bank, N.A. v. Am. Kitchen Foods, Inc. (In re Am. Kitchen Foods, Inc.)*, No. BK75-294-302ND, 1976 Bankr. LEXIS 6, at \*16-18 (Bankr. D. Me. June 8, 1976).

55. *Id.*

the case, such as those addressing plan confirmation. This provision, however, is not a license for misrepresentation in valuation hearings. A secured creditor's change in position must be based upon intervening events or the type of appraisal (going concern versus liquidation), and not upon the strategy of demeaning the value of property at an adequate protection hearing and elevating it for purposes of confirmation. The converse of this admonition is equally applicable to the trustee or its equivalent, the debtor in possession, in a chapter 11 case.

*D. Relationship Between Adequate Protection  
and §§ 362(d), 363(e), and 364(d)*

The right of the secured creditor to adequate protection limits the trustee's rights under §§ 362, 363, and 364(d). The trustee will lose the benefits of the automatic stay of an act against property of the estate (e.g., foreclosure) provided by § 362(a) if the secured creditor's interest in such property is not adequately protected.<sup>56</sup>

Section 362(d) contains three grounds for relief from the automatic stay. The first ground is for cause, including the lack of adequate protection.<sup>57</sup> The second ground with respect to a stay of an act against property of the estate is that there is no equity in the property and the property is not necessary to an effective reorganization of the debtor.<sup>58</sup> The third ground is tied to the Code's definition of single asset real estate.<sup>59</sup> If the property is a single asset real estate, the stay is to be modified unless not later than ninety days after the order for relief, or such additional time as extended by the court, the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable period of time.<sup>60</sup> Alternatively, the stay will be modified unless the debtor has commenced monthly payments on a consensual lien in an "amount equal to interest at a current fair market rate on the creditor's secured claim."<sup>61</sup>

Pursuant to Bankruptcy Rule 4001(a)(3), an order granting a motion for relief from the automatic stay made in accordance with Bankruptcy Rule 4001(a)(1) is stayed until the expiration of ten days after the entry of the order, unless the Court orders otherwise. Conversely, ex parte relief from the stay granted under § 362(f) and Bankruptcy Rule 4001(a)(2) is not subject to the ten day stay.

Section 363(e) conditions the trustee's right to continue to

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56. 11 U.S.C. § 362(d).

57. *Id.* § 362(d)(1).

58. *Id.* § 362(d)(2)(A).

59. *Id.* § 362(d)(3).

60. *Id.* § 362(d)(3)(A).

61. *Id.* § 362(d)(3)(B).

use, sell, or lease property, including cash collateral, upon adequate protection existing for the secured creditor's interest in such property. Finally, the extraordinary power of the trustee under § 364(d) to obtain credit secured by the grant of a senior or equal lien on encumbered property is subject to the primed lien being adequately protected.<sup>62</sup> Although the Code does not suggest a different standard, some courts have suggested that adequate protection must be more strictly construed for purposes of § 363 or § 364 than for purposes of § 362.<sup>63</sup>

#### *E. Entitlement to Adequate Protection: Equity Cushion*

Adequate protection payments or additional liens need be furnished only to the extent that the value of the collateral decreases during the administration of a bankruptcy case to the point that the value of the lien is jeopardized. If at all times the value of the collateral exceeds the lien, the "equity cushion" eliminates the need for adequate protection.<sup>64</sup>

In determining the adequacy of an equity cushion, the courts have looked to the stability of the collateral, the likelihood of reorganization, and the credibility of the trustee's proposal for furnishing adequate protection.<sup>65</sup> A cushion of twenty percent or more is usually considered adequate, while a cushion of less than eleven percent is usually considered inadequate.<sup>66</sup>

When adequate protection is required under §§ 362, 363, or 364, § 361 specifies three methods of furnishing such protection. They are cash payments, additional or replacement liens, and indubitable equivalents.

The most definitive method of providing adequate protection to a secured creditor is requiring the trustee to make lump sum or periodic cash payments to such creditor.<sup>67</sup> While there may be a dispute with respect to the amount of the payment required, there cannot be an issue with respect to a dollar being a dollar.<sup>68</sup> The

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62. *Id.* § 364(d)(1)(B).

63. See *In re Chevy Devco*, 78 B.R. 585, 588 (Bankr. C.D. Cal. 1987) (stating adequate protection in relief from stay proceedings merely preserves the status quo, whereas under 364 it must protect the creditor against harm caused by the imposition of a senior lien); *In re O.P. Held, Inc.*, 74 B.R. 777, 782 (Bankr. N.D.N.Y. 1987) (what may constitute protection for purposes of denying a motion to lift the stay is not necessarily adequate to authorize the debtor's use of cash collateral).

64. See generally *In re Am. Kitchen Foods*, 1976 Bankr. LEXIS at \*16-18; *In re Chauncey St. Assocs. L.P.*, 107 B.R. 7, 8 (Bankr. D. Mass. 1989).

65. See, e.g., *In re Phila. Consumer Disc. Co.*, 37 B.R. 946, 949 n.9 (Bankr. E.D. Pa. 1984).

66. See *Kost v. First Interstate Bank of Greybull (In re Kost)*, 102 B.R. 829, 831-32 (Bankr. D. Wyo. 1989).

67. 11 U.S.C. § 361(1).

68. See, e.g., *Bargas v. Rice (In re Rice)*, 82 B.R. 623, 627 (Bankr. S.D. Ga.



second method of providing adequate protection is granting the secured creditor an additional or replacement lien to the extent that the "stay, use, sale, lease or grant results in a decrease in the value" of the creditor's interest in its collateral.<sup>69</sup> The additional or replacement lien method of adequate protection is less certain than cash payments because of the potential for controversy over the value of the newly pledged collateral.<sup>70</sup> The third method of furnishing adequate protection is to give the creditor the "indubitable equivalent" of its interest in the collateral.<sup>71</sup> Satisfaction of the "indubitable equivalent" catchall of § 361(3) requires strict proof that the protection is "indubitable."<sup>72</sup> While a guaranty may constitute adequate protection under § 361(3), the cases generally require that the guaranty be adequately secured.<sup>73</sup>

Absent the secured creditor's consent, the granting of an administrative expense claim cannot constitute adequate protection.<sup>74</sup> Congress properly concluded that the protection provided by an administrative priority claim is "too uncertain to be meaningful."<sup>75</sup>

#### F. Postpetition Effect of Prepetition Security Interest

Section 552(a) sets forth the general rule that "property acquired by the estate or the debtor after the commencement of the bankruptcy case is not subject to any lien" resulting from a prepetition security agreement. A significant exception to the general rule contained in § 552(b) is that if the prepetition security interest covers "proceeds, product, offspring, or profits" of the prepetition collateral, then the security interest extends to the described items "acquired by the estate post petition to the extent provided by such security agreement and by applicable nonbankruptcy law." The amount of this entitlement, however, is subject to assessment as determined by the court based on the

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1987); *Greives v. Bank of W. Ind. (In re Greives)*, 81 B.R. 912, 962-63 (Bankr. N.D. Ind. 1987).

69. 11 U.S.C. § 361(2).

70. *See, e.g., In re Dynaco Corp.*, 162 B.R. 389, 397-98 (Bankr. D.N.H. 1993).

71. 11 U.S.C. § 361(3).

72. *Southtrust Mobile Serv., Inc. v. Englebort*, 137 B.R. 975, 983-84 (N.D. Ala. 1992) ("[A]dequate protection requires that the secured party be guaranteed that it timely realize the indubitable equivalent of its interest, meaning the whole value of its bargained-for rights." (internal quotations omitted)). *See, e.g., In re Mid-Atlantic Fuels, Inc.*, 121 B.R. 207, 210 (Bankr. S.D. W. Va. 1990).

73. *See In re T.H.B. Corp.*, 85 B.R. 192, 194-95 (Bankr. D. Mass. 1988) (holding a secured guaranty to be sufficient based upon stable substantial collateral value).

74. 11 U.S.C. § 361(3).

75. *See S. REP. NO. 95-989*, 49, 53-54 (1978).

equities of the case, e.g., the amount that the estate contributed to the creation of the proceeds. This assessment power is the postpetition counterpart to the prepetition improvement in position test contained in § 547(c)(5). It also does not detract from the trustee's power under § 506(c) to assess the collateral for the reasonable and necessary costs of preserving, or disposing of, the collateral.

Section 552(b)(2) expressly extends the scope of a prepetition mortgage to amounts paid postpetition as rents derived from the lien property or the "fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties." Here also, the postpetition entitlement is subject to assessment based on the equities of the case.<sup>76</sup>

### G. Right of Secured Creditors to Postpetition Interest and Reimbursement of Its Fees

Section 506(b) provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

This provision entitles an oversecured creditor, whether holding a consensual, judicial, or statutory lien, to postpetition interest and reimbursement of its reasonable fees, costs, or charges as provided in its contract with the debtor or applicable nonbankruptcy law.<sup>77</sup> *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*<sup>78</sup> held that an oversecured creditor is entitled to postpetition interest only "to the extent" that the value of its collateral exceeds the amount of its claim.<sup>79</sup>

Even more important for our purposes than § 506's use of terminology is its substantive effect of denying undersecured creditors postpetition interest on their claims—just as it denies oversecured creditors postpetition interest to the extent that such interest, when added to the principal amount of the claim, will

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76. 11 U.S.C. § 552(b)(2).

77. *Id.* § 506(b); *In re Lane*, 108 B.R. 6, 8 (Bankr. D. Mass. 1989). See also *Ron Pair Enters., Inc.*, 489 U.S. at 242-49 (stating oversecured claims based on either consensual or nonconsensual liens are entitled to postpetition interest). See also *In re Charter Co.*, 63 B.R. 568, 571 (Bankr. N.D. Fla. 1986).

78. 484 U.S. 365 (1988).

79. *Id.* at 372.

exceed the value of the collateral.<sup>80</sup>

It is important to note the Code's requirement that costs assessed against the collateral under Code § 506(c) are to be deducted in determining the existence of an oversecured position.<sup>81</sup>

In *Timbers*, the Supreme Court rejected an undersecured creditor's argument that adequate protection should compensate it for its "lost opportunity costs," i.e., the amount it could have received and reinvested had the automatic stay not enjoined its foreclosing on the collateral.<sup>82</sup>

#### *H. The Superpriority of § 507(b)*

If the adequate protection accorded a secured creditor proves inadequate, § 507(b) grants the secured creditor an administrative claim for its damages with priority over every other priority claim allowable under § 507(a).<sup>83</sup> Although the rationale for and the language of § 507(b) could support the opposite result, administrative claims incurred under § 503(b) in a superseding chapter 7 case have priority over a § 507(b) "inadequate protection claim" incurred in a chapter 11 case.<sup>84</sup>

The protection afforded by the § 507(b) priority is effective only to the extent that the estate has unencumbered assets sufficient to meet the adequate protection deficiency. Moreover, the priority may be preempted if credit is extended to the estate under § 364(c)(1).<sup>85</sup> To protect its interests, the secured creditor should obtain an order directing that notice of all proceedings be served upon it, so that it may monitor the conduct of the case and oppose the granting of § 364(c)(1) status for improvident extensions of credit.

### VI. CASH COLLATERAL

#### *A. Definition of Cash Collateral*

Section 363(a) defines "cash collateral" as:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the

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80. *Id.*

81. *See also* Orix Credit Alliance, Inc. v. Delta Res., Inc. (*In re* Delta Res., Inc.), 54 F.3d 722, 729-30 (11th Cir. 1995) (holding that there is no entitlement to a constant equity cushion).

82. *Timbers*, 484 U.S. at 378.

83. *Grundy Nat'l Bank v. Rife*, 876 F.2d 361, 363-64 (4th Cir. 1989). *But see* *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 865 (4th Cir. 1994) (requiring benefit to the estate for superpriority claim to be allowed).

84. 11 U.S.C. §§ 503, 726(b). *See also* *Allis-Chalmers Credit Corp. v. Nordyke* (*In re* Nordyke), 43 B.R. 856, 864 (Bankr. D. Or. 1984).

85. 11 U.S.C. § 507(b).

estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

The last clause of the definition and the legislative history accompanying Code § 363(a) clearly make the definition applicable to cash collateral existing on the petition date and to cash collateral generated postpetition as the result of a disposition or realization of property in which the estate and another entity have an interest.<sup>86</sup> Rents in the possession of the debtor at the commencement of the case or subsequently acquired are cash collateral subject to the provisions of § 363(c). Unless the trustee is permitted to use cash collateral pursuant to Code § 363(c)(2), the trustee is required to “segregate and account for any cash collateral” in his or her possession, custody, or control.<sup>87</sup>

### B. Use of Cash Collateral.

In voluntary cases, the trustee or debtor in possession is prohibited from using, selling, or leasing cash collateral, whenever generated, unless each entity having an interest therein consents<sup>88</sup> or the court, after notice and a hearing, authorizes such use, sale, or lease<sup>89</sup>. Federal Rule of Bankruptcy Procedure 4001(b) requires that a request to use cash collateral be made by motion in accordance with Federal Rule of Bankruptcy Procedure 9014.<sup>90</sup>

Until an order for relief is entered in an involuntarily commenced case, Code § 303(f) authorizes the alleged debtor to

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86. See S. REP. NO. 95-989.

87. 11 U.S.C. § 363(c)(4). See also *In re Cerrico Realty Corp.*, 127 B.R. 319, 325 (Bankr. E.D.N.Y. 1991) (holding that the debtor in possession is required to segregate cash collateral even while a hearing is pending to determine the relative rights of the debtor in possession and its secured creditor in the cash collateral).

88. 11 U.S.C. § 363(c)(2)(A).

89. *Id.* § 363(c)(2)(B). See also *Armstrong v. Norwest Bank, Minn., N.A.*, 964 F.2d 797, 801 (8th Cir. 1992) (holding neither notice nor a hearing is required for the debtor to use cash collateral in the ordinary course of business if each entity that has an interest in such collateral consents to its use); *In re Nemko, Inc.*, 143 B.R. 980, 988-89 (Bankr. E.D.N.Y. 1992) (“Where a primary secured creditor consents to the use of cash collateral but a secondary secured creditor objects, a debtor may only use the collateral by an order of the court.”).

90. See *Cerrico Realty*, 127 B.R. at 324 (holding although mortgagee consented prepetition to the debtor’s use of assigned rents by contractually waiving its right to collect the rents, the rents upon the commencement of the case constituted cash collateral and the debtor was required to obtain postpetition consent from the creditor or a court order before using them).

continue to use its property “notwithstanding § 363 . . . except to the extent that the court orders otherwise.” Therefore, the burden of preventing or conditioning the use of cash collateral during the “gap” period, the time between the filing of the involuntary case and the entry of an order for relief, rests upon the non-debtor entity asserting an interest in the cash collateral. While loan agreements customarily relieve a lender of the obligation to fund additional loans upon the filing of an involuntary petition, a provision preventing the use of cash collateral upon the filing of such a petition appears unenforceable under Code § 303(f).

1. *Motion for Authority to Use Cash Collateral*

A motion for authority to use cash collateral should include:

- (a) the amount of cash collateral to be used;
- (b) the name and address of each entity having an interest in the cash collateral;
- (c) the name and address of any entity having control over the cash collateral;
- (d) facts showing the need to use the cash collateral; and
- (e) the nature of any adequate protection to be provided.

If interim use of cash collateral is sought pending a final hearing, the motion must include the amount of cash collateral to be used during the interim period pending a final hearing.<sup>91</sup>

A hearing on a request to use cash collateral may be a preliminary hearing or may be consolidated with a final hearing. If a preliminary hearing, the court may authorize the requested use, sale, or lease of cash collateral only if there is a reasonable likelihood that the DIP will prevail at the final hearing.<sup>92</sup>

The hearing is to be scheduled in accordance with the debtor’s needs, and the court shall act promptly on any request for authority to use cash collateral.<sup>93</sup> Nevertheless, the court may not commence a final hearing on a motion for authority to use cash collateral earlier than fifteen days after service of the motion on each entity with an interest in the cash collateral, on any committee appointed pursuant to Code § 705 or § 1102. If no committee is appointed, the service of the motion on the twenty largest unsecured creditors, and on such other entities as the court may direct is required.<sup>94</sup> If requested, the court may conduct a

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91. FED. R. BANKR. P. 4001 (advisory committee’s notes to 1987 Amendments).

92. 11 U.S.C. § 363(c)(3).

93. *Id.*

94. FED. R. BANKR. P. 4001(b)(1)–(2).

preliminary hearing before the fifteen-day period expires, but may authorize the use of only that amount of cash collateral necessary to avoid immediate and irreparable harm to the estate pending the final hearing.<sup>95</sup> Additionally, the notice must properly describe the terms and protections regarding use of cash collateral.<sup>96</sup>

## 2. *Approval of Agreements for the Use of Cash Collateral*

The procedure for obtaining court approval of an agreement prohibiting or conditioning the use of cash collateral is governed by Federal Rule of Bankruptcy Procedure 4001(d). A motion for approval, accompanied by a copy of the agreement, is to be served on any committee or, if no committee has been appointed, on the twenty largest creditors and on such other entities as the court may direct. Unless the court fixes a different time, objections may be filed within fifteen days of the mailing of notice.<sup>97</sup> If no objection is filed, the court may enter an order approving or disapproving the agreement without a hearing.

If an objection is filed or the court determines that a hearing is appropriate, the court will conduct a hearing on not less than five days notice to the objector, the movant, any committee or, if no committee has been appointed, the twenty largest creditors, and such other entities as the court may direct.<sup>98</sup> Alternatively, the court may approve an agreement relating to the use of cash collateral if it determines that sufficient notice and an opportunity for a hearing was given pursuant to a related motion (i.e., in a motion requesting authority to use cash collateral).<sup>99</sup>

## 3. *Motion to Prohibit or Condition Continued Use of Cash Collateral*

Federal Rule of Bankruptcy Procedure 4001(a)(1) requires that a motion under Code § 363(e) to prohibit or condition the use, sale or lease of cash collateral as is necessary to insure adequate protection pursuant to Code § 363(e) be served on the debtor, any

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95. FED. R. BANKR. P. 4001(b)(2).

96. See, e.g., *In re Tek-Aids Indus., Inc.*, 145 B.R. 253, 257 (Bankr. N.D. Ill. 1992) (stating that because the notice stated that the bank only was seeking a security interest in the debtor's postpetition accounts receivable and inventory, the order entered by the court was void for lack of due process to the extent it granted the bank a security interest in the debtor's postpetition, "equipment and other personal property (including general intangibles)").

97. FED. R. BANKR. P. 4001(d)(2).

98. FED. R. BANKR. P. 4001(d)(3).

99. FED. R. BANKR. P. 4001(d)(4). See also *In re Manchester Ctr., Ltd.*, 123 B.R. 378, 382 (Bankr. C.D. Cal. 1991) (holding failure to provide notice of a stipulation entered into in connection with a motion for relief from the automatic stay and a motion to prohibit the continued use of cash collateral did not violate a creditor's right to due process where the creditor had actual knowledge of the underlying motions).

committee appointed pursuant to Code § 705 or § 1102 or, if no committee is appointed, the twenty largest unsecured creditors of the debtor, and such other entities as the court may direct.<sup>100</sup>

Ex parte relief from an order authorizing the use of cash collateral may be obtained pursuant to Code § 363(e) and Federal Rule of Bankruptcy Procedure 4001(a)(2). Such relief may only be granted if: (a) it clearly appears from specific facts shown by affidavit or by a verified motion that immediate and irreparable injury, loss, or damage will result to the movant before the adverse party or the attorney for the adverse party can be heard in opposition; and (b) the movant's attorney certifies to the court in writing the efforts, if any, which have been made to give notice and the reasons why, notice should not be required.<sup>101</sup>

#### 4. Real Property Rents as Cash Collateral

Under Code § 552(b), an inchoate interest in rents automatically becomes cash collateral upon the commencement of the case. A much debated issue prior to 1994 was whether revenues earned from the use and occupancy of rooms and other public facilities in hotels, motels, or other lodging properties constituted rents for purposes of cash collateral law. The Bankruptcy Reform Act of 1994 ended that debate by amending Code § 363 to provide that such revenues are rents.<sup>102</sup> It is important to recognize that the 1994 Reform Act resolved the debate only as to revenues earned from the use or occupancy of rooms and other public facilities in hotels, motels, and other lodging properties. A number of similar debates continue to exist.<sup>103</sup>

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100. See *In re* 499 W. Warren St. Assocs., L.P., 142 B.R. 53, 56 (Bankr. N.D.N.Y. 1992) (stating that creditor's interest in real property was adequately protected where a part of the rent which constituted cash collateral was applied to the property's operation and maintenance since the application contributed to the generation of additional rents upon which the creditor's security interest subsequently attached); *In re* Salem Plaza Assocs., 135 B.R. 753, 758 (Bankr. S.D.N.Y. 1992) (explaining that the debtor's use of rent receipts, which constituted cash collateral for necessary operating expenses did not diminish the value of the bank's interest in future rents but instead preserved the base that generated the future rents). Cf. *In re Delta Res. Inc.*, 54 F.3d at 730 (holding that an oversecured creditor is not entitled to postpetition interest payments during pendency of case as part of adequate protection payments).

101. FED. R. BANKR. P. 4001(a)(2)(A)(B).

102. 11 U.S.C. § 363 (b)(2).

103. See *In re* GGVXX, Ltd., 130 B.R. 322, 326 (Bankr. D. Colo. 1991) (declaring that greens fees and similar use fees from the DIP's golf course did not constitute rents or, consequently, cash collateral, because the creditor only had a lien on the DIP's real property, not its business or the revenues earned by the business; however, revenue earned from renting the golf course to a separate entity, which operated a golf school on the property, was cash

5. *Burden of Proof, Sanctions for Unauthorized Use of Cash Collateral, and the Inapplicability of Federal Rule of Bankruptcy Procedure 6004(g) to Use of Cash Collateral Orders*

In any hearing regarding the use of cash collateral, the DIP has the burden of proving that the secured creditor is adequately protected.<sup>104</sup> The secured creditor, however, has the burden of proving the validity, priority, or extent of its lien.<sup>105</sup>

The unauthorized use of cash collateral has been held to be contempt of court on the part of both the debtor and its counsel.<sup>106</sup> Moreover, a violation of Code § 363 may render the secured creditor's claim against an individual debtor nondischargeable.<sup>107</sup>

Federal Rule of Bankruptcy Procedure 6004(g) stays the execution of orders authorizing the use, sale or lease of property, other than cash collateral, until the expiration of ten days after their entry unless the court<sup>o</sup> orders otherwise. Accordingly, an order authorizing the use of cash collateral is enforceable upon entry unless stayed pending appeal pursuant to Bankruptcy Rule 8005.

6. *Appealability of Orders Authorizing Use of Cash Collateral*

In the absence of a stay pending appeal, the reversal or modification on appeal of an order authorizing the purchase or lease of estate property does not affect the validity of the sale or lease if the entity that purchased or leased the property acted in

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collateral because it was derived from the DIP's ownership of real property). See also *Wattson Pac. Ventures v. Safeguard Self-Storage Trust* (*In re Safeguard Self-Storage Trust*), 2 F.3d 967, 973 (9th Cir. 1993) (revenues from leasing storage space are rents); *In re Everett Home Town L.P.*, 146 B.R. 453, 458 (Bankr. D. Ariz. 1992) (payments by club members were "proceeds" of the membership agreements in which the creditor held a security interest); *In re McCann*, 140 B.R. 926, 930-31 (Bankr. D. Mass. 1992) (greens fees, restaurant and bar revenues, and sales of goods are services and not rent); *In re Northport Marina Assocs.*, 136 B.R. 911, 916, 921 (Bankr. E.D.N.Y. 1992) (revenues from boat slips were rents where boat owners contracted for a specific assigned slip for a six-month period but were not rents where boat owners contracted for one- to two-day periods or where boat owners received a general storage right rather than the right to occupy a specific space); *In re Ashford Apartments L.P.*, 132 B.R. 217, 218 (Bankr. D. Mass. 1991) (amounts earned from the licensing of parking garage space constituted rents).

104. 11 U.S.C. § 363(o)(1). See also *In re KNM Roswell L.P.*, 126 B.R. 548, 557 (Bankr. N.D. Ill. 1991); *In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 104 (Bankr. S.D.N.Y. 1991).

105. 11 U.S.C. § 363(o)(2).

106. *In re Krisle*, 54 B.R. 330 (Bankr. D.S.D. 1985).

107. See 11 U.S.C. § 523. *But cf. In re Henson*, 135 B.R. 346 (Bankr. E.D. Ark. 1991) (stating that the use of cash collateral did not render debt nondischargeable since debtor relied on advice of counsel and used cash collateral for the preservation and benefit of the collateral).



good faith.<sup>108</sup> Where Code § 363(m) applies, the appeal will be dismissed as moot. However, because Code §363(m) does not refer to the *use* of estate property, an appeal from an order authorizing the use of cash collateral is permissible whether or not the appellant has sought a stay pending appeal.<sup>109</sup> Even if the use of cash collateral order were reversed, however, pre-reversal transactions entered into in good faith would not be affected.<sup>110</sup>

## VII. OBTAINING CREDIT

### A. Introduction to Code § 364

Code § 364 governs obtaining credit and incurring debt by the debtor's estate. Code § 364 applies only to postpetition extensions of new credit.<sup>111</sup> It would appear that the provisions of Code § 364 are not available to an alleged debtor or trustee operating the debtor's business during the involuntary gap period, i.e. the period between the filing of an involuntary petition and the entry of an order for relief.<sup>112</sup> This result follows from § 364 (a) permitting credit to be obtained only by a trustee operating a debtor's business under specified sections of the Bankruptcy Code, e.g., §§ 721 and 1108.<sup>113</sup>

Code § 364 distinguishes among (i) obtaining unsecured credit in the ordinary course of business, (ii) obtaining unsecured credit out of the ordinary course of business, (iii) obtaining credit with specialized priority, and (iv) obtaining credit through the grant of senior or equal liens on property of the estate.<sup>114</sup>

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108. 11 U.S.C. § 363(m).

109. *In re Tek-Aids*, 145 B.R. at 259 n.6.

110 Rule 6004(g) does not apply to orders regarding the use of cash collateral and does not affect the trustee's right to use, sell, or lease property without a court order to the extent permitted under § 363 of the Code.

111. See *In re 360 Inns, Ltd.*, 76 B.R. 573, 578 (Bankr. N.D. Tex. 1987) (explaining that cash collateral creditor cannot use Code § 364(c)(3) to elevate its claim to administrative superpriority); *In re FCX Inc.*, 54 B.R. 833, 841 (Bankr. E.D.N.C. 1985) ("Section 364(c)(1) authorizes a super priority for postpetition loans; it does not authorize giving a super priority for prepetition loans.").

112. See *In re Roxy Roller Rink Joint Venture*, 73 B.R. 521, 526-27 (Bankr. S.D.N.Y. 1987).

113. 11 U.S.C. § 364(a).

114. See generally R. McCullough, *Analysis of Code Section 364(d): When Will a Court Allow a Trustee to Obtain Postpetition Financing by Granting a Superpriority Lien?*, 93 COMM. L.J. 186 (1988); Nicholas B. Telesca, *Recent Developments, Section 364(d) Superpriority Financing: Has a Secured Creditor Met His Match?*, 5 BANKR. DEV. J. 109 (1988).

## B. The Four Methods of Obtaining Credit

### 1. Code § 364(a)—Obtaining Credit in the Ordinary Course of Business

If the debtor's business is authorized to be operated, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business, unless the court orders otherwise.<sup>115</sup> To induce creditors to extend postpetition credit under Code § 364(a), such credit is allowable as an expense of administration under Code § 503(b)(1).<sup>116</sup> The postpetition lender has the burden of proving that the requested expenses, fees, and related charges associated with the extension of postpetition credit were reasonable.<sup>117</sup> Although Code § 364(a) does not require notice and a hearing, "[t]he court may limit the estates [sic] ability to incur debt under this subsection."<sup>118</sup>

### 2. Code § 364(b)—Obtaining Credit out of the Ordinary Course of Business.

Unsecured credit and unsecured debt incurred other than in the ordinary course of business may be obtained only with court approval after notice and a hearing.<sup>119</sup> The Code, however, does not define the phrase "ordinary course of business." The courts have applied two tests to determine whether a transaction is in the ordinary course of a debtor's business.<sup>120</sup>

The first test, called the "horizontal dimension test,"

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115. See *Romley v. Sun Nat'l Bank (In re Two "S" Corp.)*, 875 F.2d 240, 243 n.2 (9th Cir. 1989) ("The authority to continue business includes the right to incur unsecured debts for ordinary operating expenses."); *In re Regensteiner Printing Co.*, 122 B.R. 323, 326 (N.D. Ill. 1990) (unsecured credit obtained under Code § 364(a) or § 364(b) must relate to allowable administrative expenses such as the actual and necessary costs and expenses of preserving the estate). See also *Credit Alliance Corp. v. Idaho Asphalt Supply, Inc. (In re Blumer)*, 95 B.R. 143, 147 (B.A.P. 9th Cir. 1988); *Pittsburgh Nat'l Bank v. SMB Holdings, Inc. (In re SMB Holdings, Inc.)*, 77 B.R. 29, 32 (Bankr. W.D. Pa. 1987).

116. See *Peninsula Nat'l Bank v. Allen Carpet Shops, Inc. (In re Allen Carpet Shops, Inc.)*, 27 B.R. 354, 358 (Bankr. E.D.N.Y. 1983) (stating that the clear intent of Code § 364(a) is to allow the trustee or DIP to use the administrative priority of Code § 507(a)(1) as an inducement to entities to open lines of credit to the debtor for purposes of reorganization). See also *In re Blumer*, 66 B.R. at 114.

117. See *In re Allegheny Int'l, Inc.*, 131 B.R. 24, 29-30 (Bankr. W.D. Pa. 1991) (holding the lender failed to meet this burden).

118. H.R. REP. NO. 95-595, at 57-58 (1978).

119. See *In re Massetti*, 95 B.R. 360, 362 (Bankr. E.D. Pa. 1989).

120. See *In re Roth Am., Inc.*, 975 F.2d 949, 952-53 (3d Cir. 1992); *Burlington N. R.R. v. Dant & Russell, Inc. (In re Dant & Russell, Inc.)*, 853 F.2d 700, 704-05 (9th Cir. 1988).

compares the debtor's business to other like businesses.<sup>121</sup> The test is whether the transaction in question is similar to those in which comparable businesses engage in their day-to-day operations.<sup>122</sup> The second test is the "vertical dimension, or creditor's expectation, test."<sup>123</sup> This test analyzes the transaction "from the vantage point of a hypothetical creditor [of the debtor] and inquires whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit."<sup>124</sup> In other words, is the transaction similar to those in which the debtor engaged prepetition?<sup>125</sup> These two tests are designed "to assure that neither the debtor nor the creditor do anything abnormal to gain an advantage over other creditors. . . ."<sup>126</sup>

Absent an extensive prepetition course of dealing between the DIP and the creditor, the borrowing of money is customarily outside the ordinary course of business.<sup>127</sup> If a transaction is not clearly in the ordinary course of the debtor's business, a creditor should obtain a court order after proper notice and a hearing before providing credit to eliminate the possible adverse effect of later challenges that the extension of credit was inappropriate.

As in the case of credit or debt incurred under Code § 364(a), credit or debt incurred under Code § 364(b) is allowable as an expense of administration under Code § 503(b)(1). Code § 503(b)(1) provides that only the "actual necessary costs and expenses of preserving the estate" are allowable as administrative expenses.<sup>128</sup> Accordingly, credit extended under Code § 364(b)

121. *Roth*, 975 F.2d at 952.

122. *Id.* at 953; *Dant & Russell*, 853 F.2d at 704. *But see* *Martino v. First Nat'l Bank of Harvey (In re Garofalo's Finer Foods, Inc.)*, 186 B.R. 414, 428-30 (Bankr. N.D. Ill. 1995) (rejecting the horizontal dimension test as "unnecessary").

123. *Dant & Russell*, 853 F.2d at 705.

124. *Roth*, 975 F.2d at 953; *Dant & Russell*, 853 F.2d at 705 (quoting *Comm. of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986)).

125. *See also In re C.E.N., Inc.*, 86 B.R. 303, 305-06 (Bankr. D. Me. 1988); *In re Cascade Oil Co.*, 51 B.R. 877, 882 (Bankr. D. Kan. 1985) ("The 'ordinary course of business' generally refers to day-to-day business affairs.").

126. *Campbell v. Cannington (In re Economy Milling Co.)*, 37 B.R. 914, 922 (Bankr. D.S.C. 1983).

127. *In re Avorn Dress Co.*, 78 F.2d 681, 683 (2d Cir. 1935); *In re Standard Oil & Exploration of Del., Inc.*, 136 B.R. 141, 146 (Bankr. W.D. Mich. 1992) (explaining that the issuance of administrative priority notes which were convertible into stock of the reorganized debtor was outside the ordinary course of business); *In re SMB Holdings*, 77 B.R. at 32 (the over-drafting of debtor's bank account was not in ordinary course of business); *In re Lockwood Enters., Inc.*, 52 B.R. 871, 874 (Bankr. S.D.N.Y. 1985) (a lender's advance of funds to the debtor for payroll and operating expenses was not in the ordinary course of business).

128. 11 U.S.C. § 503(b)(1)(A).

should be supported by such a finding.<sup>129</sup>

3. *Code § 364(c)—Obtaining Credit with Specialized Priority or with Liens Junior to Existing Liens*

Code § 364(c) provides that, if the trustee cannot obtain unsecured credit based upon such credit being accorded administrative status under Code § 503(b)(1):

The court, after notice and a hearing, may authorize the obtaining of credit or incurring of debt -

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.<sup>130</sup>

The listing of incentives that a bankruptcy court may authorize under Code § 364 is not exhaustive. For example, the court may authorize contingent fee enhancements for a lender that extends the maturity date of postpetition financing where the extension benefits the estate.<sup>131</sup>

Authorization of credit under one subsection of Code § 364 does not implicitly authorize credit under another subsection. For example, a lender that was granted a security interest for postpetition credit extended to the debtor was not implicitly entitled to administrative expense status under Code §§ 364(a), (b), or (c)(1) for the undersecured portion of the loan.<sup>132</sup>

a. *Code § 364(c)(1)—Priority over Claims Under Code § 503(b) or § 507(b)*

Credit extended under the authority of Code § 364(c)(1) is superior to the claims arising in favor of a creditor entitled to adequate protection, but whose protection proves to be inadequate. This is accomplished by the express priority granted by Code § 364(c)(1) over any administrative expense specified in Code §§ 503(b) or 507(b), the last sentence of which latter section provides priority for claims arising from “inadequate” protection being afforded a creditor. A Code § 364(c)(1) claim also takes

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129. *Mark IV Props., Inc. v. Club Dev. & Mgmt. Corp.* (*In re Club Dev. & Mgmt. Corp.*), 27 B.R. 610, 611-12 (B.A.P. 9th Cir. 1982); *In re Patch Graphics*, 58 B.R. 743, 745-46 (Bankr. W.D. Wis. 1986).

130. 11 U.S.C. § 364(c)(1)-(3).

131. *Resolution Trust Corp. v. Defender Drug Stores, Inc.* (*In re Defender Drug Stores, Inc.*), 145 B.R. 312, 316-17 (B.A.P. 9th Cir. 1992).

132. *Mulligan v. Sobiech*, 131 B.R. 917, 921-22 (S.D.N.Y. 1991).

priority over fees incurred by counsel and other professionals retained by the DIP or creditors' committee, unless the fees were (a) necessary to preserve or dispose of the collateral and were incurred primarily for the benefit of the secured creditor, or (b) the secured creditor expressly or impliedly consented to assuming the costs of the professional services rendered.<sup>133</sup> The breadth of the Code § 364(c)(1) priority had led to court-ordered carve outs of amounts for the payment of the fees of counsel and other professionals retained by the DIP and the creditors' committee.<sup>134</sup>

b. Code § 364(c)—Burden of Proof

As a condition to invoking Code § 364(c), the DIP must introduce competent evidence demonstrating its inability to obtain credit under subsections (a) or (b) of Code § 364.<sup>135</sup> The court in *In re Crouse Group, Inc.*,<sup>136</sup> imposed upon the DIPs the burden of proving that (a) they could not obtain credit absent the grant of the specialized priority or security permitted by Code § 364(c);<sup>137</sup> (b) the proposed Code § 364(c) loan transaction was necessary to preserve the estate's assets;<sup>138</sup> and (c) the terms of the proposed credit agreement were fair, reasonable, and adequate.<sup>139</sup> The court declined to approve a Code § 364(c) loan where the DIPs did not demonstrate that they made "exhaustive unsuccessful efforts to obtain credit on terms in accordance with 364(b)."<sup>140</sup> In *Crouse*, the DIPs had approached only one lender, and had not approached their prepetition lenders.<sup>141</sup>

c. Code § 364(c)—Cross-Collateralization and *In re Saybrook*

Cross-collateralization in the context of a bankruptcy case is the practice of (a) granting a postpetition lender a lien on prepetition assets which secures the postpetition debt; or

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133. *Gen. Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 76-77 (2d Cir. 1984); *In re Pullman Constr. Indus., Inc.*, 107 B.R. 909, 941 (Bankr. N.D. Ill. 1989); *In re Mobile Air Drilling Co., Inc.*, 53 B.R. 605, 609 (Bankr. N.D. Ohio 1985); *In re Am. Res. Mgmt. Corp.*, 51 B.R. 713, 720-21 (Bankr. D. Utah 1985).

134. *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990).

135. *Id.* at 37.

136. 71 B.R. 544 (Bankr. E.D. Pa. 1987)

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at 550.

141. *Id.* at 550-51. See also *Norris Square Civic Ass'n. v. St. Mary Hosp. (In re St. Mary Hospital)*, 86 B.R. 393, 401 (Bankr. E.D. Pa. 1988) (denying financing by DIP's parent company where parent company completely dominated DIP and had manufactured funding crisis). *But cf. Bray v. Shenandoah Fed. Sav. & Loan Ass'n (In re Snowshoe Co.)*, 789 F.2d 1085, 1088 (4th Cir. 1986) (DIP need not show it sought credit from every possible lender).

(b) granting a prepetition lender a lien on assets first arising postpetition to secure prepetition debt owed to the lender.<sup>142</sup> While the first practice is the essence of a Code § 364(c)(2) or (3) loan, the validity of the second practice, referred to as “*Texlon-type*” cross-collateralization, or “backward” cross-collateralization,<sup>143</sup> has been the subject of substantial debate in both the courts and the scholarly journals.<sup>144</sup>

The debate was ended temporarily by *In re Saybrook Manufacturing Co.*<sup>145</sup> In considering whether backward cross-collateralization is “authorized” under Code § 364, the *Saybrook* court noted that no provision of the Code expressly authorizes cross-collateralization.<sup>146</sup> In the absence of clear statutory direction, the court considered whether the bankruptcy court could employ its equitable powers to approve cross-collateralization as a means of implementing the policies and provisions of the Code.<sup>147</sup> The court weighed the secured creditor’s argument that cross-collateralization furthers the policy of rehabilitation of debtors by inducing lenders to provide financing to DIPs against the unsecured creditors’ argument that cross-collateralization violates the policy of ensuring equitable distribution of assets among similarly situated creditors.<sup>148</sup> Reasoning that the Code’s “primary purpose” of fostering rehabilitation does not justify means that are directly contrary to the Code’s equality principle and priority scheme, the Eleventh Circuit concluded that cross-collateralization is beyond the scope of the bankruptcy court’s inherent equitable powers.<sup>149</sup> Unfortunately, recent cases have revived “backward” cross-collateralization in chapter 11 cases on the theory that the goal of reorganization trumps the principle of equality of distribution.

#### 4. Code § 364(d)—*The Extraordinary Power to Obtain Credit Secured by a Senior or Equal Lien on Property of the Estate Subject to a Valid Lien*

Code § 364(d)(1) provides that:

The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a [valid] lien only if:

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142. *Otte v. Mfrs. Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F.2d 1092, 1094 (2d Cir. 1979).

143. *Shapiro v. Saybrook Mfg Co. (In re Saybrook Mfg Co.)*, 963 F.2d 1490, 1492 (11th Cir. 1992).

144. *Id.* at 1493.

145. *Id.*

146. *Id.* at 1494-95.

147. *Id.*

148. *Id.* at 1495.

149. *Id.* at 1495-96.

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

In *In re Aqua Associates*,<sup>150</sup> the court held that senior liens will not be approved merely because credit is not available elsewhere.<sup>151</sup> The proposed loan must be of significant benefit to the estate and not of primary benefit to another party.<sup>152</sup> Also, the DIP must show that it has exhausted the possibility of obtaining alternative sources of credit.<sup>153</sup> The court must then make a qualitative assessment of the proposed loan in light of any possible alternative sources of credit before approving the senior liens.<sup>154</sup>

Under the prior Bankruptcy Act, a trustee could issue certificates of indebtedness with seniority over existing liens to secure loans for operating expenses only if he established a high degree of likelihood of a successful reorganization within a reasonable time.<sup>155</sup> A less stringent test was developed in *In re Chicago, Rock Island and Pacific Railroad Co.*,<sup>156</sup> under which, at the outset of a case, it would be sufficient to show that reorganization is not clearly impossible.<sup>157</sup> The *Collier* treatise states that "[t]he requirement of adequate protection is a substitute for the more detailed findings that were required in cases such as *In re Third Avenue*."<sup>158</sup> In order to obtain authority for a Code § 364(d) loan, the trustee will have to convince the court that sufficient value remains in the property to satisfy the interest of the "primed" lender.<sup>159</sup>

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150. 123 B.R. 192 (Bankr. E.D. Pa. 1991).

151. *Id.* at 198-99.

152. *Id.*

153. *Id.* at 199.

154. *Id.* See *In re* 495 Cent. Park Ave. Corp., 136 B.R. 626, 630-31 (Bankr. S.D.N.Y. 1992) (stating that a debtor need not seek alternate financing from every possible lender to satisfy burden of proving that it is unable to obtain financing without priming a senior lien and, in determining whether a senior lien is adequately protected, the court must consider whether the value of the debtor's property will increase as a result of the renovation to be funded by the proposed financing). See also *In re Olsen*, 87 B.R. 148, 150 (Bankr. D. Colo. 1988).

155. *In re* Third Ave. Transit Corp., 198 F.2d 703, 706-07 (2d Cir. 1952).

156. 545 F.2d 1087 (7th Cir. 1976).

157. *Id.* at 1090.

158. 2 COLLIER ON BANKRUPTCY ¶ 364.05, at 364-13 (15th ed. 1994).

159. See *In re Swedeland*, 16 F.3d at 566-67 (holding projected enhancement in value of collateral from continued development of collateral is not sufficient adequate protection). Compare *In re Timber Prods., Inc.*, 125 B.R. 433, 440 (Bankr. W.D. Pa. 1990) (credit pursuant to Code § 364(d) denied where debtor failed to show existing lienholder would be adequately protected; given debtor's unrealistic financial projections, equity cushion was insufficient), with *In re Sky Valley, Inc.*, 100 B.R. 107, 114 (Bankr. N.D. Ga. 1988) (equity

The burden of proof regarding the issue of adequate protection is expressly placed upon the trustee.<sup>160</sup> Because “super priority financing [under Code § 364(d)] displaces liens on which creditors have relied in extending credit,” the courts must be “particularly cautious” in determining whether the trustee has met his burden of proving adequate protection.<sup>161</sup>

In *In re Snowshoe Co.*, the court authorized a chapter 7 trustee to incur up to \$2,000,000 in debt secured by a senior lien<sup>162</sup> where the evidence demonstrated that (a) the trustee had contacted other financial institutions in the immediate geographical area and was unsuccessful, and (b) the objecting bank’s lien was adequately protected by an equity cushion and the debtor’s projected ability to repay the loan within one year was supported by a well-reasoned, disinterested financial analysis.<sup>163</sup> Conversely, in *In re Plabell Rubber Products, Inc.*,<sup>164</sup> the court denied the debtor’s motion to obtain credit secured by a senior lien because the court did not believe that the debtor had established that it otherwise was unable to obtain credit.<sup>165</sup>

In valuing the estate’s property where a reorganization was reasonably likely, the bankruptcy court could use going concern values to determine adequate protection and thereby justify additional loans to the DIP. Where a reorganization was not reasonably likely, the court should use liquidation values. In making the going concern or liquidation determination, the court may consider the quality of current management.<sup>166</sup>

An application under Code § 364(b), (c), or (d) may be made only by a trustee or DIP.<sup>167</sup> Credit may be obtained pursuant to

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cushion sufficient adequate protection for primed security lender).

160. 11 U.S.C. § 364(d)(2). See also *KS Invs. v. T.M. Sweeney & Sons LTL Servs., Inc.* (*In re T.M. Sweeney & Sons LTL Servs., Inc.*), 131 B.R. 984, 990-91 (Bankr. N.D. Ill. 1991) (holding the burden was not excused by the prior lienholder’s failure to object to the financing order).

161. *In re First S. Sav. Ass’n*, 820 F.2d 700, 710 (5th Cir. 1987).

162. *In re Snowshoe*, 789 F.2d at 1090.

163. *Id.* at 1088-90. See also *In re Dunes Casino Hotel*, 69 B.R. 784, 795-96 (Bankr. D.N.J. 1986) (authorizing the DIP to borrow \$697,000, secured by a senior lien, where the objecting bank, which alleged that it was owed approximately \$17,000,000, had a lien on collateral worth at least \$26,000,000 and this substantial equity cushion provided the bank with adequate protection, especially since no evidence had been presented that the property was depreciating in value).

164. 137 B.R. 897 (Bankr. N.D. Ohio 1992).

165. *Id.* at 899-90.

166. *In re Keystone Camera Prods. Corp.*, 126 B.R. 177, 185 (Bankr. D.N.J. 1991).

167. See *In re Temple Stephens Co.*, 145 B.R. 975, 977 (Bankr. W.D. Mo. 1992) (denying the bank’s motion for an order to pay a mechanic’s lien with the payment to be secured by an additional lien in favor of the bank since only the trustee or DIP can make a motion to borrow funds under Code § 364). Cf. *In re Hickey Props., Ltd.*, 181 B.R. 173, 174 (Bankr. D. Vt. 1995) (plan which



subsections (b), (c), and (d) of Code § 364 only with court approval after notice and a hearing.<sup>168</sup> Federal Rule of Bankruptcy Procedure 4001(c), which governs the mechanics of obtaining court authorization for credit under Code § 364, provides:

(1) Motion; Service. A motion for authority to obtain credit shall be made in accordance with Rule 9014 and shall be served on any committee elected pursuant to Code § 705 or appointed pursuant to § 1102 of Code or its authorized agent, or, if the case is a chapter 11 reorganization case and no committee of unsecured creditors has been appointed pursuant to Code § 1102, on the creditors included on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct. The motion shall be accompanied by a copy of the agreement.

(2) Hearing. The court may commence a final hearing on a motion for authority to obtain credit no earlier than 15 days after service of the motion. If the motion so requests, the court may conduct a hearing before such 15-day period expires, but the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.

(3) Notice. Notice of hearing pursuant to this subdivision shall be given to the parties on whom service of the motion is required by paragraph (1) of this subdivision and to such other entities as the court may direct.

A motion to obtain credit under Code § 364 should include the amount and type of credit to be extended, the lender's name and address, the terms of any agreement, the need to obtain the credit, and the efforts made to obtain credit from other sources. If the motion is made pursuant to Code § 364(c)(2) or (3) or Code § 364(d), the motion must describe the collateral and the protection to be given to existing interests in the collateral.<sup>169</sup>

Under Federal Rule of Bankruptcy Procedure 7004(b), motions, including motions to obtain credit, may be served by mail, and service is complete upon mailing. Although Federal Rule of Bankruptcy Procedure 9006(f) adds three days to the notice periods for many motions served by mail, it does not extend the fifteen-day period prescribed in Rule 4001(c)(2).<sup>170</sup>

The court may not schedule a final hearing on a motion for authority to obtain credit earlier than fifteen days after service of the motion. Federal Rule of Bankruptcy Procedure 4001(c)(2),

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depended on debtor's ability to obtain post-confirmation financing by granting superpriority lien could not be confirmed because it was not feasible, since there is no authority in the Code for creation of such a lien).

168. FED. R. BANKR. P. 4001(c).

169. FED. R. BANKR. P. 4001 (advisory committee's note).

170. *See Id.*

however, permits the court to hold a preliminary hearing before the expiration of the fifteen-day period, provided that the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing. Rule 4001(c)(3) requires that notice of the preliminary hearing be given to all parties entitled to notice of the final hearing. The language of Rule 4001(c) has been construed to prohibit *ex parte* relief.<sup>171</sup>

Rule 4001(c) does not specify the type or method of notice which must be given for a preliminary hearing. The facts and circumstances of each particular case will dictate the notice which must be given.<sup>172</sup> An agreement regarding the obtaining of credit may be approved by the filing and service of a motion pursuant to the provisions of Rule 4001(d).

Unless an order under Code § 364 is stayed, the approved credit may be extended immediately, whether or not an appeal is filed.<sup>173</sup> If the entity extending credit did so in good faith, the reversal or modification on appeal of an order authorizing the credit does not affect the validity of the extension of credit or liens accorded the lender unless the appellant obtained a stay pending appeal.<sup>174</sup> The term "good faith" is not mere surplusage, and involves more than the absence of a misrepresentation to the bankruptcy court.<sup>175</sup> The "good faith rule" will not prevent the reversal of an order authorizing the extension of credit, notwithstanding the failure to obtain a stay of that order, where

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171. 8 COLLIER ON BANKRUPTCY ¶ 4001.07[4], at 4001-37 (15th ed. 1994).

172. See *Center Enters., Inc. v. Center Wholesale, Inc.* (*In re Center Wholesale, Inc.*), 759 F.2d 1440, 1450 (9th Cir. 1985) (holding notice received one day before Code § 364(d) hearing is insufficient); *In re Allegheny*, 131 B.R. at 30 (notice and hearing requirements relating to the payment of a loan commitment fee were satisfied by a hearing and a post-hearing opportunity to submit statements on a motion to pay the bank and its attorneys their expenses); *In re FCX*, 54 B.R. at 839 (four-day telephone and mail notice to thirty largest creditors sufficient for Code 364(c)(1) financing); *In re Roblin Indus., Inc.*, 52 B.R. 241, 242 (Bankr. W.D.N.Y. 1985) (telephone notice to twenty largest unsecured creditors sufficient for interim financing).

173. Cf. *In re First South Sav. Ass'n*, 820 F.2d at 709; *Trans World Airlines, Inc. v. Texaco, Inc.* (*In re Texaco, Inc.*), 92 B.R. 38, 45 (Bankr. S.D.N.Y. 1988).

174. 11 U.S.C. § 364(e). See *Mobile Oil Corp. v. First Nat'l Bank & Trust Co.* (*In re Ellingsen MacLean Oil*), 834 F.2d 599, 604-05 (6th Cir. 1987); *Adams Apple Inc. v. Central Wash. Bank* (*In re Adams Apple, Inc.*), 829 F.2d 1484, 1489-90 (9th Cir. 1987); *Clinton St. Food Corp. v. Gen. Trading* (*In re Clinton St. Food Corp.*), 170 B.R. 216, 220-21 (Bankr. S.D.N.Y. 1994); *Bank of New England v. BWL, Inc.*, 121 B.R. 413, 417 (Bankr. D. Me. 1990); *Butler Paper Co. v. Graphic Arts Lithographers, Inc.* (*In re Graphic Arts Lithographers, Inc.*), 71 B.R. 774, 777 (B.A.P. 9th Cir. 1987). See also FED. R. BANKR. P. 8005 (governing motions for a stay pending appeal).

175. *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982). See also *N.Y. Life Ins. Co. v. Revco D.S., Inc.* (*In re Revco D.S., Inc.*), 901 F.2d 1359, 1366 (6th Cir. 1990).

the order was granted without notice. Such an order is void because it is a violation of the constitutional right of procedural due process.<sup>176</sup>

The failure to obtain a stay pending appeal may result in the appeal being dismissed as moot. In *In re Swedeland Development Group, Inc.*, the Third Circuit rejected the argument that an appeal of a Code § 364 order must automatically be dismissed if a stay of that order is not obtained.<sup>177</sup> Rather, the court held that, under the mootness doctrine, the appeal should be dismissed only if the appellate court can not grant *any effective relief*.<sup>178</sup> Because the loan had not been completely drawn down, the appeal was not moot.<sup>179</sup>

### C. Effect of Conversion

Credit extended during the course of a chapter 11 case constitutes an expense of administration of that case. When a chapter 11 case is converted to a chapter 7 case, Code § 726(b) accords post-conversion chapter 7 administrative expenses priority over the pre-conversion expenses under Code § 364(a) and (b).<sup>180</sup> It would appear that the phrase “with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b)” contained in Code § 364(c)(1) results in the credit extended thereunder overriding the provision of Code § 726(b).<sup>181</sup> Because of this potential result, as a practical matter, the courts typically require that a carve out from the Code § 364 (c)(1) priority be made for at least the professional expenses of an ensuing chapter 7 case.

## VIII. SECTION 1111(b)

### A. Introduction

Section 1111(b) of the Code affords unique rights to the holder of an undercollateralized secured claim. Its subsection (b)(1), under certain conditions, grants the right of recourse to a creditor whose claim is without recourse under applicable nonbankruptcy law. Subject to two restrictions, § 1111(b)(2) permits an

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176. *In re Blumer*, 66 B.R. at 114.

177. 16 F.3d at 559.

178. *Id.* at 558-60, 562-63.

179. *Id.* *But see In re Ellingsen*, 834 F.2d at 606-07 (holding appeal of a Code § 364 order must automatically be dismissed if order was not stayed pending appeal).

180. See 2 COLLIER ON BANKRUPTCY ¶ 364.02, at 364-66 (15th ed. 1994); *In re Blanton-Smith Corp.*, 44 B.R. 73, 75 (Bankr. M.D. Tenn. 1984), *rev'd on other grounds*, 81 B.R. 440 (Bankr. M.D. Tenn. 1987).

181. See 3 COLLIER ON BANKRUPTCY ¶ 507.05, at 45 (15th ed. 1994). *But see In re Summit Ventures, Inc.*, 135 B.R. 478, 483 (Bankr. D. Vt. 1991).

undersecured creditor to avoid having its claim treated under subsection (b)(1) and to elect to continue to have its entire claim treated as secured.<sup>182</sup> This Article discusses the development of § 1111(b) and analyzes its provisions.

Section 1111(b) provides:

(1)

(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

### *B. Background: Section 1111(b) Overturns Pine Gate*

Section 1111(b) was enacted to overturn the decision rendered in *In re Pine Gate Associates, Ltd.*<sup>183</sup> In *Pine Gate*, the debtor was a limited partnership owning a single parcel of improved real estate that was subject to *pari-passu* nonrecourse mortgages.<sup>184</sup> Upon encountering financial difficulty, Pine Gate filed a case under Chapter XII of the Bankruptcy Act.<sup>185</sup>

Among the provisions of Chapter XII was a cram down power

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182. 11 U.S.C. § 1111(b)(1)(i)-(ii).

183. No. B75-4345A, 1976 LEXIS 17366 (Bankr. N.D. Ga. Oct. 14, 1976).

184. *Id.* at \*3.

185. *Id.*

in the form of appraisal and payment in cash of the value of the collateral.<sup>186</sup> In *Pine Gate*, the mortgagees' claims totaled \$1,454,000. The value of the property was appraised at \$1,000,000.<sup>187</sup> The court confirmed a plan which permitted the debtor to retain ownership of the property by paying the appraised value in cash.<sup>188</sup>

The long-term lending community was disturbed by the decision because the absence of a public sale precluded mortgagees from bidding in their liens, while the nonrecourse feature of their notes barred them from asserting general unsecured claims for their deficiencies. In response to these concerns, the Code does not authorize appraisal and payment in cash as a form of cram down and § 1111(b) was added to prevent the *Pine Gate* result and to compensate to some degree the lender's loss of its right to foreclose and retain the property for its own account.

The provisions of § 1111(b) apply only in chapter 9 and chapter 11 cases and encompass claims secured by a lien on property of the estate.<sup>189</sup> Although most cases interpreting § 1111(b) involve claims secured by real property, the section also applies to claims secured by personal property and fixtures.<sup>190</sup> Regardless of the terms of the contract or applicable nonbankruptcy law, § 1111(b)(1)(A), in conjunction with § 506(a), grants an undercollateralized nonrecourse creditor a secured claim equal to the value of its collateral and an unsecured claim for the deficiency.<sup>191</sup> By way of example, under § 1111(b)(1), a nonrecourse mortgagee whose allowed \$1,000,000 claim is secured by real property ("Blackacre") having a value of \$800,000 has a secured claim of \$800,000 and an unsecured deficiency claim of \$200,000.

### 1. Restrictions on the Applicability of § 1111(b)(1)

Section 1111(b)(1) does not apply if the property subject to the nonrecourse claim is sold pursuant to Code § 363 or the property is to be sold under a plan and the secured creditor is afforded the opportunity to credit bid the full amount of its claim.<sup>192</sup> Under those circumstances, the creditor has received its prepetition

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186. *Id.* at \*5, \*6 nn.4-6, \*19 n.16.

187. *Id.* at \*58.

188. *Id.* at \*60.

189. 11 U.S.C. §§ 103(f), 901.

190. *In re Tuma*, 916 F.2d 488, 489 (9th Cir. 1990); *In re Griffiths*, 27 B.R. 873, 875 (Bankr. D. Kan. 1983).

191. *See, e.g.*, 680 Fifth Ave. Assocs. v. The Mutual Benefit Life Ins. Co. in Rehab. (*In re* 680 Fifth Ave. Assocs.), 29 F.3d 95, 97 (2d. Cir. 1994); *In re Bloomingdale Partners*, 155 B.R. 961, 969 (Bankr. N.D. Ill. 1993).

192. As noted in Part VI *infra*, § 1111(b)(1) is also inapplicable if the nonrecourse creditor makes the 1111(b)(2) election. *See Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone)*, 995 F.2d 1274, 1279 (5th Cir. 1991).

contractual bargain.<sup>193</sup>

In *In re DRW Property Co. 82*,<sup>194</sup> a nonrecourse mortgagee sought to “split” its claim under § 1111(b)(1) on the ground that foreclosure of the mortgage was not equivalent to a sale under § 363 or under a plan.<sup>195</sup> Under the plan, the debtor proposed to abandon the collateral and permit foreclosure, thereby denying the creditor an unsecured claim.<sup>196</sup> The court overruled the mortgagee’s objection, reasoning that the abandonment of collateral to the mortgagee or foreclosure sale conducted following the vacation of the automatic stay has the same effect as a sale under § 363(k).<sup>197</sup> The court concluded that the lack of an express reference to abandonment and foreclosure sales as exceptions to § 1111(b) was an unintentional omission.<sup>198</sup> In summary, the provisions of § 1111(b)(1) will be triggered if the debtor proposes to retain ownership of the mortgaged property, or where the sale of the property is conducted in a manner that bars the secured creditor from bidding in the full amount of its claim.

## 2. Separate Classification of § 1111(b)(1) Deficiency Claim

There is a significant split in the case law regarding the propriety of separately classifying the unsecured deficiency claim statutorily created by § 1111(b)(1) from other general unsecured claims. A minority of courts have found that such separate classification is not only permissible but mandatory. They regard the § 1111(b) unsecured deficiency claim as different from other general unsecured claims because it arises by operation of law only in chapter 9 and chapter 11 cases.<sup>199</sup>

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193. See *H&M Parmely Farms v. Farmers Home Admin.*, 127 B.R. 644, 648 (D. S.D. 1990) (when chapter 11 plan provides for liquidation of collateral, creditor must be notified of sale of collateral pursuant to 363(k) and allowed to bid the full amount of its claim); *Hancock Mutual Life Ins. Co. v. Cal. Hancock, Inc. (In re Cal. Hancock, Inc.)*, 88 B.R. 226, 230-31 (Bankr. 9th Cir. 1988) (debtor’s plan could not be confirmed when creditor, entitled to § 1111(b)(1) split, was not permitted to credit bid); *In re Kent Terminal Corp.*, 166 B.R. 555, 566-67 (Bankr. S.D.N.Y. 1994) (creditor has unconditional right to bid its lien if plan proposes sale of collateral free and clear of liens).

194. 57 B.R. 987 (Bankr. N.D. Tex. 1986).

195. *Id.* at 993.

196. *Id.* at 989.

197. *Id.* at 992.

198. *Id.* at 993. See *Tampa Bay Assocs., Ltd. v. DRW Worthington, Ltd (In re Tampa Bay Assocs.)*, 864 F.2d 47, 50 (5th Cir. 1989) (affirming reasoning of *DRW* in connected case). See also *Nat’l Real Estate Ltd. P’ship – II (In re Nat’l Real Estate Ltd. P’ship – II)*, 104 B.R. 968, 974 (Bankr. E.D. Wis. 1989) (undersecured nonrecourse lender that foreclosed upon collateral and purchased it at sheriff’s sale received the benefit of its bargain, is not a recourse claimant under § 1111(b)(1), and does not hold an unsecured deficiency claim against the debtor).

199. See, e.g., *In re Woodbrook Assocs.*, 19 F.3d 312, 318 (7th Cir. 1994); *In re*

The majority rule is that § 1111(b)(1) deficiency claims are not inherently different from other unsecured claims and, absent valid business reasons, do not allow separate classification. The Second, Third, Fourth, Fifth, and Eighth Circuits have refused to permit separate classification, particularly where gerrymandering to satisfy the requirement of § 1129(a)(10) of the Code is obvious.<sup>200</sup>

*C. Section 1111(b)(2) and Electing to  
Remain a Fully Secured Creditor*

Section 1111(b)(2) permits an undersecured creditor to continue to be treated as a fully secured creditor under a plan that provides for the debtor's retention of the collateral. For example, using the Blackacre illustration set forth above, the mortgagee could waive the automatic "split" of its claim under § 1111(b)(1), and remain a secured creditor with an allowed secured claim of \$1,000,000.<sup>201</sup> The election is advantageous in those situations where a creditor does not wish to incur an immediate loss, and believes that its collateral will increase in value with the passage of time. The effect of making the § 1111(b)(2) election was well summarized in *In re Weinstein*:<sup>202</sup>

When an undersecured creditor makes the § 1111(b)(2) election, its

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SM 104 Ltd., 160 B.R. 202, 214 (Bankr. S.D. Fla. 1993). See also *In re Gato Realty Trust Corp.*, 183 B.R. 15, 20-22 (Bankr. D. Mass. 1995) (separate classification is permissible, but not mandatory).

200. In order to invoke the cram down power of § 1129(b), all of the standards of § 1129(a) must be satisfied, except the requirement of § 1129(a)(8) that each impaired class accept the plan. Section 1129(a)(10) requires that if a class of claims is impaired under the plan, at least one class of impaired claims must have accepted the plan, without counting the acceptance of an insider. See, e.g., *Boston Post Rd. Ltd. P'Ship v. Fed. Deposit Ins. Corp.* (*In re Boston Post Rd. Ltd. P'ship*), 21 F.3d 477, 483 (2d Cir. 1994) (separate classification of unsecured deficiency claim solely to create an impaired assenting class to effectuate cram down is impermissible); *John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs.*, 987 F.2d 154, 161 (3d Cir. 1993) (classification method designed solely to affect the outcome of the voting in a "cram down" situation is improper); *Lumber Exch. Bldg. Ltd. P'ship v. Mut. Life Ins. Co. of New York* (*In re Lumber Exch. Bldg. Ltd. P'ship*), 968 F.2d 647, 649 (8th Cir. 1992) (under proposed plan, unsecured portion of undersecured creditor's claim could not be classified separately from claims of unsecured trade creditors based solely on fact that undersecured creditor's claim arose by operation of law under § 1111(b)); *Travelers Ins. Co. v. Bryson Props.*, XVIII (*In re Bryson Props.*, XVIII, 961 F.2d 496, 502 (4th Cir.) (court rejected debtor's argument that statutory, rather than contractual, basis for creditor's unsecured claim warranted separate classification); *In re Greystone*, 948 F.2d at 140 (distinction between § 1111(b) unsecured deficiency claims and other unsecured claims does not warrant separate classification).

201. See *Wade v. Bradford*, 39 F.2d 1126, 1129 (10th Cir. 1994); *Liona Corp., Inc. v. PCH Assocs.* (*In re PCH Assocs.*), 949 F.2d 585, 604-05 (2d. Cir. 1991).

202. *First Bank of Cal. v. Weinstein* (*In re Weinstein*), 227 B.R. 284 (9th Cir. B.A.P. 1998).

claim is not altered by §§ 506(a) and (d). By making the election, the creditor foregoes its unsecured, deficiency claim. Instead, its total claim is treated as the allowed secured claim for purposes of the Chapter 11 plan confirmation process. Nevertheless, because of the Code's artful language, an electing creditor's allowed secured claim is not treated the same as a fully secured claim. Rather, the § 1111(b)(2) election can be understood as giving rise to an "election claim" equal to the total claim but allotted special treatment for purposes of the plan confirmation process.<sup>203</sup>

Section 1111(b)(2) can be viewed as a classification provision under which the undercollateralized secured creditor can create its own class. The purpose of the § 1111(b)(2) election is to avoid an undersecured claim automatically being split into secured and unsecured portions, thereby depriving the creditor of the potential for appreciation in value of the asset.<sup>204</sup>

A creditor making the § 1111(b)(2) election should request that the restructured note and lien documents contain a "due-on-sale clause" providing for accelerated payment of the claim if the collateral is subsequently sold. The right to include a due-on-sale clause in the restructured agreement is enhanced if such a clause was contained in the original note and mortgage.<sup>205</sup> It also can be argued that a due-on-sale clause is a customary provision intended to promote the liquidity of institutional lenders.<sup>206</sup>

The right of the undersecured creditor to make the § 1111(b)(2) election is subject to two exceptions. The first is where the creditor's interest in the collateral is of inconsequential value.<sup>207</sup> In *In re Baxley*,<sup>208</sup> the court found that an interest valued at eight percent of the creditor's total claim is of consequential value and stated, in dictum, that an interest is of inconsequential value only if it is of no value.<sup>209</sup> Disagreeing with *Baxley*, the court

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203. *Id.* at 293.

204. *In re Elijah*, 41 B.R. 348, 351 (Bankr. W.D. Mo. 1984). See also *In re Tuma*, 916 F.2d at 491 (purpose of § 1111(b)(2) is to give the creditor the benefit of collateral's appreciation); *Etchin v. Star Servs., Inc. (In re Etchin)*, 128 B.R. 662, 666 (Bankr. W.D. Wis. 1991) (pursuant to § 1111(b)(2), "the creditor and not the debtor may receive the benefit of any appreciation of the collateral up to the full amount of the lien . . . even if the value at the time of the reorganization is substantially less").

205. *IPC Atlanta Ltd. P'ship v. Fed. Home Loan Mortgage Corp. (In re IPC Atlanta Ltd. P'ship)*, 163 B.R. 396, 401 (Bankr. N.D. Ga. 1994).

206. See, e.g., *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 145-46 (1982); *Bleecker Assocs. v. Astoria Fed. Sav. & Loan Ass'n*, 544 F. Supp. 794, 795 (S.D.N.Y. 1982).

207. 11 U.S.C. § 1111(b)(2)(i). See, e.g., *In re Union Meeting Partners*, 178 B.R. 664, 680 (Bankr. E.D. Pa. 1994).

208. 72 B.R. 195 (Bankr. D. S.C. 1986).

209. *Id.* at 198. See also *In re Tuma*, 916 F.2d at 491 ("present control of a functioning corporation" is more than inconsequential value; court does not have to determine exact value, as long as it determines that value is not



in *In re Wandler*<sup>210</sup> held that an interest valued at approximately four percent of the creditor's total claim was of inconsequential value, thereby precluding the creditor from making the § 1111(b)(2) election.<sup>211</sup>

The second exception, which mirrors Code § 1111(b)(1)(A)(ii), is where the creditor has a recourse claim and the property is sold under § 363, or the property is to be sold under the plan of reorganization and the creditor is afforded the opportunity to bid in the full amount of its claim.<sup>212</sup> Here again, the creditor is realizing its entire contractual bargain, i.e., the right to bid for the property and to file a general unsecured claim for any deficiency.<sup>213</sup>

The § 1111(b)(2) election is made by the affirmative vote of two-thirds in amount and more than half in number of the allowed claims of the class of which the claim is a part.<sup>214</sup> While the voting requirement contained in § 1126(c) of the Code for an accepting class of impaired claims may have been intended, the text of § 1111(b)(1) refers to the entire class and not only to those that have voted to accept or reject the plan. This is likely of limited significance because the class making the § 1111(b)(2) election often consists of a single secured creditor.

The election may be made at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix.<sup>215</sup> The election must be in writing and signed, unless made at the disclosure statement hearing.<sup>216</sup> The election is binding on all members of the class with respect to the plan.<sup>217</sup>

The § 1111(b)(2) election may not be withdrawn unless a proposed modification to the plan is subjectively and materially adverse to the electing creditor to the extent that would lead a hypothetical reasonable investor to reconsider its election.<sup>218</sup> *In re*

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inconsequential).

210. 77 B.R. 728 (Bankr. D. N.D. 1987).

211. *Id.* at 733.

212. 11 U.S.C. § 1111(b)(1)(B)(ii).

213. *In re 222 Liberty Assocs.*, 108 B.R. 971, 983, 993 (Bankr. E.D. Pa. 1990). See also *In re Cal. Hancock*, 88 B.R. at 230 (where creditor had a pre-petition nonrecourse claim and debtor's plan proposed to sell the collateral and deny the creditor the opportunity to "credit bid," the plan vitiated the creditor's § 1111(b) rights).

214. 11 U.S.C. § 1111(b)(1)(A)(i).

215. FED. R. BANKR. P. 3014. See *In re Rosage*, 82 B.R. 389, 389 (Bankr. W.D. Pa. 1987); *In re Century Glove, Inc.*, 74 B.R. 958, 961 (Bankr. D. Del. 1987).

216. FED. R. BANKR. P. 3014. See *H&M Parmely Farms*, 127 B.R. at 647 (D. S.D. 1990) (debtor given adequate notice of 1111(b) election by oral election at confirmation hearing).

217. FED. R. BANKR. P. 3014.

218. *Bloomingtondale Partners*, 155 B.R. at 971.

*RBS Industries, Inc.*<sup>219</sup> held the election under § 1111(b) not binding when made to a prior plan substantially different from the current plan.<sup>220</sup>

#### *D. Section 1111(b) and Confirmation*

Confirmation of a chapter 11 plan requires satisfaction of the best interests test contained in § 1129(a)(7). A separate test exists for a creditor making the § 1111(b)(2) election. The test contained in § 1129(a)(7)(B) requires that the electing creditor only receive property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.<sup>221</sup> In substance, the test eliminates from the best interest calculation the dividend that would be paid on the unsecured claim if the § 1111(b)(2) election had not been made.<sup>222</sup>

The right to cram down a plan over the rejection of a class making the § 1111(b)(2) election will be governed either by § 1129(b)(2)(A)(i) or § 1129(b)(2)(A)(iii) of the Code. Subsection (i) permits cram down where payment of the total claim is secured by the collateral and the present value of deferred cash payments received on account of that claim is equal to the value of the creditor's interest in the collateral.<sup>223</sup> Under the prior illustration, the cram down provision would be satisfied if the creditor received a note in the principal amount of \$1,000,000, payment of which was secured by Blackacre, so long as the present value of the note on the effective date of the plan was \$800,000.

Section 1111(b) of the Code affords an undersecured creditor unique rights where ownership of the creditor's collateral is retained by the reorganized debtor or a successor entity, i.e., the collateral is not exposed to sale. Whether or not the claim is a recourse claim, the unsecured creditor entitled to the benefits of § 1111(b)(1) will receive an unsecured claim for the amount of its deficiency. Alternatively, the creditor may forego the unsecured claim and elect under § 1111(b)(2) to remain a secured creditor for the full amount of its allowed claim.

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219. 115 B.R. 419 (Bankr. D. Conn. 1990).

220. *Id.* at 421.

221. 11 U.S.C. § 1129 (a)(7)(B).

222. See *Weinstein*, 227 B.R. at 293-94.

223. See *In re Cook*, 126 B.R. 575, 581 (Bankr. D. S.D. 1991) (plan cannot be confirmed unless creditor electing 1111(b) treatment receives full payment of allowed secured claim); *In re Kvamme*, 93 B.R. 698, 699 (Bankr. D. N.D. 1988).

## IX. PLAN CONFIRMATION

A. *Classification of Secured Claims*

Each secured claim is a separate class for purposes of a chapter 11 plan. A first lien on Blackacre is a separate class from the second lien on Blackacre. A creditor having a first lien on Blackacre and a first lien on Whiteacre both owned by the debtor has two separate secured claims. The simplest way of dealing with any claim, whether secured or unsecured, is not to impair it. If the mortgage bears a below market rate of interest, the plan should reinstate the mortgage according to its terms under § 1124(1). If this is done, the secured claim is unimpaired and the claimant is deemed to have accepted the plan.

B. *Confirmation Hearing and Requirements for Consensual Confirmation*

Code § 1129, in conjunction with Code § 1128(a), requires the court to make an independent assessment of the plan's compliance with the statutory requirements even where each impaired class has accepted the plan and no objection has been raised.<sup>224</sup> Any party in interest may appear at that hearing and object to confirmation.<sup>225</sup> Federal Rules of Bankruptcy Procedure 2002(b), 2002(d), 2002(f), 3017(c), 3017(d), 3020, and 9014 establish confirmation hearing procedures with respect to, inter alia, notices and the filing of objections.

Section 1129(a) specifies the 13 requirements for the confirmation of a plan that has been accepted by all impaired classes. The plan proponent carries the burden of satisfying each requirement by a preponderance of the evidence.<sup>226</sup> The requirements are discussed below.

1. *Compliance with Title 11*

The plan must comply with "the applicable provisions of this

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224. *Williams v. Hibernia Nat'l Bank (In re Williams)*, 850 F.2d 250, 253 (5th Cir. 1988).

225. 11 U.S.C. § 1128(b). *Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.)*, 898 F.2d 1544, 1551 (11th Cir.) (holding that guarantor of debtor's loan is a party in interest for purposes of objecting to confirmation); *In re Cent. Med. Ctr., Inc.*, 122 B.R. 568, 570-571 (Bankr. E.D. Mo. 1990) (ruling that debtor and bondholders' committee may object to creditor's plan even where bondholders have accepted the plan). *But see In re Cheatham*, 78 B.R. 104, 106 (Bankr. E.D.N.C. 1987) (holding that administrative claimant whose claim must be paid in full on plan's effective date has no standing to object to confirmation).

226. *Heartland Fed. Sav. Ass'n Enters. v. Briscoe Enters. Ltd. II*, 994 F.2d 1160, 1163 (5th Cir. 1993).

title [title 11].”<sup>227</sup> By substituting “title” for “chapter” in Code § 1129(a)(1) in 1984, Congress clarified its intention that a plan comply with all of the substantive provisions of the Code, and not only those contained in chapter 11.

The proponent of the plan must comply with the applicable provisions of the Code.<sup>228</sup> The legislative history of Code § 1129(a)(2) suggests that Congress was primarily concerned with ensuring that the proponent of the plan provide “adequate information” to those entities voting on the plan, as required by Code § 1125. Federal Rule of Bankruptcy Procedure 3017(d) provides that a bankruptcy court may excuse a plan proponent from transmitting the disclosure statement to members of unimpaired, non-voting classes.

### 2. *Good Faith Proposal of the Plan and Payment Disclosure*

The plan must have been proposed in good faith and not by any means forbidden by law.<sup>229</sup> Although the Code does not define “good faith,” a plan generally is considered to be proposed in good faith “if there is a reasonable likelihood that the plan will achieve a result consistent with the standards prescribed under the Code.” The plan must disclose any payments made or to be made by the proponent, by the debtor, or by any person issuing securities or acquiring property under the plan, for services or for costs and expenses in connection with the plan and the case.<sup>230</sup> Any such payment must have been approved by the court as reasonable, or be subject to such approval.<sup>231</sup>

The proponent of the plan must disclose two things. First, the identity and affiliation of each individual who will serve as a director, officer, or voting trustee of the reorganized debtor, or of any affiliate participating in a plan with the debtor, or of any successor to the debtor.<sup>232</sup> Second, the plan must disclose the nature of any compensation to be paid to any insider.<sup>233</sup> If the debtor’s rates for its services are subject to the jurisdiction of a governmental regulatory commission, any rate change provided in the plan must have been approved by such commission or conditioned upon such commission’s approval.<sup>234</sup>

### 3. *The “Best Interests” Test*

The “best interests” test of Code § 1129(a)(7) requires that all

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227. 11 U.S.C. § 1129(a)(1).

228. *Id.* § 1129(a)(2).

229. *Id.* § 1129(a)(3).

230. *Id.* § 1129(a)(4).

231. *Id.*

232. *Id.* § 1129(a)(5)(A)(i)(ii).

233. *Id.*

234. *Id.* § 1129(a)(6).

impaired creditors and interest holders fare at least as well under the plan as they would in a chapter 7 liquidation. More specifically, Code § 1129(a)(7) requires that each member of an impaired class receive or retain under the plan property of a value, as of the effective date of the plan, at least equal to that which the member would receive or retain in a chapter 7 liquidation, unless the class unanimously accepts the plan.<sup>235</sup> If Code § 1111(b)(2) is applicable to an impaired class of claims, each holder of a claim in that class must only receive or retain property having a value, as of the effective date, at least equal to the value of such holder's secured claim.<sup>236</sup>

Other than in a cram down situation under Code § 1129(b), the court may not confirm a plan unless every impaired class of claims or interests accepts the plan.<sup>237</sup> Acceptance of the plan by a class of claims requires the affirmative vote of not less than two-thirds in amount and a majority in number of the allowed claims of creditors in that class that actually vote.<sup>238</sup> Acceptance of the plan by a class of impaired interests requires the affirmative vote of two-thirds in amount of the allowed interests of the class that actually vote.<sup>239</sup> A class that is not impaired is conclusively presumed to have accepted the plan.<sup>240</sup> A class that does not receive or retain any property under the plan is deemed to have rejected the plan.<sup>241</sup> When a deemed rejection occurs, the plan may only be confirmed under the cram down power of Code § 1129(b).<sup>242</sup>

#### 4. *Treatment of Administrative and Priority Claims*

Priority claims arising under Code § 507(a)(1) (administrative expenses, court costs, and compensation of professionals) or Code § 507(a)(2) (gap period claims) must be paid in full on the effective date of the plan.<sup>243</sup> Wage and consumer priority creditors, if their classes accept the plan, may be paid over a period of time, provided that the deferred payments have a present value, as of the effective date of the plan, equal to the allowed amount of their claims.<sup>244</sup> Any administrative or priority creditor may agree to less favorable treatment than that provided by Code § 1129(a)(9).

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235. *Id.* § 1129(a)(7)(A).

236. *Id.* § 1129(a)(7)(B); *In re Weinstein*, 227 B.R. at 293-94.

237. *Id.* § 1129(a)(8).

238. *Id.* § 1126(c).

239. *Id.* § 1126(d).

240. *Id.* § 1126(f).

241. *Id.* § 1126(g).

242. *Id.* § 1129(b).

243. *Id.* § 1129(a)(9)(A).

244. *Id.* § 1129(a)(9)(B).

Certain unsecured tax obligations (i.e., those entitled to priority pursuant to Code § 507(a)(8)) may be paid over a period not exceeding six years after the date of assessment of such taxes if the taxing authority receives deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of its claim.<sup>245</sup> Secured tax obligations, such as real property taxes are subject to the cram down, but are not subject to § 1129(a)(9).

##### 5. *Affirmative Acceptance by an Impaired Class of Claims and the Plan's Feasibility*

If any class of claims is impaired by a plan, at least one such class must accept the plan, without counting the acceptances of insiders.<sup>246</sup> A plan, however, may not manufacture impaired classes merely for the purpose of garnering votes of such classes in favor of the plan.<sup>247</sup> Courts have condemned modifications to contractual rights which only slightly impair a creditor's position for no justifiable reason as being artificial impairment or a mere artifice.<sup>248</sup>

The plan must be "feasible," i.e., the court must determine that the debtor, or its successor under a plan, is not likely to require further financial reorganization or liquidation unless contemplated by the plan.<sup>249</sup> The purpose of the feasibility requirement is to prevent confirmation of a visionary scheme that promises more than the debtor possibly can achieve.<sup>250</sup> The plan need only offer a reasonable assurance of success, not a guarantee.<sup>251</sup> In evaluating the likelihood of a successful reorganization, "[p]ertinent factors to be considered include the business' earning power, the sufficiency of the capital structure, economic conditions, managerial efficiency, and whether the same management will continue to operate the company."<sup>252</sup>

##### 6. *Bankruptcy Fees and Retiree Benefits*

All bankruptcy case administration fees payable under 28 U.S.C. § 1930, including U.S. Trustee's fees, must be paid by or on the effective date of a plan.<sup>253</sup>

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245. *Id.* § 1129(a)(9)(C).

246. *Id.* § 1129(a)(10).

247. *Willows Convalescent Ctrs. Ltd. P'ship v. Unum Life Ins. Co. (In re Williams Convalescent Ctrs., Ltd. P'ship)*, 151 B.R. 220, 222 (D. Minn. 1991).

248. *Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.)*, 7 F.3d 127, 130-31 (8th Cir. 1993).

249. 11 U.S.C. § 1129(a)(11).

250. *In re Gulph Woods Corp.*, 84 B.R. 961, 973 (Bankr. E.D. Pa. 1988).

251. *Heartland*, 994 F.2d at 1163.

252. *In re Georgetown Ltd. P'ship.*, 209 B.R. 763, 801-02 (Bankr. M.D. Ga. 1997).

253. 11 U.S.C. § 1129(a)(12).

Code § 1129(a)(13) was added to the Code by the Retiree Benefits Bankruptcy Protection Act of 1988. It requires that a plan provide for the continued post-confirmation payment of all "retiree benefits" as defined in Code § 1114 for the duration of the period for which the debtor is obligated to make such payments, at the level established prior to confirmation pursuant to Code § 1114(e)(1)(B) or Code § 1114(g).<sup>254</sup> Sections 1114(e)(1)(B) and 1114(g) permit the trustee or debtor in possession to modify pre-chapter 11 retiree benefits by agreement with the authorized representative of the retiree benefit recipients (§ 1114(e)(1)(B)) or, under certain circumstances, by court order (§ 1114(g)).<sup>255</sup>

### C. Cram Down—Non Consensual Confirmation

If all of the requirements for confirmation of Code § 1129(a) have been met, except that of Code § 1129(a)(8) requiring the acceptance of each impaired class, the plan proponent may request confirmation of the plan pursuant to Code § 1129(b), commonly known as the cram down power. Conditions precedent to the invocation of Code § 1129(b) are that the plan (1) does not discriminate unfairly, and (2) is fair and equitable with respect to each rejecting class.<sup>256</sup> In light of Code § 1126's express requirement that creditors affirmatively accept a plan, the *Ruti-Sweetwater* holding must be questioned.<sup>257</sup>

#### 1. Reorganization Value

In a nonconsensual setting it is necessary to determine the value of the reorganized entity in order to determine which classes of claims or interests may receive or retain value under the plan, i.e., which classes are "in the money." Once the valuation is performed, the proponents can apply the absolute priority rule of Code § 1129(b) that no junior class may participate in the plan unless rejecting senior classes have received full compensation, provided that no class may be paid more than in full.<sup>258</sup> Determining reorganization value is an art and not a science. As

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254. *Id.*

255. *Id.*

256. *Id.* § 1129(b)(1). See *Johns-Manville*, 843 F.2d at 650. Cf. *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988) (holding that, for purposes of cram down, an impaired class consisting of one non-voting, non-objecting creditor is deemed to have accepted the plan, stating that "to hold otherwise would be to endorse the proposition that a creditor may sit idly by, not participate in any manner in the formulation and adoption of a plan of reorganization and thereafter, subsequent to the adoption of the plan, raise a challenge to the plan for the first time").

257. See 11 U.S.C. § 1126(c) and 7 COLLIER ON BANKRUPTCY (MB) ¶ 1129.03[8] n.125 (15th ed. Rev. 1997).

258. H.R. REP. NO. 95-595, at 414 (1977).

observed by one commentator: "It is a guess compounded by an estimate."<sup>259</sup>

It has been recognized that courts should use a "conservative" or "meticulous regard" standard of valuation to protect senior creditors' interests and not apply a "liberal" valuation standard that might allow junior creditors or equity interests to participate at the expense of senior creditors or the feasibility of the plan.<sup>260</sup> Similarly, that valuation should occur and be based on facts existing at the time of confirmation, and may be substantially different from a similar valuation made earlier in the chapter 11 case for purposes of adequate protection.<sup>261</sup>

## 2. The Fair and Equitable Test

For a plan to be considered fair and equitable, it must comply with the absolute priority rule with respect to all rejecting classes of claims and interests.<sup>262</sup> The absolute priority rule, as modified by the Code, prohibits a junior class from receiving or retaining any property on account of its claims or interests over the rejection of the plan by a senior class not being paid in full. The converse of the absolute priority rule is that no senior class of claims or interests may receive a premium.

Importantly, however, compliance with the absolute priority rule does not assure that a plan is fair and equitable. Code § 1129(b)(2)'s use of the word "includes" requires compliance with other fair and equitable tests, e.g., the allocation of voting power.<sup>263</sup> Rather, "a court must consider the entire plan in the context of the rights of the creditors under state law and the particular facts and circumstances when determining whether a plan is 'fair and equitable.'"<sup>264</sup>

## 3. Cram Down of Secured Claims

Although focusing upon chapter 11, the discussion of the cram down power is applicable to chapter 9, 12 and 13 cases. Chapter 9 adopts § 1129(b)(2)(A). The substantive provision of the cram down power of § 1129(b)(2)(A) and § 1325(a)(5) are the same and have been interpreted that way.<sup>265</sup> The text of § 1225(a)(5) is

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259. See 7 COLLIER ON BANKRUPTCY (MD) ¶ 1129.06[2]; Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419 (1996).

260. See *In re Evans Prods. Co.*, 65 B.R. 870, 876 (S.D. Fla. 1986).

261. See *Ahlers v. Norwest Bank Worthington*, 794 F.2d 388 (8th Cir. 1986), *rev'd on other grounds*, 485 U.S. 197 (1988).

262. 11 U.S.C. § 1129(b)(2).

263. *In re D&F Constr.*, 865 F.2d at 675.

264. *Id.* See also 11 U.S.C. § 102(3) which defines "includes" and "including" as not limiting.

265. See *Koopmans v. Farm Credit Servs. of Mid-America, ACA*, 102 F.3d 874, 875 (7th Cir. 1996).



identical to that of § 1325(a)(5). The chapter 11 cram down power has three prongs. Under subsection 1129(b)(2)(A)(i), where property is being retained by the reorganized debtor or transferred pursuant to the plan, there are two prerequisites to the invocation of the cram down power. The first is that the property be valued at its replacement value as compared to foreclosure value. This issue was resolved by the Supreme Court in 1997 in *Associates Commercial Corp. v. Rash*.<sup>266</sup> The second condition is the fixing of an interest rate with respect to deferred payments that provide the secured creditor with the present value of the allowed secured claim as of the effective date of the plan. *Till v. SCS Credit Corp.*,<sup>267</sup> a five-to-four decision rendered by the Supreme Court in 2004, held that the applicable rate of interest was the “formula rate,” the national prime rate in effect as of confirmation to which a risk adjustment factor is to be added. The Supreme Court did not analyze the risk adjustment factor but did note that it usually ranges from one to three percent.

The second cram down alternative is to sell the property free and clear of the secured creditor’s lien, subject to the creditor’s right to credit bid under Code § 363(k), with the lien attaching to the proceeds of sale, and the value of the being treated either under Code § 1129(b)(2)(A)(i) (above) or Code § 1129(b)(2)(A)(iii) (below).<sup>268</sup>

The third alternative is that the secured creditor receives the “indubitable equivalent” of its claim.<sup>269</sup> This is the same concept contained in Code § 361(3) with respect to the law of adequate protection, its origin being the decision in *In re Murel Holding Co.*<sup>270</sup> For example, adequately securing payment of the debt with United States Treasury Notes would be deemed an indubitable equivalent. But deferring payment only makes sense if the Treasury Notes have a higher interest rate than that accruing on the secured claim.

#### 4. Absolute Priority and “New Value”

In *Case v. Los Angeles Lumber Products Co.*,<sup>271</sup> the Supreme Court created what has become commonly known as the “new value exception” to the absolute priority rule.<sup>272</sup> In *Los Angeles Lumber*, the Court considered whether a plan of reorganization

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266. 520 U.S. 953, 960–62 (1997).

267. 541 U.S. 465 (2004).

268. 11 U.S.C. § 1129(b)(2)(A)(ii).

269. 11 U.S.C. § 1129(b)(2)(A)(iii).

270. 75 F.2d 941 (2d Cir. 1935). See *Arnold & Baker Farms v. United States* (*In re Arnold & Baker Farms*), 85 F.3d 1415 (9th Cir. 1996); *In re James Wilson Assocs.*, 965 F.2d 160 (7th Cir. 1992).

271. 308 U.S. 106 (1939).

272. *Id.* at 121-22.

permitting shareholders to retain an interest in the reorganized debtor without requiring a fresh contribution of capital and which plan did not pay creditors in full was “fair and equitable.”<sup>273</sup> The Court held that the plan violated the absolute priority rule but proceeded to discuss the circumstances under which prepetition equity holders might participate in a plan of reorganization where unsecured creditors were not paid in full.<sup>274</sup> The Court stated that participation by prepetition owners would not violate the absolute priority rule if they made a fresh contribution: (1) in money or money’s worth; (2) that was reasonably equivalent to the participation accorded them; and (3) that was necessary for a feasible reorganization.<sup>275</sup>

Although the Code’s cram down power incorporated the absolute priority rule of Chapter X of the Bankruptcy Act, neither the statute nor the legislative history indicated whether “the new value exception” continued to exist. The issue arose but was not decided in *Norwest Bank Worthington v. Ahlers*.<sup>276</sup> The debtors, who were farmers, proposed a chapter 11 plan permitting them to retain the equity interest in their farm in exchange for their agreement to continue to farm to generate the funds to pay creditors under the plan.<sup>277</sup> The plan did not provide for full payment to rejecting classes of creditors.<sup>278</sup> The Court held that “sweat equity” did not constitute “money or money’s worth” and, therefore, it need not decide whether the “new value exception” survived enactment of the Code.<sup>279</sup>

Post *Ahlers*, the courts divided on the vitality of the “new value exception.” The most commonly accepted view is that the “new value exception” survived the enactment of the Code. This position relies on *Dewsnup v. Timm*,<sup>280</sup> in which the Supreme Court stated that the Code did not effect any major change in pre-Code judicially created practice unless there was “at least some discussion” in the legislative history of Congressional intent to make such a change.<sup>281</sup> Since the *Los Angeles Lumber* “exception” was clearly part of pre-Code judicially created practice and the legislative history of the Code does not suggest its repeal, the new value exception should be deemed to have survived enactment of the Code.<sup>282</sup>

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273. *Id.*

274. *Id.*

275. *Id.*

276. *Ahlers*, 485 U.S. at 197.

277. *Id.*

278. *Id.*

279. *Id.* at 203 n.3.

280. *Dewsnup*, 502 U.S. at 410.

281. *Id.*

282. *See In re Woodbrook Assocs.*, 19 F.3d at 320.

Cases holding the “new value exception” to have been repealed by the Code include *In re Drimmel*.<sup>283</sup> Still other courts viewed the phrase “new value exception” as a misnomer, holding instead that the “exception” is not an exception at all, but a corollary to the absolute priority rule.<sup>284</sup> This third approach, which represents current thinking, starts with the premise that, in a cram down situation, Code § 1129(b) clearly bars prepetition owners from retaining or receiving an interest under the plan “on account of” their prior ownership interests.<sup>285</sup> However, when prepetition owners infuse into the reorganized debtor necessary new value in the form of money or money’s worth, the basis of their equity interest in the reorganized debtor is not their prepetition ownership interest in the debtor, but rather their payment of new value for an interest in the reorganized debtor.

*Bank of America National Trust and Savings Association v. 203 N. LaSalle Street Partnership*<sup>286</sup> was the second case presenting the new value issue to the Court. Through extensions of its exclusivity period, only the debtor’s equity holders were given the option to acquire equity in the reorganized partnership by making new value contributions.<sup>287</sup> The chapter 11 plan was confirmed, which decision was affirmed by the district court and, in a two to one decision, by the Seventh Circuit.<sup>288</sup>

The tone of the Supreme Court’s majority opinion suggests the Court would find “new value” to be part of current bankruptcy law. As in *Ahlers*, it decided the case on a narrow ground again leaving for another day the viability of new value.<sup>289</sup> In the majority’s view, assuming new value principles are part of chapter 11 law, a plan providing “junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of Code § 1129(b)(2)(B)(ii).”<sup>290</sup> The Court further held that: “Whether a market test would require an opportunity to offer competing plans or would be

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283. *In re Drimmel*, 108 B.R. 284, 289 (Bankr. D. Kan. 1989). See also Michael H. Strub, *New Value Rule: Applying the Single-Asset Paradigm*, 111 BANKING L.J. 228 (1994) (concluding pre-Code practice not viable); John D. Ayer, *Rethinking Absolute Priority after Ahlers*, 87 MICH. L. REV. 963 (1989); Julie L. Friedberg, Comment, 66 TEMP. L. REV. 893 (1993); Salvatore G. Gangemi & Stephen Bordanaro, Note, *The New Value Exception: Square Peg in a Round Hole*, AM. BANKR. INST. L. REV. 173 (1993).

284. *In re Bonner Mall P’ship*, 2 F.3d 899 (9th Cir. 1993), cert. granted sub nom. U.S. Bancorp Mortgage Co. v. Bonner Mall P’ship, 510 U.S. 1039, motion to vacate denied and appeal dismissed as moot, 513 U.S. 18 (1994).

285. 11 U.S.C. § 1129(b)(2)(B)(ii).

286. *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434 (1999).

287. *Id.*

288. *Id.*

289. *Id.*

290. *Id.* at 458.

satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here.”<sup>291</sup>

It has been observed that the immediate legacy of *203 N. LaSalle* is more litigation, particularly in single asset real estate cases to determine what activities are necessary to satisfy the Supreme Court’s “market test.”

#### *D. Competing Plans and the Prohibition Against Tax Avoidance and Violation of the Securities Act of 1933*

Only one plan may be confirmed. If all of the prerequisites to confirmation are met with respect to more than one plan, the court must consider, but is not bound by, the preferences of creditors and interest holders in determining which plan to confirm.<sup>292</sup> A plan may not be confirmed if a party in interest that is a governmental unit proves that the principal purpose of the plan is the avoidance of taxes or the violation of the Securities Act of 1933.<sup>293</sup>

### X. JURISDICTIONAL ADMINISTRATION OF BANKRUPTCY CASES AND PROCEEDINGS

The United States district courts have exclusive jurisdiction over cases filed under the Code.<sup>294</sup> They are vested with concurrent jurisdiction over civil proceedings arising under the Code, or arising in or related to a bankruptcy case.<sup>295</sup> The allocation of the foregoing jurisdiction between the district court, an Article III court, and its bankruptcy unit, an “Article I” court, is governed by 28 U.S.C. § 157. “Proceedings” include a secured creditor’s right to adequate protection, the estate’s right to obtain credit, the creditor’s right to elect the treatment under § 1111(b)(2) and the confirmation of a chapter 11 plan.<sup>296</sup> These four proceedings are further defined to be “core” proceedings in which the bankruptcy judge is authorized to enter a final order subject to appeal.<sup>297</sup>

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291. *Id.*

292. 11 U.S.C. § 1129(c); FED R. BANKR. P. 3018(c). See *In re South Aiken, Ltd.*, 121 B.R. 7 (Bankr. W.D. Pa. 1990) (confirming competing plan providing for immediate sale of debtor’s building, instead of debtor’s plan proposing to delay a sale and market the building for up to two years); *In re Turner Eng’g, Inc.*, 109 B.R. 956, 961 (Bankr. D. Mont. 1989).

293. 11 U.S.C. § 1129(d).

294. 28 U.S.C. § 1334(a).

295. *Id.* § 1334(b).

296. *Id.* § 157(b)(2)(A)–(O). See also *In re Burger Boys, Inc.*, 183 B.R. 682, 685 (Bankr. S.D.N.Y. 1994) (stating that a core proceeding “is generally defined as a matter which would have no existence outside of the bankruptcy case”).

297. 28 U.S.C. § 157(b)(1).

