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The Treatment of Net Rents in Bankruptcy—Adequate Protection, Payment of Interest, Return of Collateral, or Reduction of Debt

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I. INTRODUCTION

Single-asset real estate bankruptcy cases have generated more than their fair share of controversial issues.[1] These cases often focus on the treatment of secured (usually undersecured) claims.[2] The struggle in many single asset cases is between the equityholders in the debtor and a secured lender with a lien on all the debtor's significant assets.[3] Accordingly, the rights of secured creditors are the focal point in many cases.[4] For example, courts currently disagree on the treatment of net rents[5]

1. The American Bankruptcy Institute devoted the inaugural edition of its law review to the issue of single asset bankruptcy cases. *See* 1 AM. BANKR. INST. L. REV. 2 (Spring 1993) (published in conjunction with St. John's University School of Law).

2. Craig H. Averch et al., *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS. LAW. 961 (May 1992) ("Few legal issues have created more confusion or spawned more litigation than the rights of secured creditors in bankruptcy cases."). *See also* United States Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 369-79 (1988) (holding that undersecured creditors are not entitled to postpetition interest as a form of adequate protection for lost opportunity costs).

3. *See* Michael L. Molinaro, *Single-Asset Real Estate Bankruptcies: Curbing an Abuse of the Bankruptcy Process*, 24 U.C.C. L.J. 161, 166-71 (1991); H. Miles Cohn, *Single Asset Chapter 11 Cases*, 26 TULSA L.J. 523, 528 (1991); Brian S. Katz, *Single-Asset Real Estate Cases and the Good Faith Requirement: Why Reluctance to Ask Whether a Case Belongs in Bankruptcy May Lead to the Incorrect Result*, 9 BANKR. DEV. J. 77 (1992).

4. A related issue is whether single asset realty cases are the proper subject of bankruptcy relief at all. *See, e.g., In re* Dollar Assocs., 172 B.R. 945, 950 (Bankr. N.D. Cal. 1994). The authors do not address this issue. Nonetheless, the existence of this issue must be kept in mind when addressing any other issue involving the rights of creditors in such cases. *See* Honorable Lisa Hill Fenning, *The Future of Chapter 11: One View from the Bench*, 1993-94 *Norton, Annual Survey of Bankruptcy Law*, 113, 126-27 (1993); W. Scott Carlisle, III, *Single Asset Real Estate In Chapter 11 — Need For Reform*, 25 REAL PROP., PROB. AND TR. J. 673, 674 (1991).

5. The term "net rents" refers to the revenues generated from improved real estate after payment of ordinary and necessary expenses associated with operation of the underlying real

tendered to the lender during the pendency of a chapter 11 case.[6] In general, net rents are often paid to the primary secured lender during a Chapter 11 case.[7] Courts disagree on whether these payments should be categorized as adequate protection payments, interest payments, return of collateral, or reduction of a prepetition claims.[8]

Some courts have concluded that receipt of net rents during the pendency of a Chapter 11 case must reduce the prepetition claim (either the secured or unsecured portion of the claim) of an undersecured creditor.[9] These courts conclude that because undersecured creditors are not entitled to accrue postpetition interest or to be compensated for lost opportunity costs under existing precedent of the United States Supreme Court,[10] the principal amount of the claim, determined as of the petition date, must be reduced by the amount of postpetition rents received.[11] Other courts have determined that an undersecured creditor's receipt of net rents is merely a return of collateral—albeit cash collateral—with no corresponding reduction to the prepetition claim.[12]

The existing uncertainty focuses on the proper interpretation of the Supreme Court's decision in the *Timbers* case.[13] So far, the courts have not resolved the tension between (i) the mandate in *Timbers* that undersecured creditors are not entitled to compensation for their lost opportunity costs and (ii) the receipt of net rents by an undersecured creditor holding a lien on income-producing property.[14] In addition, in valuing a

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property and improvements. *See In re* Landing Assocs., Ltd., 122 B.R. 288, 291 n.2, 297 n.7 (Bankr. W.D. Tex. 1990).

6. *Compare In re* Reddington/Sunarrow Ltd. Partnership, 119 B.R. 809, 813-814 (Bankr. D.N.M. 1990) (reducing secured claim by postpetition net rents received by undersecured lender) *and In re* Club Assocs., 107 B.R. 385, 393-398 (Bankr. N.D. Ga. 1989) (reducing unsecured portion of claim by postpetition net rents received by undersecured lender), *with In re* Landing Assocs., Ltd., 122 B.R. 288, 293, 298 (Bankr. W.D. Tex. 1990) (determining undersecured creditor's receipt of net rents was a return of collateral) *and In re* Flagler-at-First Assocs., Ltd., 114 B.R. 297, 301 (Bankr. S.D. Fla. 1990) (same).

7. *See* Bonnie K. Donahue & W. David Edwards, *The Treatment of Assignments of Rents in Bankruptcy: Emerging Issues Relating to Perfection, Cash Collateral, and Plan Confirmation*, 48 BUS. LAW. 633 (Feb. 1993).

8. Grant T. Stein, *Options for Handling Adequate Protection Payments for Rents*, FAULKNER & GRAY'S BANKR. L. REV. 18 (Fall 1991).

9. *See In re* Reddington/Sunarrow, 119 B.R. at 814 and *In re* Club Assocs., 107 R.B. at 394.

10. *See* United Savings Ass'n. of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 382 (1988) (undersecured creditors are not entitled to postpetition interest as adequate protection for lost opportunity costs).

11. *Id.*

12. *See In re* Flagler-at-First Assocs., Ltd., 114 B.R. at 301.

13. United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988).

14. David G. Carlson, *Adequate Protection Payments and the Surrender of Cash Collateral in Chapter 11 Reorganization*, 15 CARDOZO L. REV. 1357, 1370-71 (1994) [hereinafter Carlson, *Adequate Protection*].

secured claim, the courts have not fully explored the relationship between the value of income-producing collateral (determined under the so-called "income approach") and the realization of the expected income.[15]

The authors suggest that the postpetition net rents received by an undersecured creditor should reduce the amount of the undersecured claim only if the net rents exceed the amount of interest accrued, at the applicable contract rate,[16] under the creditor's prepetition agreement. In accordance with established precedent under the former Bankruptcy Act of 1898,[17] undersecured creditors are entitled to postpetition interest from income producing collateral.[18] If, however, the income produced by the collateral exceeds the amount of interest accruing under the prepetition loan agreement, the excess should be used for the benefit of the debtor's estate. This view is consistent with *Timbers*,[19] the Bankruptcy Code[20] and pre-Bankruptcy Code law.[21]

This Article is based on the following observations:

(1) The *Timbers* decision did not address an undersecured creditor's entitlement to postpetition interest from postpetition income generated from prepetition collateral.[22] Arguably, *Timbers* does not prohibit such payments.[23]

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15. *See generally* Leslie K. Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Appraisal Methods To Value Income-Producing Property*, 66 S. CAL. L. REV. 2251 (1993).

16. For purposes of this Article, the authors have assumed that the prevailing market rate of interest is not significantly different from the contract rate. The authors believe, however, that in the absence of a controlling state law or statutory prohibition, the contract rate would govern over the prevailing market rate. Averch, *supra* note 2, at 990 (concluding contract default rate of interest should control). The discussion of appropriate rate of interest is outside the scope of this Article. For an in-depth explanation of interest rates for secured claims, see Aneel M. Pandey, *Determining Interest and Discount Rates Applicable to Secured Claims in the Specter of Bankruptcy Law*, 30 SAN DIEGO L. REV. 549 (1993).

17. Bankruptcy Act of 1898, ch. 541, 30 Stat. (codified as amended at 11 U.S.C. §§ 1-1255) (1976) (repealed 1978).

18. *See* David G. Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 591 (1989).

19. *See* Robert E. Scott, *Sharing the Risks of Bankruptcy:* Timbers, Ahlers, *and Beyond*, 1989 COL. BUS. L. REV. 183, 185 n.5 (1989).

20. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2608 *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333; Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3008; Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610; Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789; Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified at 11 U.S.C. §§ 101-1330 (1988 & Supp. III 1994) (the "Bankruptcy Code").

21. Seth D. Gould, Comment, *Unsecured Creditors' Entitlement to Postpetition Interest In Solvent Debtor Bankruptcy: The Code's Silent Abrogation Of A Pre-Code Doctrine*, 37 WAYNE L. REV. 1849, 1852 (1991).

22. *See* Scott, *supra* note 19.

23. Howard J. Weg, *The Secured Creditor's Rights to Rents from Real Property*, 17 REAL

(2) The Bankruptcy Code does not address the undersecured creditor's right to postpetition interest from the encumbered postpetition income derived from prepetition collateral.[24] The pre-Bankruptcy Code practice, however, is clear: undersecured creditors were entitled to postpetition interest from income-producing collateral.[25]

(3) A credible argument can be made that the value of a secured claim determined under section 506(a) of the Bankruptcy Code includes encumbered postpetition net rent and, therefore, the value of the "secured claim" is increased by the net rents regardless of the appraised value of the underlying property.[26] An undersecured creditor, however, cannot be entitled to both the net rents as part of its secured claim and postpetition interest on its secured claim. By definition, there are not enough net rents to pay interest *and* increase the secured claim.

(4) Section 552(b) of the Bankruptcy Code gives a bankruptcy court the equitable discretion to disencumber a prepetition lien on postpetition rents.[27] Courts should utilize this equitable discretion to limit payments made to an undersecured creditor to accrued interest at the applicable contract rate. To allow the undersecured creditor to receive the full net rents in excess of interest would allow the undersecured creditor its full lost opportunity cost, in violation of *Timbers*.

Part II of this Article illustrates the issue by describing a common fact pattern and including a discussion of various alternatives adopted by the published case law. Part III of this Article analyzes security interests in rents and leases, while Part IV provides an overview of the treatment of secured claims in bankruptcy. Included in Part IV is a comparison of interest to adequate protection payments and rents, and a discussion of general principles of valuation of property in bankruptcy cases. In addition, Part IV addresses the proper treatment of net rents in light of the statutory construction of the Bankruptcy Code. A statutory and policy

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EST. L.J. 29, 47 n.41 (1988) ("*Timbers* does not bear directly on the subject of the secured creditor's rights to rents from real property, but the Court's analysis of Sections 506(b) and 552(b) of the Bankruptcy Code does appear to confirm that a secured creditor with a perfected security interest in postpetition rents from real property is entitled to apply the postpetition rents received to any postpetition interest that accrues on the secured creditor's claim, whether the claim is oversecured or undersecured.").

24. 11 U.S.C. §§ 105(a), 502(b)(2), 506(b), 726(a)(5), 1129, 1225, and 1325.

25. Sexton v. Dreyfus, 219 U.S. 339, 346 (1911).

26. *In re* Bloomingdale Partners, 160 B.R. 93, 100-101 (Bankr. N.D. Ill. 1993).

27. 11 U.S.C. § 552(b). Section 552(b) was amended as part of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106. Under prior law, a prepetition security interest in rents generated postpetition was recognized only "to then extent provided by . . . [the security agreement *and by applicable non-bankruptcy law* . . . ." 11 U.S.C. 552(b) (1993) (emphasis added). The amendment deletes the italicized language. *See* 108 Stat. 4106, § 214(a)(3). Although Congress's intent may have been to preserve a security interest in rents that was not perfected under state law, it remains unclear how a court can determine, without refernece to state law, the "extent" to which a security agreement applies to rents.

analysis is provided in Part V. Finally, Part VI concludes that the Bankruptcy Code and fundamental bankruptcy policies allow an undersecured creditor the right to postpetition interest, accruing at the applicable contract rate, from the net rents received.[28]

II. CLASSIC SCENARIO

The following hypothetical situation illustrates the potential alternative treatments of an undersecured creditor's receipt of net rents:

> Basic Fee-Simple Development Corp. ("BFD") acquires Run-of-the-Mill Apartments for $16 million. Credit Yield Association ("CYA") financed 100% of the acquisition. CYA holds a first lien on the Run-of-the-Mill Apartments and a "perfected" lien on the leases and rents. BFD is unable to make its monthly interest payment to CYA at the note rate of 10% per annum because Run-of-the-Mill generated only $1 million per year of net operating income. Consequently, BFD files a voluntary petition under Chapter 11 of the Bankruptcy Code. During the first week of the case, BFD and CYA enter into an agreed cash collateral order allowing BFD to use the rents to pay ordinary and necessary operating expenses. The agreed order further provides that the net rents shall be delivered to CYA on a monthly basis. Two years later, after CYA has received $2.4 million in net rents, BFD proposes a plan to pay CYA the present value of its secured claim. The unsecured portion of CYA's claim, and all other unsecured claims, would receive a cash payment. The value of the Run-of-the-Mill Apartments is $10 million both at the date of confirmation and on the petition date.

Assuming that the agreed cash collateral order is silent on the issue of the application of the postpetition rents received by CYA, how should the net rents be accounted for? There are several alternatives.

A. *Reduction of the Secured Claim*

Under *Timbers*, CYA is not entitled to postpetition interest as compensation for its lost opportunity costs.[29] In addition, unsecured creditors generally are not allowed payment before confirmation of a reorganization plan.[30] Some courts, therefore, would reduce the "secured claim" of CYA from $10 million to $7.6 million to account for the $2.4 million received during the pendency of the case.[31] This first

28. *See supra* note 16.

29. United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988) [hereinafter *Timbers*].

30. *See,* B & W Enters., Inc. v. Goodman Oil Co., 713 F.2d 534, 537 (9th Cir. 1983) (refusing to allow postpetition payments to suppliers under the "necessity of payment" rule).

31. *See, e.g., In re* 354 East 66th St. Realty Corp., 177 B.R. 776, 781 (Bankr. E.D.N.Y. 1995); *In re* Kalian, 169 B.R. 503, 507 (Bankr. D.R.I. 1994); *In re* IPC Atlanta Ltd. Partnership, 142 B.R.

alternative is represented in *In re Reddington*.[32]

In *Reddington*, the bankruptcy court concluded that the creditor's prepetition secured claim had to be reduced by the amount of the postpetition rent payments received.[33] The debtor, Reddington/Sunarrow Limited Partnership ("Reddington"), owned an apartment complex located in El Paso, Texas. Victoria Savings Association ("Victoria") held a first lien on the apartment complex and on the rents.[34] The *Reddington* court entered an Agreed Order Regarding Interim Use Of Cash Collateral And Providing Adequate Protection. The cash collateral order provided that Victoria would receive a portion of the rents as adequate protection of its security interest in the rents. Victoria received payments of approximately $600,000. Victoria was owed approximately $5,400,000.[35]

Reddington proposed a plan of reorganization in which Victoria would receive a promissory note in the approximate principal amount of $4 million.[36] The parties stipulated that the property had a fair market value of $4 million.[37] Reddington proposed to reduce the secured claim by the amount of the postpetition payments made pursuant to the cash collateral order. Reddington admitted that if the secured claim was not reduced, the plan would not be feasible within the meaning of section 1129(a)(11) of the Bankruptcy Code.[38] Victoria stipulated that its collateral had not decreased in value during the pendency of the case.[39]

Victoria argued that if the rents had been sequestered, the value of the collateral would have increased and in turn the amount of the secured claim would have increased. Victoria, therefore, contended that its secured position would have eroded over time.[40]

The *Reddington* court concluded that the amount of the creditor's secured claim for adequate protection purposes was the value of the collateral as of the petition date.[41] The court also concluded that Victoria's secured claim had to be reduced; otherwise, Victoria was an undersecured creditor that improperly received postpetition payments.[42] The

547, 558-59 (Bankr. N.D. Ga. 1992); Confederation Life Ins. Co. v. Beau Rivage, Ltd., 126 B.R. 632, 641 (N.D. Ga. 1991) ("If payments are made to an undersecured creditor, they must be allowed to reduce the allowed secured claim of the creditor."); *In re* Reddington/Sunarrow Ltd. Partnership, 119 B.R. 809, 813 (Bankr. D.N.M. 1990) (same).

32. 119 B.R. 809 (Bankr. D.N.M. 1990).
33. *Id.* at 814.
34. *Id.* at 810.
35. *Id.* at 810-11.
36. *Id.* at 811.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.* at 812.
41. *Id.* at 813.
42. *Id.*

court rejected Victoria's argument, concluding that "[w]hether the allegation is that the payments are adequate protection payments, interest payments or lost opportunity costs, the Supreme Court in *Timbers* made it clear that an undersecured creditor whose collateral is not depreciating is not entitled to such payments."[43] According to the *Reddington* court, "[i]n *Timbers*, the Court was concerned that an undersecured creditor not improve its position with respect to other creditors."[44] The *Reddington* court concluded that "[i]f payments are made to an undersecured creditor, they must be allowed to reduce the allowed secured claim of the creditor. Otherwise the payments would be treated as interest payments or use value, in direct contravention of *Timbers* and § 506."[45]

The *Reddington* court's analysis is based on a number of assumptions that are questionable. First, the *Timbers* court did not address whether the creditor was entitled to postpetition interest because its collateral produced income that could be used to pay interest.[46] Second, *Timbers* did not address whether a creditor is entitled to postpetition payments of interest from encumbered collateral.[47] Third, *Timbers* may not prohibit undersecured creditors from receiving payments generated from encumbered collateral during a bankruptcy case.[48]

Similarly, in *In re IPC Atlanta Ltd. Partnership*,[49] the bankruptcy court concluded that *Timbers* mandated that the creditor apply postpetition rents received to reduce its secured claim even though the creditor had a perfected security interest in the rents.[50] In *IPC*, the debtor owned an apartment complex located in Clayton County, Georgia. The debtor purchased the property for $2,516,683.05, and as part of the purchase price, assumed a loan from the Federal Home Loan Mortgage Corporation ("Freddie Mac").[51]

After defaulting under its loan, the debtor filed a Chapter 11 petition. As of the petition date, the amount of Freddie Mac's claim was $1,782,114. The court entered an agreed cash collateral order authorizing the debtor to use rents and to pay Freddie Mac the net rents remaining after payment of operating expenses.[52]

The debtor proposed a plan of reorganization pursuant to which

43. *Id.*
44. *Id.*
45. *Id.*
46. Robert E. Scott, *Sharing the Risks of Bankruptcy:* Timbers, Ahlers, *and Beyond*, 1989 COLUM. BUS. L. REV. 183, 185 n.5 (1989).
47. *Timbers*, 484 U.S. 365.
48. *Id.*
49. 142 B.R. 547 (Bankr. N.D. Ga. 1992).
50. *Id.* at 559.
51. *Id.* at 549.
52. *Id.*

Freddie Mac would receive a new note in the amount of $1,350,000. The plan also provided that the postpetition payments made to Freddie Mac would be used to make the first eight payments due under the plan.[53]

Freddie Mac contended that the payments should not be used to reduce its secured claim because they were adequate protection payments. Arguing that it had a security interest in both the real property and the rents, and that the debtor used the rents, Freddie Mac contended that it was entitled to adequate protection as compensation.[54] The bankruptcy court rejected these arguments.[55]

The *IPC* court noted that Freddie Mac had a claim for $1,782,114. The court reasoned that if Freddie Mac was allowed to keep the postpetition payments without crediting them to reduce the debt, then Freddie Mac, an undersecured creditor, would be receiving both the entire amount of its claim and the postpetition payments.[56] The court concluded that in these circumstances, the creditor would be receiving more than the amount of its claim,[57] and that this situation would result in Freddie Mac receiving postpetition interest in violation of *Timbers*.[58] The court also held that if Freddie Mac were right, the amount of its secured claim would grow during the pendency of the case in violation of *Timbers*.[59]

The *IPC* case raises many of the same questions presented in the *Reddington* decision. As stated above, *Timbers* arguably does not prevent an undersecured creditor from receiving postpetition interest from encumbered collateral.[60] Second, the *IPC* court incorrectly assumed that allowing the creditor to receive postpetition payments without crediting the debt would cause the creditor's secured claim to increase.[61]

An undersecured lender can avoid this unfavorable result through careful consideration of the language contained in the cash collateral order.[62] The following provision protects the undersecured creditor in a cash collateral order:

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53. *Id.* at 551, 558.
54. *Id.* at 558.
55. *Id.*
56. *Id.* at 559.
57. *Id.*
58. *Id.*
59. *Id.*
60. Scott, *supra* note 46.
61. 142 B.R. at 559.
62. Craig H. Averch, *Bankruptcy Documents: Selected Drafting Issues (Including Issues in Anticipation of Insolvency)*, presented at the ALI-ABA Course of Study on Real Estate Defaults, Workouts, and Reorganizations, held August 26-28, 1993 in Coronado, California, Vol. I, at 301, 348-52.

> All Rents, including any Rents used by the Debtor pursuant to this Order shall be deemed to be part of the Lenders' collateral for purposes for determining the value and amount of the Lender's secured claim under section 506(a) of the Bankruptcy Code and added to the value of the remaining Property on the projected effective date of confirmation for purposes of determining the amount of, and the treatment to be afforded to, the Lender's allowed secured claim in the context of any plan of reorganization or liquidation in this case, and no recovery, charges or assessment shall be allowable or claimed under Section 506(c) against the Lender by reason of any expenditure of Rents by the Debtor.[63]

Of course, without sufficient negotiation leverage, the undersecured creditor is unlikely to get such a concession from the debtor.

In *In re Oaks Partners, Ltd.*,[64] the bankruptcy court held that a debtor's plan of reorganization properly applied postpetition payments made to a secured creditor to reduce the creditor's secured claim.[65] In *Oaks Partners*, the creditor's claim as of the petition date was $14,360,000. Pursuant to the debtor's motion, the court determined that the value of the property was $12,036,200. During the pendency of the case, the debtor had paid the secured creditor a total of $3,111,227.[66]

In its plan of reorganization, the debtor proposed that the creditor's claim be reduced by the amount of postpetition payments made to the lender. The debtor agreed with the creditor that payments should be applied to the creditor's debt only up to the point that the payments equaled the value of the project. The creditor argued that its claim should not be reduced to the extent that payments were made from rents. The court stated: "The fundamental problem with [the creditor's] argument is that if the payments of $3,155,834.00 are not applied to the debt, why were they made and what were they for? If they are not applied to the debt, what are they — a gift?"[67] These questions were never answered to the court's satisfaction.

In *Confederation Life Ins. Co. v. Beau Rivage Ltd.*,[68] the district court affirmed the bankruptcy court's decision that *Timbers* would be violated unless the creditor's adequate protection payments were applied to reduce the creditor's allowed secured claim.[69] In *Beau Rivage*, the debtor's sole significant asset was an apartment complex that it purchased in 1981. In 1986, debtor Beau Rivage obtained a refinancing

63. *Id.* at 352.
64. 135 B.R. 440 (Bankr. N.D. Ga. 1991).
65. *Id.* at 451.
66. *Id.* at 441.
67. *Id.* at 449.
68. 126 B.R. 632 (N.D. Ga. 1991).
69. *Id.* at 640.

loan from creditor Confederation Life Insurance Company ("Confederation Life") in the approximate amount of $9.8 million. The loan was secured by a deed of trust on the real property and an assignment of rents.[70]

On November 29, 1989, Beau Rivage filed its Chapter 11 petition. Confederation Life then filed a proof of claim in the amount of $11,001,455. On April 11, 1990, the bankruptcy court authorized Beau Rivage to pay Confederation Life half of its $85,099 monthly mortgage payment for the months of February and March, and full mortgage payments for each month thereafter as adequate protection for use of the cash collateral.[71]

On May 2, 1990, the bankruptcy court entered an order valuing the property at $9,300,000. Confederation Life requested the bankruptcy court modify the order because it did not take into account its security interest in postpetition rents. The bankruptcy court denied the motion.[72]

In its plan of reorganization, Beau Rivage provided that the amount of Confederation Life's claim was $9,953,474.[73] The plan also provided that the first four adequate protection payments would be applied to reduce the principal amount of the debt.[74]

Confederation Life appealed the Bankruptcy court's order confirming the plan to the federal district court. First, relying on *Flagler-at-First*,[75] Confederation Life argued that the pre-confirmation adequate protection payments should not be used to offset postconfirmation plan obligations. Second, it argued that the bankruptcy court undervalued its secured claim by not considering pre-confirmation rents.[76]

The district court agreed with the bankruptcy court that Confederation Life's reliance on *Flagler* was misplaced. The bankruptcy court concluded that the *Flagler* court neglected to consider "the possible increase in value of the primary collateral as a result of the infusion of rent proceeds."[77] Specifically, the court concluded that Beau Rivage's use of the rents increased the value of the real property and that this transfer of value was reflected in the valuation order.[78]

The district court also concluded that *Timbers* required that the postpetition payments be used to reduce the amount of Confederation

70. *Id.* at 633.
71. *Id.* at 634.
72. *Id.*
73. *Id.* at 634 n.1.
74. *Id.* at 639.
75. *In re* Flagler-at-First Assocs., Ltd., 114 B.R. 297 (Bankr. S.D. Fla. 1990).
76. 126 B.R. at 638.
77. *Id.* at 639.
78. *Id.* at 641.

Life's second claim. According to the district court, the *Timbers* court "was concerned that an undersecured creditor not improve its position with respect to other creditors."[79]

B. *Reduction of the Unsecured Claim*

Alternatively, some courts would reduce the "unsecured claim" of CYA from $6 million to $3.6 million to account for the $2.4 million in postpetition rent.[80] CYA should prefer this result to a reduction of its secured claim. Of course, if unsecured creditors are receiving a 20% distribution on the account of unsecured claims under the plan proposed by BFD, CYA has received *more* than its *pro rata* share. By crediting the $2.4 million to the unsecured claim of CYA, it could be argued that CYA must return $1.2 million to avoid having received better treatment on the account of its unsecured claim than other holders of unsecured claims.

This effect is demonstrated in *Club Associates*.[81] In *Club Associates*, Consolidated Capital Realty Corporation ("CCRC") was owed approximately $22 million on a secured wraparound note executed by the debtor (Club Associates). The underlying lien was worth approximately $7.8 million. During the time the Chapter 11 case was pending, Club Associates paid CCRC approximately $4.3 million in net rents. In turn, CCRC used a substantial portion of the $4.3 million to pay on a current basis the underlying debt.[82]

The bankruptcy court valued the property at $18.75 million, giving CCRC, an undersecured creditor, a secured claim of $18.75 million and an unsecured claim of $3.25 million. The bankruptcy court refused to give CCRC credit for *any* amounts that CCRC paid on the underlying debt and reduced CCRC's total indebtedness by approximately $3.8 million (*i.e.*, the $4.3 million less tax escrow payments). Thus, CCRC lost its unsecured claim and had its secured claim reduced to $18.1 million. Given the fact that CCRC only received a small portion of the $3.8 million, the result in *Club Associates* seems especially harsh.[83]

The reduction of the unsecured portion of an undersecured creditor's claim is arguably inconsistent with the general prohibition against the payment of an unsecured creditor's prepetition claim during the pendency of a Chapter 11 case.[84] Only in limited circumstances have courts

79. *Id.* at 640.
80. *In re* Club Assocs., 107 B.R. 385, 393-98 (Bankr. N.D. Ga. 1989).
81. *Id.* at 397-98.
82. *Id.* at 392.
83. *Id.* at 398.
84. *See* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its*

authorized payments of prepetition unsecured claims. One such situation is when key creditors have threatened to withhold essential supplies or services unless prepetition claims are paid.[85] Another situation is when payment of prepetition claims is intended to improve future profits, such as honoring frequent flyer programs so customers will not boycott the debtor-airline or paying employees so they will not desert the ship, or worse yet, wreak havoc on their way out.[86] Applying rent payments to reduce the Lender's unsecured claim, therefore, poses significant problems.

C. *Return of Collateral*

Finally, the recent trend is to conclude that the lender merely received a return of its collateral.[87] Under this analysis, if CYA had not received the $2.4 million in rents during the case, CYA's secured claim would have been increased by $2.4 million. Instead of leaving the net rent in the hands of BFD and increasing the secured claim of CYA to $12.4 million, CYA received $2.4 million and, therefore, its secured claim remains at $10 million. This analysis has a lot of appeal,[88] espe-

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Parameters, 73 MARQ. L. REV. 1, 5 (1989); Hon. W. Donald Boe, Jr., *Necessity, The Mother of All Excuses*, 12 NORTON BANKR. L. ADVISER 1, 6 (December 1991).

85. Pension Benefit Guar. Corp. v. Sharon Steel Corp., 159 B.R. 730, 736-37 (Bankr. W.D. Pa. 1993).

86. *See In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991).

87. *See, e.g., In re* Union Meeting Partners, 178 B.R. 664, 677 (Bankr. E.D. Pa. 1995); *In re* Columbia Office Assocs. Ltd. Partnership, 175 B.R. 199, 204 (Bankr. D. Md. 1994); *In re* Johansen, Thackery, MacKenzie Properties, Ltd., 166 B.R. 962, 963 (D. Utah 1994); *In re* Veeco Ins., Co., 170 B.R. 149, 153 (Bankr. E.D. Mo. 1994); Mutual Life Ins. Co. v. Paradise Springs Assocs. (*In re* Paradis Springs Assocs.), 165 B.R. 913, 926 (Bankr. D. Ariz. 1993); *In re* Bloomingdale Partners, 155 B.R 961, 975-76 (Bankr. N.D. Ill. 1993); *In re* Vermont Inv. Ltd. Partnership, 142 B.R. 571, 573-576 (Bankr. D.D.C. 1992); *In re* Flagler-at-First Assocs., Ltd., 114 B.R. 297, 302 (Bankr. S.D. Fla. 1990); *In re* Landing Assocs., 122 B.R. 288, 297 (Bankr. W.D. Tex. 1990).

88. Indeed, one renowned bankruptcy commentator finds the return-of-collateral argument "irresistible." Letter from Jay L. Westbrook, Benno C. Schmidt, Chair of Business Law The University of Texas at Austin School of Law, to Craig H. Averch, Jan. 13, 1994 (on file with authors). Specifically, Professor Westbrook states:

> If one once concludes that rents are products included in the lien like proceeds under that section, why isn't the return of collateral analysis irresistible? It is true that one encounters some conundra and anomalies along the way, especially in that one ordinarily wants to value a secured claim at filing. But if you have a $100,000 debt secured by a genuine Fred Jones sculpture worth $50,000 at the time of filing and Fred then helpfully dies, making the sculpture worth $125,000, none of us would doubt that your secured claim is now oversecured. Why not the same result when your $50 goose lays a $100,000 egg? And if that is true, why not the proceeds of lotsa ordinary eggs? Or rents?

Id. Like Professor Westbrook some bankruptcy courts have drawn the same conclusion. Such a conclusion, however, misses two important points. First, although section 552(b) provides an exception to the general rule that a prepetition lien extends to postpetition after-acquired prop-

cially for secured creditors. There are, however, several problems to overcome with this analysis, including the *Timbers* decision.

In re Flagler-at-First Associates, Ltd.[89] illustrates this return-of-collateral approach. In *Flagler*, the debtor had paid its undersecured lender almost seventy thousand dollars a month under an agreed order allowing use of cash collateral. The debtor argued that the payments should be applied to reduce the lender's secured claim. The debtor contended that under *Timbers*, an undersecured creditor is not entitled to adequate protection payments, as such, unless the value of the collateral is declining. In the debtor's view, therefore, the payments had to be credited against the secured portion of the lender's claim.

The court first distinguished *Timbers* and the handful of bankruptcy court decisions which suggest that reduction of the secured claim is appropriate.[90] As the court noted, *Timbers* did not involve a lien on postpetition rents under section 552(b) of the Bankruptcy Code. Indeed, the Supreme Court implied in dicta that the result might have been different if section 552(b) had been applicable.[91] The effect of *Timbers* is to prohibit payments for postpetition lost opportunity costs, not payments to protect rights in postpetition collateral.[92] Thus, the court in *Flagler* refused to apply *Timbers* as broadly as the debtor requested.

According to the *Flagler* court, because the lender clearly held a security interest in postpetition rents, the accrual of rents caused the amount of the lender's secured claim to rise over time.[93] However, the amount of the secured claim must then be reduced — by the same amount — because the lender would have already received the money:

> The result is essentially a "wash" in that the additional collateral value represented by the excess rents is to be set-off by the fact that [the lender] has already received them during the course of the Chapter 11. No further reduction of the [lender's] secured claim is appropriate.[94]

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erty—like postpetition rents—section 552(b) also contains an "equities exception" to the exception. The conclusion that satisfying the section 552(b) exception ends the analysis makes the equities exception to the exception in section 552(b) meaningless. That is, a court should give effect to all of the language in section 552(b) and ending the analysis half-way through the section fails to acknowledge the remainder. Second, *Timbers* denies the right of an undersecured creditor to lost opportunity costs. As discussed, *infra*, allowing a creditor to receive *all* the net rents without application arguably violates the mandate of *Timbers*. Moreover, as discussed, *infra*, the return of collateral argument posits difficulties in determining the secured claim for both section 506(a) and 1129(b) purposes.

89. 114 B.R. 297 (Bankr. S.D. Fla. 1990).

90. *Id.* at 299.

91. *Timbers*, 484 U.S. at 374.

92. *Flagler*, 114 B.R. at 303.

93. *Id.* at 302.

94. *Id.*

In *In re Vermont Investment Limited Partnership*,[95] the bankruptcy court also adopted the return of collateral view. In *Vermont Investment*, the debtor owned an office building located in the District of Columbia that was worth $19.1 million. Homefed Bank, F.S.B. ("Homefed") held a deed of trust on the building and a security interest in the revenues generated therefrom.[96] As of the petition date, Homefed was owed $18,828,820.16 in principal and $559,537.16 in interest.[97] During the pendency of the case, the debtor paid $1,445,690.18 to Homefed. The bank applied this amount first to outstanding prepetition interest in the amount of $559,537.16, and then to postpetition interest and taxes in the amount of $670,763.[98]

Homefed requested relief from the automatic stay. The debtor contended that the motion should be denied because the postpetition payments should be applied to the prepetition principal balance of Homefed's allowed secured claim, which would have given Homefed a significant equity cushion.[99]

The *Vermont Investment* court rejected this argument. First, the court concluded that the debtor's argument ignored that "rents are collateral distinct from the underlying real estate and that post-petition interest accruals may be collected from such rent collateral by virtue of 11 U.S.C. § 552(b)."[100] The court then reasoned that the payments resulted in a "wash" because the postpetition rents both increased the amount of the bank's allowed secured claim and decreased the allowed claim when they were paid to the lender.[101]

The *Vermont Investment* court then concluded that the *Timbers* decision supported the lender. The court emphasized that *Timbers* addressed the narrow issue of "whether an undersecured creditor is entitled to payments for the 'lost opportunity costs,' " and did not address the proper "application of payments [based] on a security interest *in rents*."[102]

In *In re Bloomingdale Partners*,[103] as of the petition date, the lender held an $11,160,387 claim secured by collateral worth $10 million. A postpetition cash collateral order provided that the lender was to

95. 142 B.R. 571 (Bankr. D.D.C. 1992).
96. *Id.* at 572.
97. *Id.* at 573.
98. *Id.*
99. *Id.* An "equity cushion" exists when the value of a lender's collateral exceeds the outstanding amount of the secured debt. *See* Paula A. Franzese, *Secured Financing's Uneasy Place in Bankruptcy: Claims for Interests in Chapter 11*, 19 HOFSTRA L. REV. 1, 3 (1991).
100. *Vermont Investment*, 142 B.R. at 573.
101. *Id.*
102. *Id.* at 574.
103. 155 B.R. 961 (Bankr. N.D. Ill. 1993).

"receive net rents after payment of ordinary and necessary operating expenses."[104] The debtor's proposed treatment of the secured portion of the lender's claim in the debtor's second amended plan was based on the assumption that net rent payments during the case would be deducted from the amount of the secured claim. The court rejected this premise, noting that the debtor's analysis ignored the effect of section 552(b).[105] The court did treat the net rents as prepayments of the lender's claim, although accrual of the net rents caused the secured portion of the lender's claim to increase commensurately, thereby leaving the secured and undersecured interests unaffected by the prepaid net rents.

The debtor filed a third amended plan and again requested confirmation. This time, the lender argued that the section 506(a) bifurcation of its claim was frozen as of the petition date, and that accrual of net rents during the case caused the lender to become oversecured. Therefore, according to the lender, postpetition interest was collectible as to the secured portion of the Lender's claim under both section 506(b) and *Timbers*. The court rejected this argument, noting that valuation for confirmation purposes is as of the confirmation date.[106] With one minor refinement, the court stuck by its original treatment of the rents, analyzing them as prepayments of the lender's allowed claim.[107]

One of the problems with the return-of-collateral approach is that, in some circumstances, the undersecured creditor may get a recovery that is both inequitable and contrary to *Timbers*. This would occur when the amount of net rents exceeds the amount of accrued interest. In *Timbers*, the undersecured creditor was not entitled to postpetition interest as compensation for lost opportunity cost. In the preceding hypothetical, the undersecured creditor arguably is receiving *more* than interest on its secured claim by obtaining net rents. Generally, interest should be *less* than rent.[108] Otherwise, the borrower is better off defaulting.[109]

Applying the return-of-collateral view to the hypothetical, CYA would receive the net rents from Run-of-the-Mill Apartments without reducing the amount of CYA's secured or unsecured claims. Thus, CYA would be receiving its full opportunity costs. By receiving the net rents, CYA is receiving precisely what it would have received from a

104. *Id.* at 975 n.8.

105. *Id.* at 975.

106. *In re* Bloomingdale Partners, 160 B.R. 93, 96-99 (Bankr. N.D. Ill. 1993).

107. *Id.* at 99 ("post-petition payments made to [the secured creditor] shall be deemed prepayments of [the secured creditor's] allowed claim, *including § 506(b) interest*, measured as of the effective date of confirmation").

108. David G. Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 608 (1989).

109. *Id.*

foreclosure. Therefore, CYA has not lost any opportunity costs.[110]

Much of the confusion on the issue of accounting for net rents can be traced to the historical treatment of security interests in leases and rents. Part III examines this subject. Later in this Article, the authors will show how these ancient concepts are manifested in modern bankruptcy law.

III. COMMON LAW CONCEPTS OF SECURITY INTERESTS IN LEASES AND RENTS

A. *Generally*

A security interest in rents and/or leases can be understood only in light of the history underlying property law.[111] Security interests in real property are governed, for the most part, by historical common-law principles.[112] Although categorized as real property interests, leases, and the rents derived therefrom, are far different from an underlying fee title interest.[113] A lease is a nonfreehold estate. On the other hand, the real property interest in the dirt, sticks, bricks, and mortar (*i.e.*, the "fee interest") is a freehold estate — freely divisible.[114]

Historically, nonfreehold estates, like leases, were not well favored by the law.[115] Indeed, nonfreehold estates were called by the "ambiguous name chattels real and were treated as personal property for various purposes."[116] Leases create both personal property rights (*i.e.*, contract rights) and real property rights (*i.e.*, the rights to occupy and use the underlying real property).[117] The landlord's interests during a tenancy include contract rights to enforce covenants and the real property interest of reversion after the leasehold estate expires or is terminated.[118] Both the landlord's reversionary interest and contractual interest in the lease

110. Arguably, CYA has lost the opportunity to sell the Run-of-the-Mill Apartments and reinvest the sale proceeds. However, because fully developed property does not generally sell for an internal rate of return greater than the cash flow, and internal rates of return reflect investment value, CYA's lost sale opportunity is not significant.

111. "[T]he law as to leases is not a matter of logic in [vacuum]; it is a matter of history that has not forgotten Lord Coke." Gardiner v. Wm. S. Butler & Co., 245 U.S. 603, 605 (1918).

112. U.C.C. §§ 9-102(1) and 9-104(j) (Uniform Commercial Code inapplicable to security interests in real property). *See generally* R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1470-71 (1993).

113. *See generally* Patrick A. Randolph, Jr., *The Mortgagee's Interest In Rents: Some Policy Considerations and Proposals*, 29 U. KAN. L. REV. 1 (1980).

114. *See* Frank S. Alexander, *Federal Intervention in Real Estate Finance: Preemption and Federal Common Law*, 71 N.C. L. REV. 293, 300-03 (1993).

115. JOHN E. CRIBBET, PRINCIPLES OF THE LAW OF PROPERTY 52 (2d ed. 1975).

116. *Id.*

117. *Id.* at 196.

118. *Id.* at 224-25.

can be mortgaged or assigned.[119]

The right to receive rents derived from a real property lease is one "stick" in the bundle of rights associated with the lease. Accrued rents are personalty. Unaccrued rentals, however, are not personalty but are incident to the reversion and follow the land.[120] A transfer of rent, by mortgage or assignment, *does not* "transfer an estate or interest in the land but operates to transfer a mere chose in action [under existing leases]."[121] Consequently, a landlord cannot alienate an interest in rents derived from the property in perpetuity unless such transfer of rents includes the reversionary rights held by the landlord.[122]

A mortgage of the landlord's reversionary interest has an effect on leases and rents. Assuming that the mortgagee has not received an assignment of the rents or the leases, all leases not in existence before the creation of the mortgage can be extinguished by foreclosing the mortgage.[123] Pre-existing leases, however, cannot be terminated by foreclosure.[124] Of course, with respect to post-mortgage leases, the assignment of any rights under such leases, including the right to the rents, is terminated by a foreclosing mortgagee,[125] even if the mortgagee did not obtain an assignment of the leases or rents. A foreclosing mortgagee that did not obtain an assignment of the rents and leases, however, would take the property subject to any previous assignment of the rents or leases in existence before the mortgage. If the landlord previously assigned the leases and rents before the mortgage, the foreclosing mortgagee obtains only the reversionary interest of the landlord which is subject to the previous assignments.[126]

The treatment of an interest in rents is substantially different from the treatment of an interest in leases.[127] Because an assignment of rents "operates to transfer a mere chose in action," the assignment can be enforced through judicial proceedings (*e.g.*, sequestration, receivership, or similar actions) without foreclosing or otherwise obtaining a posses-

119. Any ownership interest in property that may be transferred, sold or conveyed may also be mortgaged or conveyed in trust. *See* First Fed. Savs. of Ark., F.A. v. City Nat'l Bank of Fort Smith, Ark., 87 B.R. 565, 566 (W.D. Ark. 1988) ("It is also familiar law, recognized everywhere, that rent may not only be assigned absolutely but also by way of mortgage.").

120. CRIBBET, *supra* note 115, at 225.

121. *Id.*

122. *Id.*

123. This is true regardless whether the state is a so-called lien theory or title theory jurisdiction. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.22, at 195 (2d ed. 1985).

124. *Id.* § 4.23, at 200.

125. *Id.* § 4.22, at 196 (title theory), § 4.23, at 199 (lien theory).

126. *See* CRIBBET, *supra* note 115, at 225.

127. *Id.*

sory interest in the reversionary interest held by the landlord.[128] Perhaps because of a perceived liability associated with obtaining an assignment of leases[129] (or because of the follow-the-leader principle adopted by many real estate attorneys), lenders often take an assignment of the rents as part of the collateral package instead of an assignment of the leases.

These concepts are not just of historical importance. The disfavor with which courts viewed security interest in "soft" collateral—rents, accounts, inventory, and the like—is reflected in section 552(b) of the Bankruptcy Code.[130] On the other hand, secured interests in "hard" collateral are almost sacrosanct under the Bankruptcy Code and are required to be adequately protected.[131] Section 552(b) of the Bankruptcy Code, however, gives bankruptcy courts the power, to disencumber postpetition rents and similar types of collateral.[132] As this Article discusses, it is this equitable power that enables a court to cap an undersecured creditor's recovery of net rents at the amount of accrued interest.

B. *The Courts' Struggle with the Concept of Security Interest or "Vested Assignment"*

The confusion over the meaning of an assignment (even characterized in absolute form) of rents in mortgage lending transactions is mystifying. The purpose of a mortgage lending transaction is to secure repayment of a loan. Since the "intent" is to create a security interest, and substance is supposed to prevail over form, courts have traditionally looked through an absolute transfer in form to find a security interest.[133] Thus, if an indebtedness is left unaffected by form with a so-called "absolute assignment" of rents, the intent (and substance) is the creation of a security interest.[134]

In a case involving the assignment of a construction contract, a bankruptcy court looked through the form of an outright assignment to find a pledge for security.[135] In stressing that form does not control over substance, the bankruptcy court stated the following:

Courts should be extremely reluctant to give effect to lending docu-

128. *Id.*

129. Unless a covenant in a lease (i) pertained to a thing not *in esse* or (ii) did not "touch and concern" the land, the assignee of the lease could be held liable for the landlord's breach of any covenant in the lease. CRIBBET, *supra* note 115, at 197.

130. 11 U.S.C. § 552(b) (1988).

131. 11 U.S.C. §§ 361-363 (1988).

132. 11 U.S.C. § 552(b) (1988).

133. *See generally* NELSON & WHITMAN, *supra* note 123, §§ 3.5-3.8 (2d. ed. 1985).

134. *Id.* at § 3.8, p. 49 ("The most important factor in determining whether an absolute deed is a mortgage is whether there is an indebtedness on the part of the grantor to the grantee left unaffected by the conveyance.").

135. OLM Assocs. v. Bright Banc Sav. Ass'n, 98 B.R. 271, 275 (Bankr. N.D. Tex. 1989).

> ments that would obviate the need for a creditor to go through state promulgated procedures to recover collateral. Judicial foreclosure proceedings are required to recover pledged collateral unless a statute provides otherwise. *A creative draftsman should not be permitted to allow a creditor to deprive a debtor of its due process rights under state foreclosure laws.*[136]

When it comes to collateralization of rents, however, some courts appear to exalt form over substance. In *Federal Deposit Insurance Corporation v. International Property Management, Inc.*,[137] a conservator of a mortgagee sought to prohibit a management company hired by the mortgagor from disbursing rental proceeds, following the mortgagor's default on its obligations under deed of trust. A temporary restraining order was issued, followed by a preliminary injunction. The mortgagor intervened and counterclaimed, asserting a right to the rents collected before the entry of the temporary restraining order. The United States District Court for the Southern District of Texas entered summary judgment on behalf of the conservator, and the mortgagor appealed. The Fifth Circuit Court of Appeals held that under Texas law, the assignment-of-rents clause in the deed of trust passed immediate title to the rent proceeds to the mortgagee, with enjoyment of rents postponed as long as the mortgagor was not in default, rather than creating a security interest which the mortgagee was required to perfect by taking some affirmative action.[138]

In *International Property*, the court held that the particular assignment-of-rents provision contained in the deed of trust did, in fact, constitute an "absolute" assignment of rents under Texas law.[139] The court noted that the Texas Supreme Court in *Taylor v. Brennan*[140] had indicated that an absolute assignment could be found in a mortgage loan transaction, and that if such a provision existed, a Texas court would enforce it.[141] The court distinguished its holdings in *Village Properties*[142] and *Casbeer*[143] on two grounds. The first dealt with the language of the provision in question, which stated that "the assignment contained

136. *Id.* (emphasis added).

137. 929 F.2d 1033 (5th Cir. 1991).

138. *Id.* at 1034.

139. *Id.* at 1038.

140. 621 S.W.2d 592 (Tex. 1981).

141. *Int'l Property*, 929 F.2d at 1035-36.

142. Wolters Village, Ltd. v. Village Properties, Ltd., 723 F.2d 441, 443 (5th Cir.), *cert. denied*, 466 U.S. 974 (1984) (holding that a pledge of rents, if not clear as to the intent of the parties to create an absolute assignment, merely creates a security interest in the rents).

143. Casbeer v. State Fed. Sav. & Loan Ass'n of Lubbock, 793 F.2d 1436, 1443-44 (5th Cir. 1986) (holding that a creditor with a security interest in rents must take some action before its security interest becomes perfected).

in this Section 5.2 is intended to be absolute, unconditional and presently effective."[144] The court noted that the words "security" and "pledge" were not used in this particular assignment of rents.[145] The court emphasized the last sentence of the assignment of rents, which provided that "[i]t shall never be necessary for [a] Holder to institute legal proceedings of any kind whatsoever to enforce the provisions of this [assignment]."[146] The court concluded that these provisions evidenced a "clear intent" by the parties that the assignment of rents provision be absolute.[147]

The court also noted the following facts: (1) the borrower had not been collecting rents directly from the tenants; (2) the rents being collected by the borrower's agent were not deposited into the borrower's account; (3) the rents were not commingled with any other funds in any other accounts, but remained separate, identifiable proceeds from the property; and (3) there was no dispute as to the rights of third parties. The court's reasoning in footnote 7 of the opinion suggests that, had the situation involved a borrower actually collecting the rents directly, a commingling of rents with other funds, or the existence of third-party claims to the rents, a different outcome could well have resulted.[148]

The Fifth Circuit in *International Property* placed too much emphasis on the collection of the rents by the secured creditor. The collection by a secured creditor and/or lock box arrangement merely gives the secured creditor additional control over its collateral. The rents are nevertheless collateral securing the repayment of the loan.

Moreover, the *International Property* decision opens a Pandora's box of other issues. For example, the acquisition of a property right by a secured lender (*i.e.*, the right to collect the rents in perpetuity) could require a *pro tanto* reduction of the debt.[149] The property right acquired could be construed to be the entire value of the property. Under an income-approach valuation, the right to receive the rents in perpetuity is equal to the entire value of the property! Consequently, the *pro tanto* reduction of the debt requirement could require the secured creditor to credit the debt for the value of the property upon receipt of the "absolute" assignment of the rents. This could lead to usury implications for the creditor charging interest on the full uncredited debt.

144. 929 F.2d at 1037.
145. *Id.* at 1038.
146. *Id.*
147. *Id.*
148. *Id.* at 1038 n.7.
149. *See, e.g., In re* Fry Road Assocs., Ltd., 66 B.R. 602, 605 (Bankr. W.D. Tex. 1986).

IV. TREATMENT OF SECURED CLAIMS IN BANKRUPTCY—BASIC PRINCIPLES

A. *Generally*

"The Bankruptcy Code replaced the terms *secured creditor* and *unsecured creditor* with the terms *secured claim* and *unsecured claim*."[150] A creditor whose claim exceeds the value of its collateral (*i.e.*, the holder of an undersecured claim) actually has two claims: (1) a secured claim to the extent of the value of its collateral (the allowed secured claim) and (2) an unsecured claim for the deficiency.[151] On the other hand, a creditor whose collateral value exceeds the amount of its claim has only one claim, an oversecured claim.[152] The amount by which the value of the collateral exceeds the amount of the claim often is referred to as the "equity cushion" or the "security cushion."[153] Pursuant to section 506(b) of the Bankruptcy Code, the creditor's security cushion governs the extent of the creditor's rights to postpetition interest, fees, and charges.[154]

B. *Adequate Protection*

One of the most significant protections for secured creditors under the Bankruptcy Code is the concept of adequate protection. A secured creditor is entitled to adequate protection of its lien in a chapter 11 case.[155] The Bankruptcy Code does not define "adequate protection."[156] Rather, section 361 of the Bankruptcy Code merely gives three examples of possible forms of adequate protection.[157]

In general, the term "adequate protection" means that protection necessary to preserve the value of a lien at the commencement of the case throughout the pendency of the case.[158] The legislative history of

150. Craig H. Averch et al., *The Right of Oversecured Creditors to Default Rates of Interest From a Debtor in Bankruptcy*, 47 BUS. LAW. 961, 966 (May 1992) (emphasis in original).

151. 11 U.S.C. § 506(a) (1988).

152. *Id.*

153. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372 (1988) ("this provision permits postpetition interest to be paid only out of the 'security cushion' "). *See* David G. Carlson, *Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys' Fees, and Collection Expenses*, 7 BANKR. DEV. J. 381, 383 (1990).

154. *See* Kathryn R. Heidt, *Interest Under Section 506(b) of the Bankruptcy Code: The Right, the Rate and the Relationship to Bankruptcy Policy*, 1991 UTAH L. REV. 361, 364-65 (1991).

155. 11 U.S.C. § 361 (1988).

156. Bankers Life Ins. Co. of Nebraska v. Alyucan Interstate Corp., 12 B.R. 803, 805 (Bankr. D. Utah 1981).

157. 11 U.S.C. § 361 (1988).

158. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380, 1389 (5th Cir.), *vacated*, 802 F.2d 777 (5th Cir. 1986), *reinstated on reh'g en banc*, 808 F.2d 363, 364 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988). *See also In re* Rupprect, 161 B.R. 48, 49-50

the Bankruptcy Code indicates that the concept of adequate protection was designed to reconcile the tension between the United States Constitution's prohibition against the taking of property without just compensation[159] and the need in a bankruptcy case to impair the rights and remedies of a secured creditor.[160] Based on these comments, courts and commentators have assumed that adequate protection has constitutional dimensions.[161] This assumption is subject to question.[162] In any event, a secured creditor is entitled to adequate protection only from decreases in the value of his collateral due to the pendency of the bankruptcy case.[163]

The Supreme Court's decision in the *Timbers* case demonstrates that the interest entitled to adequate protection is the value of the creditor's lien.[164] For example, suppose the debtor owes the creditor $1,000,000 on the petition date and the claim is secured by an apartment complex worth $800,000. In these circumstances, the creditor would be entitled to adequate protection to ensure that the value of its lien does not decline below $800,000.

In single-asset realty cases, secured creditors often have security interests in the bricks, mortar, and personal property of the physical asset, as well as the revenues generated from the physical asset. With regard to the physical asset, adequate protection is designed to ensure that the physical asset does not decrease in value during the pendency of the case, and to compensate the lender if it does so decrease.

Adequate protection of a security interest in the revenues generated from the property is a more complicated matter. In real estate cases, the

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(Bankr. D. Neb. 1993) (undersecured creditor entitled to adequate protection payments equal to amount of interest accruing on secured tax claim); *In Robbins*, 119 B.R. 1, 6 (Bankr. D. Mass. 1990) (accrual of interest on senior mortgage required adequate protection for junior undersecured creditor).

159. U.S. CONST. amend. V.

160. H.R. REP. No. 595, 95th Cong., 2d Sess. 339, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6295.

161. *See, e.g.*, Honorable Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562, 566 (1991) ("The concept of adequate protection is based on the fifth amendment's command that no private property shall be taken for public use without just compensation.").

162. *See* David G. Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 585 (1989).

163. The concept of adequate protection protects the creditor against decreases in the value of its collateral only if the decrease is caused by the pendency of the case. Bankers Life Ins. Co. of Nebraska v. Alyucan Interstate Corp., 12 B.R. 803, 809 (Bankr. D. Utah 1981) ("Not every decline in value must be recompensed, only those which, but for the [automatic] stay, could be and probably would be prevented or mitigated."). *See also* Honorable Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562, 569 n.34 (1991).

164. 484 U.S. at 371.

debtor often is permitted to use revenues to maintain and operate the property. The debtor generally provides the lender with adequate protection by using the revenues pursuant to a budget. The budget generally provides the requisite adequate protection.[165] In almost all cases, some maintenance and payment of operating expenses would be necessary, no matter who holds the property, including the secured lender. Additional adequate protection, therefore, needs to be provided *only* for expenses not directly related to maintaining and preserving the real property and improvements.[166] If neither the property values nor the rents are declining, the secured party's interests are adequately protected by preserving the property, which in turn preserves the rental stream.

The concept of adequate protection influences the undersecured lender's preference as to how the receipt of rents should be treated. A secured claim is entitled to adequate protection; an unsecured claim is not.[167] A lender generally prefers that rents be used to reduce the unsecured portion of its claim, rather than the secured portion. Best of all for the lender, however, is the return of collateral view, which does not reduce the claim at all. The approach that the authors advocate, however, protects the lender's rights of adequate protection while avoiding a windfall.

C. *Postpetition Interest*

Under the Bankruptcy Act of 1898 ("Bankruptcy Act"),[168] creditors generally were not entitled to postpetition interest.[169] Several rationales

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165. *See, e.g.*, Principal Mut. Life Ins. Co. v. Atrium Dev. Co., 159 B.R. 464, 471 (Bankr. E.D. Va. 1993) ("Adequate protection is typically established by the fact that the cash is being used to maintain and enhance the value of the underlying income producing real property in which the creditor also usually holds a security interest."); Fed. Nat'l Mortgage Ass'n v. Dacon Bolingbrook Assocs. Ltd. Partnership, 153 B.R. 204, 214 (N.D Ill. 1993) (required adequate protection satisfied where rents reinvested "in the operation and maintenance of the property"); *In re* Ledgemere Land Corp., 116 B.R. 338, 343 (Bankr. D. Mass. 1990); Chaussee v. Morning Star Ranch Resorts Co., 64 B.R. 818, 822-23 (Bankr. D. Colo. 1986); Hartigan v. Pine Lake Village Apartment Co., 16 B.R. 750, 756-57 (Bankr. S.D.N.Y. 1982).

166. Payment of net rents, after deduction of necessary operating expenses, has been justified as the equivalent of surcharging one part of the lender's collateral (the gross rents) for expenses in maintaining the value of another part of the lender's collateral (the real property). *See In re* Bloomingdale Partners, 155 B.R. 961, 975 n.8 (Bankr. N.D. Ill. 1993); *In re* Vermont Inv. Ltd. Partnership, 142 B.R. 571, 574 n.4 (Bankr. D.C. 1992); *In re* Landing Assocs., Ltd., 122 B.R. 288, 297 n.7 (Bankr. W.D. Tex. 1990). *See also* 11 U.S.C. § 506(c) (1988) (estate can surcharge collateral for expenses in maintaining it).

167. *See* David G. Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 584, 598 (1989) [hereinafter Carlson, *Postpetition Interest*].

168. Ch. 541, 30 Stat. 544 (1898) (*as substantially revised by* The Chandler Act of 1938, ch. 575, 52 Stat. 840). The Bankruptcy Act was repealed and superseded by the enactment of the Bankruptcy Code in 1978.

169. *See* Nicholas v. United States, 384 U.S. 678, 685 (1966); Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 163 (1946); Sexton v. Dreyfus, 219 U.S. 339, 343-44 (1911);

supported this rule.[170] First, interest was thought to be a penalty for the detention of money that should not accrue after the petition date.[171] Because the bankruptcy laws, not the debtor, prevented creditors from collecting their claims after a bankruptcy filing, inequities would likely result from allowing creditors to collect postpetition interest.[172] Second, the denial of postpetition interest was a rule of administrative convenience.[173] Courts considered the date of the bankruptcy filing to be a convenient date for calculating creditors' claims against a debtor's estate; the award of postpetition interest would complicate that calculation.[174]

There were exceptions to the general rule.[175] Interest was allowed where the debtor ultimately proved to be solvent.[176] Interest was also allowed where the claimant's collateral produced income after the filing of the bankruptcy petition, in which case the postpetition income could be applied against postpetition interest on the main claim.[177] Additionally, several courts recognized that secured creditors who held oversecured claims[178] at the time the plan of arrangement was confirmed were allowed to accrue postpetition interest.[179] In contrast, courts did not allow undersecured creditors to add postpetition interest to the amount of their claims.[180] The primary rationale for this treatment was that undersecured creditors resembled general unsecured creditors more

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Thomas v. Western Car Co., 149 U.S. 95, 116-17 (1893) (filing of bankruptcy petition halts all interest accrual). *See also* 3 Collier on Bankruptcy ¶ 502.02[2], at 502-29 to -30 (15th ed. 1991). *But see* Bankruptcy Act § 63(a)(5). 52 Stat. 873 (repealed 1978) (covering interest accruing between date of petition and date provable debt was reduced to judgment). *See generally* Robin E. Phelan & Stacey Jernigan, *Solvent Seems To Be The Hardest Word*, NORTON BANKR. L. ADVISER, Aug. 1991, at 3.

170. Gould, *supra* note 21, at 1851-52.

171. *See* American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266-68 (1914).

172. *Vanston*, 329 U.S. at 164.

173. *In re* Fesco Plastics Corp., 996 F.2d 152, 155 (7th Cir. 1993).

174. Hanna v. United States, 872 F.2d 829, 830 (8th Cir. 1989).

175. Carlson, *Postpetition Interest*, *supra* note 167, at 590-91.

176. *See id.* at 591 (citing Coder v. Arts, 152 F. 943, 949-50 (8th Cir. 1907), *aff'd*, 212 U.S. 223 (1909)).

177. *See id.*

178. Oversecured claims are claims in which the value of the creditor's collateral exceeds the principal and interest due. *See* Evan D. Flaschen, *Adequate Protection for Oversecured Creditors*, 61 AM. BANKR. L.J. 341, 343 (1987).

179. *See* Carlson, *Postpetition Interest*, *supra* note 167, at 591 (citing Sexton v. Dreyfus, 219 U.S. 339 (1911), *rev'g In re* Kessler & Co., 171 F. 751 (S.D.N.Y. 1909), *aff'd*, 180 F. 979 (2d Cir. 1910)).

180. *See id. See also*, *Sexton*, 219 U.S. at 344-46 (holding that undersecured parties are analogous to general unsecured creditors, who are specifically denied postpetition interest under Bankruptcy Act); United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380, 1381 (5th Cir. 1986), *vacated*, 802 F.2d 777, *reinstated on reh'g en banc*, 808 F.2d 363, 364 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988).

than they resembled secured creditors.[181]

Unlike the Bankruptcy Act, the Bankruptcy Code expressly addresses creditors' rights to postpetition interest.[182] Section 502(b) of the Code states that a claim for unmatured interest is not allowable.[183] Section 506(b) of the Code, however, states that an oversecured creditor can receive interest to the extent of its security cushion.[184] In addition, section 726(a)(5) of the Code states that, in a case involving a solvent Chapter 7 estate, unsecured creditors may receive postpetition interest.[185] In the context of bankruptcy plans, sections 1129(b), 1225(a)(5), and 1325(a)(5) of the Code present the parameters for nonconsensual treatment of secured claims, which include providing for interest to ensure that the creditor receives the present value of its claim.[186] Also, secured claims may be cured and reinstated under sections 1124, 1122, and 1322 of the Code, and the claims necessarily include the payment of interest accruing prior to reinstatement.[187]

D. *Treatment of Security Interests in Rents and Leases in Bankruptcy*

Against the backdrop of the common law governing interests in leases and rents, it is no wonder that the overlay of bankruptcy law has caused additional confusion. Indeed, one of the most litigated and potentially confusing areas of bankruptcy law involves the determination of the right of a debtor to use rents from its real property during a bankruptcy case.[188] Few areas of bankruptcy law have produced the number of published decisions and commentaries as has the litigation over whether rents are properly characterized as cash collateral.[189] The cases,

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181. *See generally id.*

182. 11 U.S.C. §§ 502(b)(2), 506(b), 726(a)(5), 1129(b), 1225(a)(5), and 1325(a)(5) (1988).

183. 11 U.S.C. § 502(b)(2) (1988).

184. *Id.* § 506(b).

185. *Id.* § 726(a)(5). *See also* Thompson v. Kentucky Lumber Co., 860 F.2d 674, 676 (6th Cir. 1988); Fed. Sav. & Loan Ins. Corp. v. Moneymaker, 96 B.R. 287, 290 (C.D. Cal. 1988); Boyer v. Bernstein, 90 B.R. 200, 201 (Bankr. D.S.C. 1988); Comm'r of Revenue v. Adcom, Inc., 89 B.R. 2 (D. Mass. 1988).

186. 11 U.S.C. §§ 1129(b), 1225(a)(5), and 1325(a)(5) (1988).

187. *Id.* §§ 1124, 1122, 1322.

188. Honorable John C. Minahan, Jr., *Rents and Profits in Bankruptcy*, 27 CREIGHTON L. REV. 158, 158 (1993); Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents As Cash Collateral In Bankruptcy: The Need For A Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1, 2 (1992). It remains to be seen whether the recent amendment to section 552(b) of the Bankruptcy Code will clarify the issue. *See supra* note 27.

189. *See In re* Salmanson, 132 B.R. 547, 551 (Bankr. W.D. Tex. 1991) (creditor's motion to prohibit use of cash collateral operated as a Bankruptcy Code-created remedy to perfect its interest in rents; subsequent foreclosure of property by second lienholder terminated bank's perfected security interest). *Compare* First American Bank of Virginia WNB Corp. v. Harbour Pointe Ltd. Partnership, 132 B.R. 501, 502 (Bankr. D.D.C. 1991); *In re* Gelwicks, 81 B.R. 445, 448 (Bankr.

however, should be neither difficult nor complex. Under the common law principles of property discussed above, a mortgage and/or assignment of rents *creates* a lien (or in title states, transfers ownership) when such documents are duly executed by the borrower and recorded in the appropriate real property records.

Moreover, as previously discussed, a mortgagee's valid lien on the rents, like many liens, needs judicial enforcement to entitle the mortgagee to collect the rents and obtain possessory rights to, or ownership of, the rents. Under common law principles, the issuance of judicial enforcement of a mortgagee's lien on the rents may be sufficient to divest the debtor of all rights in the rents and to vest the possessory right and ownership of the rents in the mortgagee.[190]

In an attempt to blur the issues, debtors in Chapter 11 use the words "entitlement," "ownership," "right to collect," and "absolute assignment" interchangeably with the words "security interest" and "lien." The words, however, are not interchangeable and serve only to confuse

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N.D. Ill. 1987); *In re* Crabtree, 51 B.R. 521, 526 (Bankr. D. Tenn. 1985); *In re* Colter, Inc., 46 B.R. 510, 514 (Bankr. D. Colo. 1984), *aff'd sub nom.* Consol. Capital Income Trust v. Colter, Inc., 47 B.R. 1008 (D. Colo. 1985); and *In re* Fluge, 57 B.R. 451, 457 (Bankr. D.N.D. 1985) *with* Sears Sav. Bank v. Tucson Indus. Partners, 129 B.R. 614, 623-24 (Bankr. 9th Cir. 1991), *dism'd*, 990 F.2d 1099 (9th Cir. 1993) (dismissed as moot because of settlement agreement). The Bankruptcy Appellate Panel in *Tucson Industrial* held that under Arizona law, a properly recorded assignment of rents was the equivalent of a perfected lien and the rents constituted the lender's cash collateral, even though the lien would be enforceable only if the lender took certain actions such as appointing a receiver, taking possession of the property, collecting the rents, or obtaining an injunction. *But see* Fed. Home Life Ins. Co. v. American Continental Corp., 105 B.R. 564, 573 (Bankr. D. Ariz. 1989) (affirmative postpetition action necessary). Under Georgia law, bankruptcy courts have held when there exists an assignment of rents separate from the mortgage on real property, no further action is necessary to perfect the security interest in those rents after a default has occurred. *See, e.g.*, Jones v. United States, 77 B.R. 981, 983 (Bankr. M.D. Ga. 1987). Other courts, however, have required postpetition actions. *In re* Johnson, Wilson and Dillon, 123 B.R. 439, 440-41 (Bankr. N.D. Ga. 1990). Finally, two recent decisions from the bankruptcy courts in the Northern District of Georgia have used a mix and match approach to the use of the terms "collection," "entitlement," and "perfection." *See In re* Polo Club Apartments Assocs. Ltd. Partnership, 150 B.R. 840, 850-52 (Bankr. N.D. Ga. 1993) and *In re* Keller, 150 B.R. 835 (Bankr. N.D. Ga. 1993). Both the *Polo Club* and *Keller* decisions apparently hold that mortgagees do not have a perfected security interest in rents unless sufficient prepetition action is taken or an "appropriate" motion is filed postpetition. A notice under section 546(b) does not count.

190. *See, e.g.*, *In re* Mount Pleasant Ltd. Partnership, 144 B.R. 727, 734 (Bankr. W.D. Mich. 1992) (prepetition action sufficient to divest debtor of right to the rents); Imperial Gardens Liquidating Trust v. Northwest Commons, Inc., 136 B.R. 215, 218 (Bankr. E.D. Mo. 1991) (same). *But see* Principal Mut. Life Ins. Co. v. Atrium Dev. Co., 159 B.R. 464, 470 (Bankr. E.D. Va. 1993) (as long as debtor has an "interest" in rents which can be realized by payment of a loan, rent will be property of the bankruptcy estate). At first glance, the divestiture of a debtor's right to the rents appears to critically wound the debtor's ability to reorganize under the Bankruptcy Code. Generally, the prepetition action divesting the debtor from the rents occurs shortly before the bankruptcy filing. Consequently, the prepetition action which would divest a debtor of ownership of the rents is a strong candidate for avoidance as a preferential transfer. 11 U.S.C. § 547(b) (1988).

the issue further.[191] The words "right to collect," "ownership," and "entitlement" are applicable only if the court finds that the mortgagee fully and completely *enforced* its lien on the rents prior to the filing of bankruptcy. The "security interest" and "lien" on the rents exists under common law principles regardless of whether or not the lien was enforced.[192]

E. Timbers of Inwood Forest

In *Timbers*, the United States Supreme Court held that an undersecured creditor is not entitled to postpetition interest as compensation for its lost opportunity costs.[193] In doing so, the Supreme Court clarified

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191. *See* Donahue & Edwards, *supra* note 7, at 641-42; Patrick A. Randolph, *Recognizing Lenders' Rents Interests In Bankruptcy*, 27 REAL PROP., PROB. AND TRUST J. 281 (Summer 1992).

192. *See, e.g.*, Vienna Park Properties v. United Postal Sav. Ass'n, 976 F.2d 106, 112 (2d Cir. 1992) (utilizing *Butner* to determine if Virginia law is applicable). "Under Virginia law, an assignment of rents is 'perfected' when it is recorded along with the deed of trust in the land records." *See In re* Hall Colttree Assocs., 146 B.R. 675, 677 (Bankr. E.D. Va. 1992); *In re* Park at Dash Point L.P., 121 B.R. 850, 859 (Bankr. W.D. Wash. 1990), *aff'd*, 152 B.R. 300 (W.D. Wash. 1991), *aff'd*, 958 F.2d 1008 (9th Cir. 1993). The distinction between the right to collect rents and the existence of a collateral interest in them was also discussed by the United States Bankruptcy Court for the District of New Hampshire in *In re* Rancourt, 123 B.R. 143 (Bankr. D.N.H. 1991). In that case the court held that a creditor's rights in the rents from the debtor's rental property were an "interest" in property within the meaning of Bankruptcy Code § 363 and "a security interest [that] extends to . . . rents . . . to the extent provided by [the] security agreement and by applicable nonbankruptcy law" under Bankruptcy Code § 552(b). *Id.* at 148. The court stated that it could "see no principled way to support a ruling that the mortgagees involved in the present matter have no 'cash collateral' security interest in rents, simply because prebankruptcy they did not have any *effectuated* rights to *collect* specific rent payments." *Id.* (emphasis in original).

193. United States Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988). The considerable commentary before and after the *Timbers* decision includes the following: H. Miles Cohn, *Protecting Secured Creditors Against the Costs of Delay in Bankruptcy:* Timbers of Inwood Forest *and Its Aftermath*, 6 BANKR. DEV. J. 147 (1989); Carlos J. Cuevas, *Lost Compensation Costs and the Undersecured Creditor: A Journey Into the* Inwood Forest, 33 N.Y.L. SCH. L. REV. 1 (1988); Richard A. Marshack, *Adequate Protection for the Undersecured Creditor Under the Bankruptcy Code*, 88 COM. L.J. 621 (1983); Raymond T. Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1 (1983); Joseph U. Schorer, *The Right of the Undersecured Creditor to Postpetition Interest in Bankruptcy on the Value of Its Collateral: Implications of Recent Cases*, 21 U.C.C. L.J. 61 (1988); Tazewell T. Shepard III, *The Plight of Secured Creditors After In re* Timbers of Inwood Forest Associates, Ltd., 94 COM. L.J. 26 (1989); Richard B. Webber II, *Adequate Protection and the Undersecured Creditor:* United Savings Association of Texas v. Timbers of Inwood Forest, Assocs., 41 OKLA. L. REV. 637 (1988); Note, *"Adequate Protection" and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy*, 100 HARV. L. REV. 1106 (1987); J. Kevin Bird, Note, *Adequate Protection of Time Value for Undersecured Creditors During the Automatic Stay in Bankruptcy: Where Are We After* American Mariner?, 2 BANKR. DEV. J. 341 (1985); Frances F. Gecker, Comment, *The Recovery of Opportunity Costs as Just Compensation: A Takings Analysis of Adequate Protection*, 81 N.W.U.L. REV. 953 (1987); Chris Juravich, Note, *In Re* Timbers of Inwood Forest Associates*: Lost Opportunity Cost Uncompensable Under the Automatic Stay Provision for Adequate Protection*, 24 HOUS. L. REV. 801 (1987); Thomas O. Kelly III, Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. CHI. L. REV. 305 (1983); Daniel J.

the rights of secured creditors in bankruptcy cases. First, the Supreme Court defined the secured creditor's "interest in property" as that phrase is used in section 506(a) of the Bankruptcy Code.[194] In interpreting section 506(a) of the Bankruptcy Code, the Supreme Court stated that "the creditor's 'interest in property' obviously means his security interest without taking account of his right to immediate possession of the collateral on default."[195] The Supreme Court then stated that the " 'value of such creditor's interest' in § 506(a) means the 'value of the collateral.' "[196] The Supreme Court held that similar language with respect to adequate protection of an "interest in property" in section 361 of the Bankruptcy Code had the same meaning.[197]

An undersecured creditor, therefore, is not entitled to postpetition interest on the value of the collateral. Pointing to the general rule disallowing such interest to unsecured creditors, the Court concluded that providing an undersecured creditor with interest on the value of its collateral would violate the general prohibition against the payment of postpetition interest to unsecured creditors.[198] Only a decrease in the value of the collateral entitled an undersecured creditor to adequate protection.[199] In sum, the Supreme Court's decision in *Timbers* means that an undersecured creditor is not entitled to compensation for the loss of the time-value of its collateral—whether that compensation is characterized as "interest" or "adequate protection."[200] This does not, however, mean that an undersecured creditor is never entitled to adequate protection payments. Certainly, if the value of the property decreases, the secured creditor would be entitled to adequate protection.[201]

F. *Case Law Distinguishing* Timbers

The bankruptcy court in *Timbers* refused to rule on whether net rents received by the undersecured creditor could be credited against postpetition interest obligations.[202] Consequently, the Supreme Court in

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Warren, Comment, *Lost Opportunity Costs as a Measure of Adequate Protection: The Sinking of* American Mariner*?*, 4 BANKR. DEV. J. 477 (1987).

194. 11 U.S.C. § 506(a) (1988).

195. 484 U.S. at 372.

196. *Id.* (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 181, 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6141, 6312).

197. *Id.*

198. *Id.* at 373.

199. *Id.* at 370.

200. *Id.*

201. 11 U.S.C. § 361(a) (1988).

202. Republic Bank Houston v. Bear Creek Ministorage, Inc., 49 B.R. 454, 460 (Bankr. S.D. Tex. 1985), *aff'd sub nom.* United Sav. Assn. of Texas v. Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380, *aff'd en banc*, 808 F.2d 363 (5th Cir.) *aff'd*, 484 U.S. 365 (1988).

Timbers never squarely addressed the issue of an undersecured creditors' entitlement to postpetition interest from encumbered net rents.[203]

In *In re Birdneck Apartment Associates, II, L.P.*,[204] the bankruptcy court concluded that *Timbers* did not address the treatment of net rents in bankruptcy cases.[205] In *Birdneck*, the debtor's sole asset was a 100-unit apartment complex located in Virginia Beach, Virginia.[206] Potomac Equity Portfolio Partnership, L.P. ("Potomac") was secured by a deed of trust on the property and a security interest in all revenues.[207] Potomac, which was an undersecured creditor, was owed approximately $3,051,000, and its collateral was valued at $2,900,000. The property was also encumbered with a first priority tax lien in the amount of $153,000.

Potomac's unsecured deficiency claim was large enough to give Potomac control of the class of unsecured claims, and Potomac voted to reject the plan. The debtor argued that Potomac did not have an unsecured claim because Potomac received postpetition payments totalling $438,191.57 pursuant to a cash collateral order, and these payments should have been applied to reduce principal instead of interest.[208] Alternatively, the debtor contended that the postpetition payments should be added to the value of the collateral, thus making Potomac an oversecured creditor.[209] The court rejected both alternatives.

First, the *Birdneck* court emphasized that the debtor's reliance on *Timbers* was misplaced because *Timbers* merely "prohibits payments to undersecured creditors only from 'unencumbered' assets where there is no evidence of decline in collateral value."[210] Because Potomac had a valid perfected security interest in revenues, the revenues were Potomac's cash collateral and *Timbers* would not prohibit postpetition payments from cash collateral.[211]

Second, the court noted that pursuant to a cash collateral order, the debtor was permitted to use cash collateral to pay operating expenses only because (1) the debtor was making monthly payments pursuant to the terms of the prepetition loan documents and (2) Potomac was granted a lien on all postpetition revenues.[212] In a footnote, the court stated that:

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203. Carlson, *Adequate Protection*, *supra* note 14, at 1370-71.
204. 156 B.R. 499 (Bankr. E.D. Va. 1993).
205. *Id.* at 505.
206. *Id.* at 502.
207. *Id.* at 501.
208. *Id.* at 505.
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.*

> In cash collateral and relief from stay litigation when there is little or no equity in the subject collateral, this court often denies the creditor relief conditioned upon the chapter 11 debtor maintaining interest current on the debt as a form of adequate protection. To allow chapter 11 debtors to recharacterize this relief at confirmation would be contrary to the court's intention and wholly inequitable to the secured creditor.[213]

Third, the *Birdneck* court recognized that even if the payments were properly characterized as "additional collateral value," this value would be offset by Potomac's increased claim resulting from the accrual of interest under section 506(b) of the Bankruptcy Code.[214] Based on this analysis, the *Birdneck* court concluded that the result would be a "wash," and, therefore, a reduction in Potomac's secured claim would be inappropriate.[215]

The essence of the *Birdneck* decision is the court's analysis of the *Timbers* decision. The *Birdneck* court is correct that *Timbers* did not address whether a secured creditor is entitled to postpetition payments from its collateral. The court's justification for its decision, however, is subject to criticism. The court failed to explain why a debtor should be required to make current interest payments as a form of adequate protection.

The real question presented by *Birdneck* is what is the proper form of adequate protection for the use of net rents. For example, suppose instead of paying the net rents to the lender, the debtor used the net rents. Arguably, the amount of the creditor's secured claim would be increased by the amount of the net rents that are not paid to the lender. On the other hand, if the debtor was to pay the net rents to the lender, the amount of the secured lender's claim arguably should be reduced to the extent it receives these payments.

The *Birdneck* court's analysis depends upon whether the creditor had a right to postpetition interest. The court concluded that the creditor had a right to postpetition interest under section 506(b) of the Bankruptcy Code. The court, however, failed to explain how the creditor could be oversecured given that the value of the collateral as only $2,900,000 and the creditor was owed $3,051,000.

Other courts have also concluded that *Timbers* does not address the treatment of net rents. In *Unsecured Creditors' Committee v. Jones Truck Lines, Inc.*,[216] the cash collateral order granted the prepetition

213. *Id.*
214. *Id.* at 506.
215. *Id.*
216. 156 B.R. 608 (W.D. Ark. 1992).

lender additional "adequate protection" for the use of its cash collateral in the form of postpetition interest payments. The unsecured creditors' committee argued that the lender was undersecured and, therefore, not entitled to postpetition interest. Specifically, the committee argued that the "cash collateral represents, in essence, an old pre-petition loan, not a post-petition advance, and the bank therefore is earning post-petition interest on a pre-petition debt."[217]

On the other hand, the lender argued that it was not receiving postpetition interest on prepetition debt in violation of *Timbers*, but rather was receiving postpetition interest on postpetition advances in the form of cash collateral.[218] In essence, the lender contended that it was entitled to postpetition interest because the use of cash collateral constituted a new loan or cash advance. Based on this rationale, the lender contended that it was entitled to receive postpetition interest because the money being used would otherwise be paid to the bank.[219]

The district court agreed with the lender. The court noted that "*Timbers* did not address whether a post-petition grant of cash collateral based on pre-petition debt may earn post-petition interest."[220] The court agreed with the lender that granting the use of cash collateral could be deemed to be a postpetition loan that could include the accrual of interest.[221]

This analysis is subject to criticism, because the court failed to appreciate the distinction between use of cash collateral and the making of a new loan.[222]

G. *Summary: Distinguishing Rents, Adequate Protection, and Interest*

On a basic level, "rents," "adequate protection payments," and "interest" are all the same. That is, all relate to the use of property.[223] Indeed, all three types of payments serve to allocate risks. Interest is charged to cover the risk associated with (i) the failure of the debtor to pay the loan, and (ii) the failure of the collateral to cover the loss associ-

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217. *Id.* at 613.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. David A. Warfield, *Is it Use of Cash Collateral or Post-Petition Borrowing: How Much Protection Does the Creditor Deserve?*, 94 COMM. L.J. 369, 374 (1989).

223. Carlson, *Postpetition Interest*, *supra* note 167, at 607 ("At the appropriate levels of generality, all things are the same or all things are different . . . . Rent is to property what interest is to money — both are charges for use.").

ated with a defaulted loan.[224] Adequate protection addresses the risk of loss of collateral value after a bankruptcy case is commenced.[225] Rents provide the cash flow to service the loan. The leases generating the cash flow have a risk of nonperformance that attaches to the rents.[226]

There are, however, significant differences between the treatment of interest, rents, and adequate protection payments under the Bankruptcy Code. For example, courts have discretion over grants of adequate protection[227] and whether rents are characterized as cash collateral.[228] Interest, on the other hand, is mandated when the creditor is oversecured[229] and generally disallowed when the creditor is undersecured.[230] Another difference between these three types of payments is that interest does not reduce the principal amount of the debt, while receipt of adequate protection payments or net rents may do so.

H. *Valuing the Collateral*

1. OVERVIEW

The concepts governing valuations of real estate are simple to state, but difficult to apply.[231] Generally, a bankruptcy court will entertain testimony from experts who appraise property based on estimates and approximations.[232] Approaching valuation as a pure fact issue, however, misses an important point.[233] Judgments about value should consider which party would bear the risk of an erroneous valuation.[234] While necessarily referring to the factual evidence presented, valuation choices should be resolved in light of the practical effect of the valuation.[235]

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224. *See* Craig H. Averch et al., *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS. LAW. 961, 979 (May 1992).

225. *See, e.g.*, *In re* Camellia Court Apartments, Ltd., 117 B.R. 316, 319 (Bankr. S.D. Ohio 1990) (declining to provide adequate protection where collateral value was stable).

226. STEPHEN A. PHYRR & JAMES R. COOPER, REAL ESTATE INVESTMENT 632-37 (1982).

227. 11 U.S.C. § 361 (1988).

228. Specifically, section 552(b) of the Bankruptcy Code allows a court to eliminate an encumbrance on rents "based on the equities of the case." *See Collier on Bankruptcy* ¶ 552 at 552 (15th ed. 1993).

229. 11 U.S.C. § 506(b) (1988).

230. *Timbers*, 484 U.S. at 370-73.

231. *See* Craig H. Averch & Michael J. Collins, *Avoidance of Foreclosure Sales as Preferential Transfers: Another Serious Threat to Secured Creditors?*, 24 TEX. TECH L. REV. 985, 1017-25 (1993) (examining real property valuation under section 547(b)(5)).

232. Raymond T. Nimmer, Secured Claims in Reorganization Plans 6 (1992) (unpublished manuscript on file with author) ("No single or true market value exists. The search for such value is a search doomed to failure.").

233. *Id.*

234. *Id.*

235. *Id.*

Section 506(a) of the Bankruptcy Code, which governs valuations of secured claims in bankruptcy cases, states:

> (a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.[236]

In pertinent part, the legislative history of section 506(a) states that "[w]hile courts will have to determine value on a case-by-case basis, the subsection makes it clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property."[237]

Congress gave no guidance concerning the valuation standard to be used by the bankruptcy courts. Not surprisingly, bankruptcy courts have used a variety of methods for calculating value, (*e.g.*, fair market value, retail value, going concern value, or wholesale value).[238] The method for calculating value may also depend, at least in part, on the purpose for which the valuation is made.[239] The uncertainty that the parties face when placing valuation issues in the hands of the bankruptcy court often will result in the parties reaching agreement without court intervention.

There is further flexibility in terms of the setting in which such a valuation is performed, *e.g.*, (i) at a hearing on relief from the automatic stay, which may also involve a demand for adequate protection; (ii) at a hearing in which a debtor in possession proposes to sell, use, or otherwise dispose of collateral other than under a plan of reorganization; or (iii) at a confirmation hearing to consider a plan of reorganization that may affect a creditor's interest in collateral. The case-by-case approach has not yielded a clear standard. In general, however, the bankruptcy courts, have tended to disfavor a "liquidation" standard, which incorporates a forced-sale or quick-sale valuation.[240] Courts have generally

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236. 11 U.S.C. § 506(a) (1988).

237. S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5854.

238. James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 19-20 (1987).

239. *See* 11 U.S.C. § 506(a) (1988).

240. *See, e.g., In re* Crowthers McCall Pattern, Inc., 120 B.R. 279, 299-301 (Bankr. S.D.N.Y. 1990).

concluded that unless the debtor is on its financial deathbed, the debtor's assets should be valued at their going concern value for purposes of determining whether the debtor was insolvent.[241]

"As Justice Brandeis once observed, '[v]alue is a word of many meanings.' "[242] The uncertainty associated with the concept of "value" has been the subject of numerous judicial opinions and scholarly commentaries. For example, Judge Jerome Frank stated:

> The fallacy in that argument stems largely from lack of recognition of the eely character of the word 'value.' It is a bewitching word which, for years, has disturbed mental peace and caused numerous useless debates. Perhaps it would be better for [peace of mind] if the word were abolished. Reams of good paper and gallons of good ink have been wasted by those who have tried to give it a constant and precise meaning.[243]

2. THE DATE OF VALUATION

Section 506 of the Bankruptcy Code does not establish the date as of which the value of collateral should be determined.[244] There are three views concerning the date for valuing a secured creditor's collateral. For adequate protection purposes, some courts conclude that the petition date is the applicable point in time for valuation of collateral.[245] Other courts hold that collateral should be valued as of the date of the hearing.[246] Still other courts state that the collateral should be valued as of the effective date of the plan of reorganization.[247]

In determining the effect of receipt of net rents by an undersecured creditor, the timing of the valuation of the secured claim under section

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241. *See* Moody v. Security Pac. Business Credit, Inc., 971 F.2d 1056, 1067 (3d Cir. 1992); *In re* Taxman Clothing Co., 905 F.2d 166, 170 (7th Cir. 1990).

242. Bundles v. Baker, 856 F.2d 815, 823 (7th Cir. 1988) (quoting Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 310 (1923) (Brandeis, J., concurring)).

243. Commissioner of Internal Revenue v. Marshall, 125 F.2d 943, 946 (2d Cir. 1942).

244. *See* David G. Carlson, *Time, Value, and the Rights of Secured Creditors in Bankruptcy, or, When Does Adequate Protection Begin?*, 1 J. BANKR. L. & PRAC. 113 (1991); Patrick Fitzgerald, Comment, *Bankruptcy Code Section 506(a) and Undersecured Creditors: What Date for Valuation?*, 34 UCLA L. REV. 1953, 1955 (1987).

245. Westchase I Assocs., L.P. v. Lincoln Nat'l Life Ins. Co., 126 B.R. 692, 694 (Bankr. W.D.N.C. 1991); *In re* Beard, 108 B.R. 322, 324 (Bankr. N.D. Ala. 1989). Chrysler Credit Corp. v. Van Nort, 9 B.R. 218, 221-22 (Bankr. E.D. Mich. 1981); *In re* Adams, 2 B.R. 313, 314 (Bankr. M.D. Fla. 1980).

246. Blakey v. Pierce, 76 B.R. 465, 468 (Bankr. E.D. Pa. 1987) (following 3 *Collier on Bankruptcy*, ¶ 506.04, at 506-37 (15th Ed. Rev. 1989)).

247. *In re* Cook, 38 B.R. 870, 872 (Bankr. D. Utah 1984); Ahlers v. Norwest Bank Worthington, 794 F.2d 388, 398-99 (8th Cir. 1986), *rev'd on other grounds*, 485 U.S. 197 (1988). *In re* Seip, 116 B.R. 709, 710-11 (Bankr. D. Neb. 1990); *In re* Landing Assocs., Ltd., 122 B.R. 288, 292 (Bankr. W.D. Tex. 1990).

506(a) of the Bankruptcy Code may be determinative. If the value of the "secured claim" is determined as of the petition date, arguably the postpetition net rent is not, by definition, part of the secured claim.[248]

In *Dewsnup v. Timm*,[249] the Supreme Court addressed the issue of valuation as a moving target during the pendency of a bankruptcy case.[250] In *Dewsnup*, the Supreme Court held that a debtor in a Chapter 7 case could not limit an allowed secured claim to the petition date collateral value under section 506(a) of the Bankruptcy Code.[251] The Supreme Court observed that any increase over the judicially determined valuation during bankruptcy accrues to the benefit of the secured creditor, not to the benefit of the bankruptcy estate.[252] *Dewsnup*, however, does not satisfactorily answer the issue at hand because the actual value of the collateral does not change simply through the accrual of postpetition net rents.[253]

3. THE INCOME APPROACH TO VALUATION

In general, the principles governing the valuation of income-producing real property are settled.[254] When valuing income-producing property, appraisers often use the "cost approach," the "sales comparison approach," and the "income capitalization approach."[255] The "income capitalization approach" is considered by some appraisers to be the most reliable.[256]

Under the income capitalization approach, the value of the property is a function of its ability to generate an income stream in the future.[257]

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248. This argument, however, misses an important point. As discussed *infra*, the "income approach" to valuation includes the capitalization of future income. Postpetition rents, therefore, are included in the valuation. *See* Leslie K. Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Appraisal Methods to Value Income-Producing Property*, 66 S. CAL. L. REV. 2251, 2273 (1993).

249. 112 S. Ct. 773 (1992).

250. *Id.* at 778.

251. *Id.*

252. *Id.* (the increase in the value of property "during bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor and not to the benefit of other unsecured creditors whose claims have been allowed and who had nothing to do with the mortgagor-mortgagee bargain").

253. For purposes of this Article, it is assumed that the property is properly maintained, necessary capital improvements are made, and the market is stable.

254. *See In re* Vienna Park Properties, 132 B.R. 517, 519 (Bankr. S.D.N.Y. 1991).

255. *Id.*

256. *Id. But see* Leslie K. Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Appraisal Methods to Value Income-Producing Property*, 66 S. CAL. L. REV. 2251, 2273-78 (1993).

257. APPRAISAL INSTITUTE OF REAL ESTATE APPRAISERS, THE APPRAISAL OF REAL ESTATE, 71-72 (10th ed. 1992).

In essence, a two-step inquiry is made.[258] First, the appraiser projects the level of income that the property will produce for the foreseeable future and totals the amount.[259] This amount is then discounted by applying an appropriate discount rate to determine what a willing buyer would pay a willing seller today for the opportunity to receive the income stream as it accrues.[260]

The capitalization of income is the process of translating net annual income into an expression of capital worth. The basic formula of most capitalization methods is to divide net annual income by rate of return.[261] The two most important factors in capitalization are the selection of the appropriate capitalization rate and the capitalization technique to be used. The unique characteristics of the property and the actions of the market determine both the capitalization rate and the most suitable technique.[262]

Yield capitalization is a method used to convert future benefits or cash flows into a present worth, based on a required level of profit or rate of return on invested capital. This method is profit or yield oriented.[263] It is intended to simulate the *typical* investor's requirements by calculating the present worth of an anticipated future income stream according to a presumed requirement of profit or yield.[264] The conversion of the future benefits or cash flows at the specified yield rate (discount rate) is referred to as discounting when used in this analytical procedure.

The discounting procedure is based on the time value of money (*i.e.*, a dollar received today is worth more than a dollar received in the future). The rate that compensates investors to hold an investment is based on a satisfactory yield or rate of return on the investment plus a complete recovery of the initial capital invested.[265] The rate of return or yield rate varies with the degree of risk involved in a project and the market, as well as by individual investor's preferences.

In yield capitalization by discounted cash flow analysis, a holding period is selected first. Then all future cash flows, or patterns and relationships between present and future cash flows, are identified (including the sale of the property at the end of the holding period). Next, an appropriate discount rate (yield rate) is selected. Finally, the future cash

258. *Id.*
259. *Id.*
260. *Id.*
261. *Id.* at 408-428.
262. *Id.* at 414-19.
263. *Id.* at 415-16.
264. *Id.* at 413.
265. *Id.* at 416-17.

flow is converted into value by discounting and combining each annual future benefit and the reversion.[266]

In certain situations, adjustments are then made to the appraised value of the property to take into account such factors as changes in market conditions, the condition of the property, and the cost of repairs.[267]

4. APPLICATION OF VALUATION PRINCIPLES IN DETERMINING THE SECURED CLAIM

a. The Approach in *Landing Associates*

Nowhere are valuation principles more difficult to apply than in determining the amount of the secured claim under section 506(a) of the Bankruptcy Code.[268] This difficulty is exemplified in *In re Landing Associates, Ltd.*[269]

In *Landing Associates*, the debtor owned a 216-unit apartment complex located in San Antonio, Texas. United Savings Association of Texas, FSB ("United Savings") held a lien on the real property and the revenues generated therefrom.[270] On May 2, 1989, the debtor filed its Chapter 11 petition.[271] On May 26, 1989, United Savings filed its "Notice of Perfection of Security Interest in Rents in Lieu of Seizure of Property or Commencement of Action" under section 546(b).[272] United Savings filed a proof of claim alleging that it was owed $5,242,988.81 on the petition date. United Savings also claimed that interest was accruing at the per diem contract rate of $2,378.95.[273]

The debtor filed a motion requesting the bankruptcy court to determine the allowed amount of United Savings's secured claim. The debtor contended that the hypothetical costs of liquidation should be deducted from the value of the property. The debtor also argued that United Savings's interests in the rents should not be valued separately from the real estate because the value of the rents was subsumed in the value of the real property. Third, the debtor contended that the collateral should be valued as of the petition date. Finally, the debtor argued that because United Savings was an undersecured creditor and its collateral was not declining in value, United Savings was not entitled to receive the net

266. *Id.* at 421.
267. *In re* Vienna Park Properties, 132 B.R. 517, 520 (Bankr. S.D.N.Y. 1991).
268. *See* David G. Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 78-79 (1991).
269. 122 B.R. 288 (Bankr. W.D. Tex. 1990).
270. *Id.* at 290.
271. *Id.*
272. *Id.* at 290-91.
273. *Id.* at 291.

rents as adequate protection.[274]

United Savings, on the other hand, argued that its interest in the rents should be separate and apart from the real property that generated the rents.[275] The *Landing Associates* court agreed with this position.[276]

First, the court noted that although United Savings was owed only one debt, it held three items of collateral: a deed of trust on real property; an assignment of rents; and a security interest in personal property.[277] The court rejected the debtor's argument that the interests in rents had no value even though it was subsumed into the value of the real property. The court reasoned that a deed of trust entitles a creditor to foreclose on real property and become the owner. After becoming the owner of the real property, the creditor would be entitled to the rents generated from the property. According to the *Landing Associates* court, the assignment of rents gives the creditor the added right to take possession of the rents upon default and before foreclosure. The court then stated that:

> When a debtor files bankruptcy, the automatic stay prevents the lender holding this bundle of rights from enjoying them. The rents collected post-petition are presumed to be rents which, *but for* the bankruptcy, would have been collected by the lender under its assignment of rents. A lender with only a deed of trust lacks the extra bundle of rights which would permit it to benefit from the operation of Section 552(b), i.e., a lender, by virtue of its deed of trust alone, could not collect rents prior to foreclosure. Just as we afford adequate protection to a lender with a mere deed of trust as though it would have foreclosed on the property and enjoyed the full benefits of its deed of trust as of the filing date but for the bankruptcy filing, we similarly afford adequate protection to the secured creditor with an assignments of rents . . . . Thus an assignment of rents confers rights which have discrete value apart from the underlying deed of trust interest in the real property generating those rents.[278]

The essence of the *Landing Associates* court's analysis is the statement that the "income approach more precisely values *the ability to produce income*, rather than the income itself."[279] In pertinent part, the court states that:

> What appraisers are valuing (or predicting) is what someone would be willing to pay to *own* the property and enjoy its fruits. The income approach measures the *ability* of the property to produce a

274. *Id.*
275. *Id.* at 296.
276. *Id.*
277. *Id.*
278. *Id.* (emphasis in original).
279. *Id.* at 297 (emphasis in original).

> return on investment (via an income stream) that would justify a buyer's paying the indicated market value to own the property. The right to specific rents *prior* to ownership of the property conferred by an assignment of rents, is *a priori* not calculated into this value.[280]

Landing Associates makes a point that is often overlooked. The "fair market value" of the property under the income approach to valuation measures a hypothetical individual investor's value.[281] The "estate's interest" measured under section 506(a) includes the "fair market value" plus the net rents accruing until the sale of the property. Absent material changes in the real estate market, interest rates, or other factors that affect investment decisions, the "fair market value" of the property should remain fairly constant. The investment value, therefore, is the same. The ownership value or "estate's interest," however, includes the receipt of net rents — which is not considered in determining market value.

The analysis in *Landing Associates* is not flawless. For example, *Landing Associates* appears to bifurcate the secured creditor's claim into separate interests, one conferred by a deed of trust and the other conferred by an assignment of rents.[282] By creating the two separate security interests, *Landing Associates* blurs the obvious point. Although "market value" includes the future rents, market value measures the investor's interest and not the owner's (or estate's) interest which is subject to a security interest.

b. The Market Value Approach

The straight market value approach to valuation differs from that used in *Landing Associates*. Under a straight market value approach, the collateral of the undersecured creditor *does not* grow simply by the realization of the expected income derived from the property. For example, if the income-producing real property in question has a value of $1 million on the petition date, that value is based on a present-value calculation of the future cash flow from the property. The actual accrual of the future rents should not change the value of the property and, therefore, the value of the secured claim should not change. Thus, the accrual of net rents can be characterized as merely the realization of what was expected and valued as of the petition date.

Arguably, the capitalization of future income does not correctly

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280. *Id.* (emphasis in original).

281. *Id.* at 296-97.

282. *Id.* at 297 ("The appraisals only valued the interest conferred by USAT's deed of trust. They did not purport to value the wholly separate interest conferred by USAT's assignment of rents . . . .").

value the secured claim as of the petition date. The fair market value of the property cannot be determined unless the net rents from the petition date to "closing" were included. Fair market value usually measures what a willing buyer would pay a willing seller, with no compulsion to buy or sell, as of a specific date.[283]

A willing buyer purchasing the property on the petition date for fair market value would receive the net rents accruing thereafter. The secured creditor would receive the value of its "secured claim" on the petition date.

The lack of existence of a petition date sale requires a reevaluation of what a willing buyer would pay a willing seller on the petition date. Since the willing buyer cannot acquire the property until closing (which would occur sometime after the petition date), the willing buyer tendering the fair market value purchase price on the petition date must expect to receive the postpetition rents through closing. Otherwise, the purchase price would be reduced. Thus, the fair market value of the property as of the petition date is erroneous, unless provision is made for the inclusion of postpetition rents.

The value of the secured claim determined under section 506(a) of the Bankruptcy Code includes encumbered postpetition net rent and, therefore, the value of the "secured claim" is increased by the net rent regardless of the appraised value of the property. This argument, however, misses another point. An undersecured creditor cannot be entitled to both the net rents as part of its secured claim and postpetition interest on its secured claim. By definition, there is not enough net rent to pay interest *and* increase the secured claim.

V. ANALYSIS

A. *Statutory Construction*

1. PLAIN LANGUAGE

The United States Supreme Court has clarified the analysis that courts generally should apply when interpreting the Bankruptcy Code.[284]

283. *See* Chaim J. Fortgang & Thomas M. Mayer, *Valuation In Bankruptcy*, 32 UCLA L. REV. 1061 (1985); Steven L. Pottle, Note, *Bankruptcy Valuation Under Selected Liquidation Provisions*, 40 VAND. L. REV. 177, 183 (1987).

284. *See generally* Peter H. Carroll, III, *Literalism: The United States Supreme Court's Methodology for Statutory Construction in Bankruptcy Cases*, 25 ST. MARY'S L.J. 143 (1993); Robert K. Rasmussen, *A Study of the Costs and Benefits Of Textualism: The Supreme Court's Bankruptcy Cases*, 71 WASH. U. L.Q. 535 (1993); Walter A. Effross, *Grammarians at the Gate: The Rehnquist's Court's Evolving "Plain Meaning" Approach to Bankruptcy Jurisprudence*, 23 SETON HALL L. REV. 1636 (1993); Charles J. Tabb & Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823 (1991).

Questions concerning the proper interpretation of the Bankruptcy Code should be resolved by reference to its " 'text, history, and purpose.' "[285] Because the language of the Bankruptcy Code should be dispositive,[286] a bankruptcy court should look first to the statutory language and then to the legislative history if the statutory language is unclear.[287] In addition, the Supreme Court has emphasized that the plain meaning of the Bankruptcy Code should be controlling in issues of statutory interpretation, except in the " 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.' "[288] Courts, therefore, should depart from the strict language of a section of the Bankruptcy Code only if the language is unclear, ambiguous, or clearly contrary to the Bankruptcy Code's purpose and history.[289]

Because of its view that overemphasis on legislative materials might lead to a distorted view of statutory purpose, the Supreme Court fashioned these interpretive rules with an emphasis on strict textual construction.[290] With respect to the Bankruptcy Code in particular, the Supreme Court has cautioned:

> [I]n such a substantial overhaul of the system, it is not appropriate or realistic to expect Congress to have explained with particularity each step it took. Rather, as long as the statutory scheme is coherent and consistent, there is generally no need for a court to inquire beyond the plain language of the statute.[291]

The Supreme Court's position on statutory interpretation does not imply that extrinsic aids, such as legislative history, prior law, and policy analyses are irrelevant in all cases. These aids are useful for determining whether the plain language reflects Congress's true intent in

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285. Johnson v. Home State Bank, 111 S. Ct. 2150, 2153 (1991) (quoting Farrey v. Sanderfoot, 111 S. Ct. 1825, 1830 (1991)).

286. *See id.* at 2155.

287. *Id.*

288. United States v. Ron Pair Enters., 489 U.S. 235, 242 (1989) (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)). *See also* Adam J. Wiensch, Comment, *The Supreme Court, Textualism, and the Treatment of Pre-Bankruptcy Code Law*, 79 GEO. L.J. 1831, 1832-34 (1991) (examining and supporting Supreme Court's Textualist approach to interpretation of Bankruptcy Code). *But cf.* Dewsnup v. Timm, 112 S. Ct. 773, 778 (1992) (finding phrase "allowed secured claim" ambiguous and not tied to definitions in other sections of Bankruptcy Code.).

289. *See In re* Continental Airlines, Inc., 932 F.2d 282, 287 (3d Cir. 1991).

290. *See* Paskel v. Heckler, 768 F.2d 540, 544 (3d Cir. 1985) ("[M]uch less thought is spent on the future implications of committee reports and explanations on the floor than in choosing the words of a statute.") (quoting Archibald Cox, *Judge Learned Hand and the Interpretation of Statutes*, 60 HARV. L. REV. 370, 381 (1947)).

291. 932 F.2d at 287 (quoting United States v. Ron Pair Enters., Inc., 489 U.S. 235, 240-41 (1989)).

enacting the statute.[292] Of course, where the statutory language is less than clear, extrinsic aids may be essential. When the statutory language is clear on its face, however, "a party seeking to counter that language must produce other evidence that exhibits at least as much clarity."[293]

The plain language doctrine is not a panacea in resolving disputes arising under the Bankruptcy Code. Apparently, the "plain language" is what five United States Supreme Court justices consider it to be even if it is the opposite of what the other four justices considered it to be.[294] Moreover, the source for the interpretation of the "plain language" is subject to debate among the current justices.[295]

The Bankruptcy Code does not contain a provision dictating the characterization or application of net rents received by an undersecured creditor. Consequently, other nonspecific provisions of the Bankruptcy Code must be examined.

2. THE INTERRELATIONSHIP OF SECTIONS OF THE BANKRUPTCY CODE ON THE RECEIPT OF NET RENTS

The Supreme Court has instructed the bench and bar that bankruptcy laws cannot be read "with the ease of a computer."[296] In fact, the Court has emphasized that a "holistic" approach should be employed when interpreting the Bankruptcy Code.[297] As a consequence, courts should give effect to the differences in the statutory language among the various sections of the Bankruptcy Code.

Section 506(a) of the Bankruptcy Code governs the amount and value of a secured claim.[298] Section 552(b) contemplates that a secured creditor may (if the court decides not to exercise its equitable discretion),[299] increase its secured claim by the accrual of postpetition rents.

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292. *Id.*

293. *Id.*

294. *See, e.g.*, United States v. Ron Pair Enters., Inc., 489 U.S. 235 (1989) (five-to-four decision).

295. *Compare* Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. Partnership, 113 S. Ct. 1489, 1494-95 (1993) (relying on Webster's Dictionary) *with* Rake v. Wade, 113 S. Ct. 2187, 2192 (1993) (unanimously relying on the American Heritage Dictionary) *and* United States Dep't of Treasury v. Fabe, 113 S. Ct. 2202, 2210 (1993) (relying in part on Black's Law Dictionary).

296. Bank of Marin v. England, 385 U.S. 99, 103 (1966).

297. "A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear . . . or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." Timbers, 484 U.S. 365, 371. *But cf.* Dewsnup v. Timm, 112 S. Ct. 773, 776, 778 (1992) (holding that ambiguity of § 506(d) is not resolved by reference to interrelationship with § 506(a)).

298. 11 U.S.C. § 506(a) (1988).

299. The court's equitable discretion to disencumber a secured creditor's security interest in postpetition revenue derived from prepetition collateral is unique. Nowhere else in the Bankruptcy Code does a court have discretion to avoid a properly perfected lien. To the contrary,

Thus, the secured claim of the creditor includes the "gross" postpetition rentals if sections 506(a) and 552 are construed together.

Then, the secured claim of the creditor can be reduced under section 506(c) for an amount equal to the postpetition expenses necessary to maintain and operate the remainder of the secured creditor's collateral (*i.e.*, the real property and improvements).[300] Consequently, when section 506(c) reductions are added to the mix, the secured creditor's secured claim is only increased in the amount of the "net" rents. The foregoing statutory analysis is consistent with *Timbers*, in which the Supreme Court recognized that a security interest in rents enforceable under state law is "a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors."[301]

The foregoing analysis, while shedding some light on the issue, is not conclusive. For example, the secured creditor's receipt of net rents during the pendency of the Chapter 11 case may allow the secured creditor to receive *more* than the present value of its secured claim in violation of section 1129(b)(2)(A)(i). A secured creditor is only entitled to the present value of its secured claim as of the "effective date" of a Chapter 11 plan. If the secured creditor receives reductions of its secured claim before confirmation, a post-effective date market rate of interest on the remainder of the secured claim will enable the secured creditor to receive a net present value in excess of what would have been received if postpetition (pre-effective date) net rents were not in fact paid to the undersecured creditor.

Moreover, the Bankruptcy Code has specific provisions dealing with postpetition entitlements for secured creditors—namely, section 506(b). There is, however, no provision in the Bankruptcy Code specifically granting an undersecured creditor a right to postpetition interest. This is true even if the undersecured creditor's collateral is producing income. Consequently, it is appropriate to examine the law prior to the enactment of the Bankruptcy Code.[302]

3. THE SURVIVAL OF PRE-BANKRUPTCY CODE LAW

Because the Bankruptcy Code does not address the right of an undersecured creditor to receive the net rents generated from its collat-

courts are required to provide adequate protection for all other security interests. 11 U.S.C. §§ 361-364 (1988).

300. *See* David G. Carlson, *Secured Creditors And Expenses Of Bankruptcy Administration*, 70 N. CAR. L. REV. 417 (1992).

301. *Timbers*, 484 U.S. at 374.

302. *Dewsnup*, 112 S. Ct. at 779 (When Congress amended the bankruptcy laws, it did not start from scratch.).

eral postpetition, it is appropriate to examine the rights of undersecured creditors to postpetition payments before the enactment of the Bankruptcy Code. Indeed, "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."[303] This rule should be followed with particular care when construing the Bankruptcy Code.[304] Thus, unless Congress provides a clear indication of its intent to abandon past bankruptcy practices, the Bankruptcy Code should be construed in accordance with pre-Code law.[305]

The pre-Bankruptcy Code practice is clear. In *Sexton v. Dreyfus*,[306] the Supreme Court squarely addressed the entitlement of undersecured creditors to postpetition payments. In *Sexton*, the undersecured creditors requested to have cash proceeds of liquidated collateral applied to postpetition interest that accrued prior to the liquidation. The undersecured creditors would then apply the proceeds to a paydown of the principal. Thus, if postpetition interest were paid in cash, the undersecured party would have a larger unsecured deficiency claim in the bankruptcy case.[307] Justice Holmes, in delivering the unanimous opinion of the Court, stated the general rule that undersecured creditors are not entitled to postpetition interest.[308] Justice Holmes recognized, however, that an undersecured party may receive postpetition interest when the collateral produced income, but not otherwise.[309] Specifically, Justice Holmes stated: "There is no more reason for allowing the bankrupt estate to profit by the delay beyond the day of settlement than there is for letting the creditors do so. Therefore, to apply these subsequent dividends, [etc.], to subsequent interest seems just."[310]

Perhaps because the question was authoritatively settled in *Sexton*, there are almost no cases under the Bankruptcy Act addressing undersecured creditors' entitlement to postpetition interest from its collateral. Consequently, the pre-Bankruptcy Code practice would clearly entitle an undersecured creditor to receive the net rents, at least to the extent of the postpetition interest accrual. Since the postpetition interest accrual generally exceeds the monthly net rental income, pre-Bankruptcy Code practice would generally entitle an undersecured creditor to all the

303. Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 501 (1986); Kelly v. Robinson, 479 U.S. 36, 47 (1986).

304. Bonner Mall Partnership v. U.S. Bancorp Mortgage Co., 2 F.3d 899, 912 (9th Cir. 1993) (citing *Midlantic*, 474 U.S. at 501).

305. *Id.* (citing Pennsylvania Public Welfare Dep't v. Davenport, 495 U.S. 552, 563 (1990)).

306. 219 U.S. 339 (1911).

307. *Id.* at 346.

308. *Id.*

309. *Id.*

310. *Id.*

postpetition net rentals without reduction of the principal amount of the debt.[311]

4. THE BANKRUPTCY CODE LIMITS INTEREST TO THE SECURED PORTION OF AN UNDERSECURED CREDITOR'S CLAIM

Unlike the Bankruptcy Act, the Bankruptcy Code expressly addresses creditors' rights to postpetition interest. Section 502(b) of the Bankruptcy Code does not allow a claim for unmatured interest.[312] In addition, section 726(a)(5) of the Bankruptcy Code states that, in a case involving a solvent Chapter 7 estate, unsecured creditors may receive postpetition interest.[313] The unsecured portion of an undersecured claim is similar to, and treated for the most part like, an unsecured claim. Thus, the Bankruptcy Code would be violated if postpetition interest is paid on the unsecured portion of an undersecured claim. This conclusion is reinforced by the construction of sections 1111(b)(2) and 1129(b)(2)(A)(i)(II) of the Bankruptcy Code. Even though an undersecured creditor may elect to be treated as fully secured,[314] such undersecured creditor is only entitled to the present value (*i.e.*, "interest") on the "secured" portion of the claims.[315] Consequently, an undersecured creditor should receive interest only on the secured portion of its claim.

5. APPLICATION OF SECTION 552(B) EQUITABLE CONSIDERATIONS

Section 552(b) of the Bankruptcy Code, while extending protection to certain prepetition security interests, nevertheless allows a court to void such security interests "after notice and a hearing and based on the equities of the case."[316] The question, therefore, arises as to whether or when an admitted cash collateral interest in net rents should be disencumbered and made available to pay general unsecured creditors. In *Butner v. United States*,[317] the Supreme Court determined that state law should apply to a mortgagee's property rights and held that bankruptcy courts should "take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he

311. *See* Robert E. Scott, *Sharing The Risks of Bankruptcy:* Timbers, Ahlers *and Beyond*, 1989 COL. BUS. L. REV. 183, 185 n.5 (1989).

312. 11 U.S.C. § 502(b)(2) (1988).

313. 11 U.S.C. § 726(a)(5) (1988). *See also* Thompson v. Kentucky Lumber Co., 860 F.2d 674, 679 (6th Cir. 1988); Fed. Sav. & Loan Ins. Corp. v. Moneymaker, 96 B.R. 287, 290 (C.D. Cal. 1988); Boyer v. Bernstein, 90 B.R. 200, 201 (Bankr. D.S.C. 1988); Commissioner of Revenue v. Adcom, Inc., 89 B.R. 2 (D. Mass. 1988).

314. 11 U.S.C. § 1111(b)(2) (1988).

315. *Id.* § 1129(b)(2)(A)(i)(II) (1988).

316. *Id.* § 552(b) (1988).

317. 440 U.S. 48 (1979).

would have under state law if no bankruptcy had ensued."[318] At least one published decision has interpreted *Butner* to mean that:

> While the mortgagee should not have any *lesser* property interest because of the bankruptcy filing, it would equally violate the *Butner* standard to give the mortgagee *greater* rights in the rentals than it would have absent a bankruptcy filing.[319]

On the other hand, the First Circuit, in citing the legislative history of section 552(b), concluded:

> The 'equities of the case' proviso is a legislative attempt to address those instances where expenditures of the estate enhance the value of proceeds which, if not adjusted, would lead to an unjust improvement of the secured party's position. In such cases Congress intended for courts to limit the secured party's interest in the proceeds according to the equities of the case so as to avoid prejudicing the unsecured creditors.[320]

In further support of its interpretation of the "equities of the case" instruction, the *Cross Baking* court noted:

> [T]he flexible approach taken by section 552(b) permits the court to preserve valid security interests in proceeds, rents and the like, but at the same time, allows the court to protect the interests of the unsecured creditors.[321]

Thus, depending on the Court's evaluation of the equity,[322] net rents may be apportioned between the estate and the secured party as the court deems appropriate. In considering the "equities of the case," certain facts deserve attention. For example, if the undersecured creditor was entitled to increase its secured claim by the amount the net rent exceeds postpetition interest, the undersecured creditor would be receiving its full opportunity costs during the pendency of a bankruptcy proceeding. Notably, postconfirmation the unsecured creditor is entitled to interest only on its secured claim, even if the net rent exceeds the amount of interest due on the secured claim.

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318. *Id.* at 56.

319. *In re* Rancourt, 123 B.R. 143, 150 (Bankr. D. N.H. 1991) (emphasis in original).

320. New Hampshire Business Dev. Corp. v. Cross Baking Co., 818 F.2d 1027, 1033 (1st Cir. 1987) (citing S. Rep. No. 989, 95th Cong. 2d Sess. 91 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877; H.R. Rep. No. 595, 95th Cong., 1st Sess. 376-77 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6333).

321. *Cross Baking*, 818 F.2d at 1033.

322. Unlike other provisions of the Bankruptcy Code, section 552(b) expressly allows the bankruptcy court discretion to determine the "equities of the case." Defining the proper scope of a court's discretionary power has been the subject of other articles. *See, e.g.*, Honorable Henry J. Friendly, *Indiscretion About Discretion*, 31 EMORY L.J. 747 (1982).

B. *Normative Bankruptcy Principles*

1. THE CLASSIC CREDITORS' BARGAIN

In 1979, Professors Thomas Jackson and Anthony Kronman created a new law-and-economic analysis of bankruptcy.[323] Soon thereafter, Thomas Jackson developed the "creditors' bargain" model to analyze virtually every bankruptcy issue by asking the question what creditors would have agreed to if they had been asked in advance.[324] Professor Jackson argues that normative bankruptcy principles should be viewed as resolving a common-pool problem caused by a state-law system of individual creditor remedies where the debtor does not have enough assets to satisfy all of the claims.[325] Obviously a collection of assets can be more valuable when held together than they would be if they were immediately divided and distributed. Even though a debtor may be insolvent and the common pool insufficient to satisfy all claims, creditors as a group may be better off if the assets of the debtor are held together and individual creditor actions are postponed in an attempt to maximize the value of the assets to satisfy the claims.[326] Professor Jackson supposes that by imposing a collective and compulsory proceeding on creditors that supersedes state "grab law," bankruptcy laws provide a mechanism to maximize the value of the assets of the common pool.[327]

Notwithstanding the collective norm embodied by the creditors' bargain, Professors Thomas Jackson and Douglas Baird argue that bankruptcy law should not alter the prebankruptcy (state law) entitlements among creditors.[328] They believe that a secured creditor who has state law priority over unsecured creditors should always maintain that priority irrespective of the goal of maximizing the collective benefit.[329] They contend that the retention and foreclosure of collateral does not impair

323. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

324. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982) (analyzing "bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position").

325. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10-11 (1986).

326. *Id.* at 14.

327. Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 160 (1989) ("The hypothetical bargain thus yields a normative criterion, grounded on principles of autonomy, for evaluating the legitimacy of the bankruptcy process.").

328. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 103 (1984) ("[B]ankruptcy law is, and should be, concerned with the interests of those . . . who, outside of bankruptcy, have property rights . . . .").

329. *Id.* at 110.

the value-maximization goal in any meaningful manner.[330] They argue that a bankruptcy rule that avoids an entitlement which is valid against unsecured creditors under non-bankruptcy law provides a perverse incentive to general creditors to file a bankruptcy petition.[331]

Bankruptcy law, analyzed by the law-and-economics movement through the "creditors' bargain," became the subject of a highly charged debate regarding the right of an undersecured creditor to postpetition interest. The law-and-economics bankruptcy theory propounded by Professors Jackson and Baird is that promoting reorganization without requiring payment of all real costs (including postpetition interest) is economically inefficient.[332] Specifically, proponents of the "creditors' bargain" recommend that undersecured creditors should receive postpetition interest on the secured portions of their claims.[333] In *Timbers*, however, the Supreme Court rejected the law-and-economics theory of the "creditors' bargain." Moreover, as one commentator noted, the law-and-economics theory of the creditors' bargain has lost much of its appeal in recent times:

> Since *Timbers of Inwood Forest*, the creditors' bargain has been in recession. Most typically, law professors have complained about the totalizing nature of the utilitarianism implicit in the creditors' bargain. In such criticism, maximizing wealth is conceded to be a valid

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330. Douglas G. Baird, *Loss Distribution, Form Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 824-28 (1987). This argument, however, is subject to dispute. Craig H. Averch & Michael J. Collins, *Avoidance of Foreclosure Sales as Preferential Transfers: Another Serious Threat to Secured Creditors*, 24 TEX. TECH L. REV. 985, 1033 (1993). Specifically, the authors stated the following:

> There is, perhaps, at least one more way to view the role of bankruptcy law on the non-bankruptcy relationship of creditors. Specifically, there are two major characteristics governing the non-bankruptcy relationship between secured and unsecured creditors that deserves enforcement in bankruptcy. First, secured creditors are entitled to the pledged assets of the debtor to the full extent of the security interest. This entitlement, of course, does not allow the secured creditor to receive more than payment in full. Second, unsecured creditors are entitled to the value of the pledged assets in excess of what is necessary to compensate the secured creditors. Enforcing this "bargain" under state law is next to impossible. Unsecured creditors are generally not entitled to notice of a foreclosure sale. And, even if so notified, would be in the awkward position of either bidding at the foreclosure sale or losing the equity. Consequently, it is appropriate for bankruptcy policy to enforce the foregoing "bargains" between secured and unsecured creditors.

Id. (footnotes omitted).

331. JACKSON, *supra* note 325.

332. Douglas G. Baird & Thomas H. Jackson, Kovacs *and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199, 1202-03 (1984).

333. Thomas Jackson filed amicus briefs on this question. *See In re* Timbers of Inwood Forest Associates, 808 F.2d 363, 380 (Jones, J. dissenting); brief for amicus curiae, Thomas H. Jackson, pro se (October term 1987) (LDK. no. 86-1602); *In re* Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988); Crocker Nat'l Bank v. American Mariner Indus., Inc., 734 F.2d 426, 435 n.10 (9th Cir. 1984).

> goal, but the complaint is that other worthy goals are excluded in this wealth maximizing theory. [Note omitted.] Criticism exists from within the tradition of economic theory as well.[334]

Perhaps Professor Elizabeth Warren best characterized the state of bankruptcy economic modeling by stating:

> To model improved systems that operate only in perfect markets, or to ignore the high costs of collection outside the bankruptcy system when critiquing the high costs of collection in bankruptcy, is to design an airplane that carries no payload, flies only in a gravity-free environment, and consumes no fuel. The exercise may be great fun, but it yields little that is useful for those who need to build planes that fly. It is important to separate debates about bankruptcy fancy from debates about bankruptcy policy.[335]

2. TRADITIONAL BANKRUPTCY POLICIES

With the failure of the "creditors' bargain" to yield any significant, positive bankruptcy law, commentators have attempted to develop new theories to explain bankruptcy law.[336] As one commentator noted, there is no deep-rooted policy structure to bankruptcy law that can be determined from normative economic theory.[337] Because bankruptcy laws are a "historic artifact,"[338] the guiding philosophies of bankruptcy laws should be examined through the historical development of the Bankruptcy Code. Consequently, it is perhaps more appropriate to examine the simplified, traditional bankruptcy policies.

Traditionally, bankruptcy law has been considered to promote two basic policies — the "Equity Policy" and the "Reorganization Policy."[339] No doubt, the Equity Policy and Reorganization Policy are amorphous. That is, what one person believes appropriately serves a given policy, another person can probably provide counter-justifications

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334. David G. Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 456 (1992).

335. Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 386 (1993).

336. *See id.* at 336 (recognizing that "thoughtful articulation of bankruptcy policy has fallen on somewhat hard times"); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993); Lucian A. Bebchuck, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

337. David G. Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1389 (1989) (finding the search for a "deep structure" for bankruptcy to be futile).

338. *Id.*

339. The two policies are not complex. Simply put, they are the fostering of the equitable distribution of a troubled company's assets through the equal sharing of losses by creditors of equal rank, and the restructuring of a business to preserve jobs, to pay creditors, to produce a return for owners, and to obtain for the Nation the fruits of American enterprise.

MARTIN J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 1-2 (PLI 1987) [footnotes omitted].

for the opposite result under the same policy. Nonetheless, this Article attempts to provide one view of a narrow issue through the traditional Equity and Reorganization Policies as embodied in the Bankruptcy Code.

The Equity Policy underlying bankruptcy law has been described to "facilitate . . . equality of distribution among creditors of the debtor."[340] The structure of the Bankruptcy Code establishes that like creditors should be treated the same.[341] The United States Supreme Court has emphasized that "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property."[342]

Based on the fundamental principle embodied in the Equity Policy, distributions should not be made to prepetition unsecured creditors outside a plan. Otherwise, the principle of equality of distribution may be violated because until confirmation of a plan, a bankruptcy court cannot determine whether like creditors will be treated the same.[343]

The payment of interest on the unsecured portion of an undersecured claim would violate the Equity Policy for at least one reason. Unless the debtor is solvent, unsecured creditors are not going to receive interest on the account of their claims. The payment of interest on the unsecured portion of the undersecured claim, therefore, enables the undersecured creditor to receive a greater distribution on the account of the unsecured portion of its claim. There is no substantive difference between the undersecured portion of a claim held by a secured creditor and any other unsecured claim.[344] Consequently, the Equity Policy can be construed to prohibit the payment of interest on the unsecured portion of an undersecured creditor's claim.

On the other hand, the Equity Policy has always permitted the undersecured creditor the right to receive postpetition interest from the encumbered income derived from the undersecured creditor's collateral. The equitable principle that encumbered assets not be used to benefit one class of creditors at the expense of another class[345] is unaffected if

340. H.R. REP. No. 95, 95th Cong., 1st Sess., at 338-39 (1977). *See* Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941) ("[T]he theme of the Bankruptcy Act [of 1898] is equality of distribution.").

341. *See, e.g.*, H.R. Rep. 95-595, 95th Cong., 1st Sess. 177-78 at 339 (1977).

342. Begier v. Internal Revenue Serv., 110 S. Ct. 2258, 2262-63 (1990).

343. *See, e.g.*, Official Committee of Equity Security Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); 11 U.S.C. § 507 (Bankruptcy Code system of priorities).

344. Perhaps to adjust for certain perceptions of unfairness, the Bankruptcy Code allows an undersecured creditor to elect to be treated as fully secured in a chapter 11 case. 11 U.S.C. § 1111(b)(2). Even then, however, an undersecured creditor is not entitled to interest on the undersecured portion of its claim. 11 U.S.C. § 1129(b)(2)(A)(i)(II).

345. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380,

the undersecured creditor is receiving postpetition interest from unencumbered funds.

Application of the Reorganization Policy is considerably more difficult. Although it is relatively clear that opportunity-cost payments run counter to the Reorganization Policy,[346] the payment of interest from encumbered funds cannot be so clearly analyzed under the Reorganization Policy. Generally, when a debtor seeks to reorganize under federal bankruptcy law, it is typically because the debtor is unable to make interest payments to the secured creditor. Therefore, it could be argued that the imposition of the requirement to pay postpetition interest to a secured creditor may severely impede the opportunity for a debtor to reorganize. This argument, however, misses an important point. That is, the debtor is required to pay interest to the secured creditor only out of encumbered income derived from collateral that is pledged to the secured creditor. If there is no income, the Equity Policy does not require (and in fact would prohibit) the payment of interest to an undersecured creditor. Thus, it is not a significant burden on the debtor to make interest payments from encumbered income, and such a requirement does not run counter to the Reorganization Policy.

VI. CONCLUSION

The Supreme Court was not asked to, and did not, decide in *Timbers* whether an undersecured creditor was entitled to postpetition interest from an encumbered income stream. Supreme Court precedent existing prior to the enactment of the Bankruptcy Code was clear that undersecured creditors are entitled to postpetition interest from an encumbered income stream. Nothing in the Bankruptcy Code prohibits an undersecured creditor from receiving interest from encumbered income. The return-of-collateral treatment of net rents reaches the right result in many cases. However, courts should use the principles of equity referenced in section 552(b) of the Bankruptcy Code to credit net rents exceeding accrued interest against the amount of the undersecured lender's claim.

In failing to recognize that undersecured creditors *are* entitled to postpetition interest from encumbered income, the conflicting caselaw has created confusion over the application and character of postpetition net rents. By understanding that the encumbered net rents can be used to

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1387, *aff'd*, 808 F.2d 363 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988) ("In summary, the interest provisions of the Code and its predecessors, as interpreted by the Supreme Court for almost a century, are premised on the equitable principle that the unencumbered assets of a debtor's estate will not be used to benefit one class of creditors at the expense of another class.").

346. BIENENSTOCK, *supra* note 339, at 181.

pay interest on the secured portion of an undersecured creditor's claim, most, if not all, of the confusion can be eliminated.