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Adequate Protection- The Equitable Yardstick of Chapter 11

Amy S. Ashworth
University of Richmond

ADEQUATE PROTECTION—THE EQUITABLE YARDSTICK OF CHAPTER 11

I. INTRODUCTION

A debtor who files a petition for relief under the Bankruptcy Reform Act of 1978[1] (the Code) triggers the automatic stay provisions of the Code.[2] The automatic stay precludes creditors from enforcing their rights in the collateral pending further order of the Bankruptcy Court.[3] An issue which has spurred continued controversy is whether undersecured creditors who are stayed from repossessing their collateral are entitled to compensation for the delay in enforcing their rights in the collateral. It is agreed that the concept of adequate protection provides for the preservation of the value of the collateral due to its use, depreciation, or age.[4] However, the Circuit Courts of Appeals are not in accord in determining whether an undersecured creditor should be compensated for more than the collateral's depreciation. This circuit court split has to some extent been resolved by the recent United States Supreme Court opinion affirming a Fifth Circuit decision finding that an undersecured creditor is not entitled to compensation for the delay caused by the automatic stay in foreclosing on the collateral.[5]

This Comment addresses the question of adequate protection for undersecured creditors with reference to Congress's recent enactment of the Family Farmer Bankruptcy Act of 1986[6] and the policy underlying the enactment of Chapter 11 of the Code.

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1. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 1-151326 (1982).

2. 11 U.S.C. § 362(a) (1982).

3. *See id.* Section 362(a) of the Code sets out in detail the statutory restrictions placed upon secured creditors and other parties claiming an interest in property owned by a debtor filing for relief under the Code. The automatic stay prevents the creditor from commencing or continuing any administrative or judicial action, any act to obtain possession of property of the estate, to create or enforce a lien against property of the estate, or to assess or recover a claim against the debtor that arose before the commencement of the case. Sanctions may be imposed against a creditor found to have wilfully violated the automatic stay. *Id.* § 362(h) (Supp. 1982). The creditor may be liable for actual damages including costs and attorney's fees and, under some circumstances, punitive damages. *Id.*

4. *In re* Timbers of Inwood Forest Assocs., 793 F.2d 1380, 1384 (5th Cir. 1986), *aff'd on rehearing*, 808 F.2d 363 (5th Cir. 1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

5. United Savings Assoc. of Tex. v. Timbers of Inwood Forest Assoc., 108 S. Ct. 626 (1988).

6. Pub. L. No. 99-554, 100 Stat. 3088 (1986).

II. Mechanics of the Code

A. *The Automatic Stay*

The purpose of the automatic stay is two-fold. It first gives the debtor a "breathing spell" from his creditors, thus permitting the debtor to attempt a repayment or reorganization plan.[7] The stay also provides creditor protection by delineating an orderly liquidation procedure, which avoids a creditors' race for the debtor's assets.[8] The automatic stay is not permanent. The stay continues until the "property is no longer property of the estate."[9] Confirmation of a reorganization plan terminates the existence of the estate.[10] The automatic stay may otherwise continue until the case is closed, dismissed, or the discharge is granted or denied.[11]

A secured party may seek relief from the stay under section 362(d) of the Code.[12] That section authorizes the court to "grant relief from the stay . . . for cause, including the lack of adequate protection of an interest in [the] property" of the secured creditor.[13] Section 361 of the Code sets forth the basic concept of adequate protection.[14]

B. *The Statutory Guidelines for Adequate Protection*

The term "adequate protection" is not defined in section 361 or elsewhere in the Code. The Code sets forth nonexclusive guidelines for what constitutes "adequate protection," but it does not mandate the use of any

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7. H.R. Rep. No. 595, 95th Cong., 1st Sess. 338, 340, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6296-97.

8. *Id.* at 341, *reprinted in* 1978 U.S. Code Cong. & Admin. News at 6298.

9. 11 U.S.C. § 362(c)(1).

10. *Id.* § 1141(b).

11. *Id.* § 362(c)(2).

12. *Id.* § 362(d)(1). The secured party may also seek relief under section 362(d)(2). Relief will be granted under section 362(d)(2) only if: (A) the debtor does not have an equity in such property and (B) such property is not necessary to an effective reorganization. *Id.* § 362(d)(2).

If the debtor shows that the property is required to effectively reorganize, an undersecured creditor is limited to seeking relief from the stay under section 362(d)(1). When a creditor's protection is deemed inadequate, the court may prohibit or condition a debtor's use, sale or lease of property as is necessary to provide adequate protection to the creditor having an interest in such property. *Id.* § 363(e).

13. *Id.* § 362(d).

14. *Id.* § 361. The concept of adequate protection applies primarily to Chapter 11 business reorganizations, where a debtor is left in possession of its property and allowed to operate and use its assets to carry out its business. If the creditor's interest in such property is adversely affected by the debtor's use (section 362), the debtor's sale or lease of property (section 363), or the debtor incurring debt (section 364) then adequate protection may be required. Ackerly, *Real Estate Interest*, Va. Inst. on Bankr. Reorganization, II -10 (1986).

one of the three methods that it describes.[15] The three examples of adequate protection listed under section 361 include:

> (1) requiring . . . [a cash payment or] periodic cash payments to [the secured creditor], to the extent that the stay . . . results in a decrease in the value of [the creditor's] interest in such property;
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> (2) providing . . . an additional or replacement lien to the extent [the] stay . . . results in a decrease in the value of [the secured creditor's] interest in such property; or
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> (3) granting such other relief . . . as will result in the realization by [the secured creditor] of the indubitable equivalent of [its] interest in such property.[16]

The controversy in interpreting section 361 revolves around determining what interest in the collateral is to be adequately protected, and what is required to adequately protect that interest.[17] Rules of statutory interpretation require that courts construe the statute's language with the purpose of effecting the intent of Congress when it enacted the legislation.[18] However, an examination of the legislative history of the automatic stay and adequate protection provisions of the Code breeds even further controversy because the language of the provisions supports contrasting interpretations.[19]

C. *The Language and Legislative History of Section 361*

The 1973 Bankruptcy Commission proposal described adequate protection as protection against the depreciation of the collateral's value during the period in which the debtor is using that collateral.[20] It is unclear whether Congress intended adequate protection to mean more than compensation for the economic depreciation of the creditor's collateral when it included the concept in the 1978 Code. Section 361(3), as enacted, is the product of compromise during the House-Senate conference.[21] The

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15. *See* 11 U.S.C. § 361.

16. *Id.*

17. *Compare In re* American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984) (holding that undersecured creditor is entitled to compensation for the delay in enforcing its rights in the collateral, and compensation may be in the form of postpetition interest payments) *with In re* Timbers of Inwood Forest Assocs., 808 F.2d 363 (5th Cir. 1987) (en banc) (holding that sections 362(d)(1) and 361 of the Code do not require post-petition payments for interest or lost opportunity cost to an undersecured creditor), *aff'd*, 108 S. Ct. 626 (1988).

18. Badaracco v. Commissioner, 464 U.S. 386, 398 (1984).

19. *See infra* notes 23-31 and accompanying text.

20. H.R. Doc. No. 137, 93d Cong., 1st Sess. 237 (1973).

21. *American Mariner*, 734 F.2d at 432 (citing 124 Cong. Rec. H11092 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards)). The Senate proposed a more restrictive version of adequate protection than did the House. The Senate specified two ways of providing adequate protection. Those two methods were: (1) periodic cash payments to compensate for

present section 361(3) provides that a secured creditor may be granted the "indubitable equivalent" of his interest in the collateral.[22]

Proponents of the theory that an undersecured creditor should be compensated for the loss of income it would have received if it had sold the collateral and invested the proceeds,[23] rely on the "indubitable equivalent" language of section 361(3) to support their theory.[24] The lost opportunity cost proponents contend that the source of the "indubitable equivalent" language in section 361(3) is *In re Murel Holding Corp.*,[25] a case holding under section 77B of the Bankruptcy Act of 1898. In *Murel*, Judge Hand concluded that the creditor's right to get its money or property may be denied under a reorganization plan only if the debtor provides " 'a substitute of the most indubitable equivalence.' "[26]

The "indubitable equivalent" requirement also appears in section 1129(b), the so-called "cram down" provision of the Code.[27] Under section

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depreciation and (2) " 'an additional or replacement lien on other property of the debtor to the extent of the decrease in value or actual consumption of the property involved.' " *Timbers*, 793 F.2d at 1398 (citing S. REP. No. 989, 95th Cong., 2d Sess. 54, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5840.

The House proposal provided two additional examples of adequate protection. These included "an administrative expense priority to the protected entity to the extent of his loss" and "such other relief as will result in the realization by the protected entity of the value of its interest in the property involved." *Timbers*, 793 F.2d at 1397 H.R. REP. No. 595, 95th Cong., 1st Sess. 338, (citing 340, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6296). The conferees did not adopt the administrative expense priority and added the requirement of "indubitable equivalence," which is included in the current section 361(3). *American Mariner*, 734 F.2d at 432.

22. 11 U.S.C. § 361(3) (1982).

23. *In re* Sun Valley Ranchers, Inc., 43 Bankr. 641 (D. Idaho 1984) explains the basic concept behind the lost opportunity cost theory. Lost opportunity cost compensation "requires the periodic payment of a sum of cash equal to the interest that the undercollateralized secured creditor might earn on an amount of money equal to the value of the collateral securing the debt." *H.R. Conf. Rep. No.* 958, 99th Cong., 1st Sess. 49, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250.

24. *See, e.g.*, *American Mariner*, 734 F.2d at 432-33.

25. 75 F.2d 941 (2d Cir. 1935).

26. *Id.* at 942. In *Murel*, the court rejected a plan in which the debtor offered to pay the creditor over a ten year period, at 5 ½ percent interest per year, and without any amortization of prinicipal. Judge Hand explained that:

> '[A]dequate protection' must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

Id.

27. 11 U.S.C. § 1129(b)(2)(A)(iii). Section 1129(b)(2) provides for confirmation of a reorganization plan over the objections of a class of dissenting creditors. If two-thirds of each class of creditors do not consent to the plan, then the plan must provide adequate protec-

1129(b), a reorganization plan will not be confirmed over the objections of a class of secured creditors unless present value compensation is included.[28] The holding of *Murel* and the interpretation of "indubitable equivalent" under section 1129(b) may not be accurately extended to section 361(3).[29] *Murel* involved the consideration of the cram down provisions under the Bankruptcy Act of 1898 which required adequate protection for the full value of the creditor's claim.[30] *Murel* is good precedent for adequate protection in the context of plan confirmation, but it may not be considered as such in the context of section 361.[31]

D. *Section 361: Its Interaction with Other Code Provisions*

A review of the legislative history of section 361 does not clarify the provision's language, nor the intent with which Congress enacted section 361. Therefore, it is necessary to consider the adequate protection concept of section 361 in light of other provisions in the Code.[32] An effort has been made to discern Congress's intent in including the concept of adequate protection in section 361 by analyzing sections 502 and 506 of the Code.

In the case of a secured creditor, the allowable amount of the "secured claim" is limited by the value of the collateral.[33] The creditor has a secured claim to the extent of the value of its collateral, and it has an un-

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tion for the realization by them of the full value of their interest, claims or liens. *See id.* § 361.

28. *Id.* § 1129(b)(2)(A)(iii).

29. The secured creditor's right to receive the present value of his collateral under a reorganization plan is not sanctioned by the "indubitable equivalent" language in section 1129(b)(2)(A)(iii); rather, it stems from the provision guaranteeing payments "as of the effective date of the plan" that are equal to the value of the collateral. United Savings Assoc. of Tex. v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626, 633 (1988). The secured creditor only receives payment of the prinicpal of his collateral upon confirmation of the reorganization, and not immediately, "as of the date of relief." *Id. See* Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1073 (1985) (explaining that the purpose for which valuation of the collateral is made is important in determining what constitutes adequate protection.).

30. *Id.*

31. *See* 11 U.S.C. § 361(3); *see also* General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987 (D. Utah 1982). The court, in determining whether an undersecured creditor was entitled to lost opportunity cost for delay in foreclosure, concluded that the indubitable equivalent language of section 361(3) is "fact-specific [to *Murel*], not a categorical imperative." *Id.* at 992 n.4.

32. *See In re* All-Way Services, Inc., 73 Bankr. 556, 574 (E.D. Wis. 1987) (citing Kelly v. Robinson, 107 S. Ct. 353, 358 (1986) ("In expounding a statute, we must . . . look to the provisions of the whole law, and to its object and policy.").

33. 11 U.S.C. § 506(a) (1982). "Allowed secured claim" is defined in § 506(a). If the creditor is oversecured, the allowed secured claim is the amount of the debt. If he is undersecured, it is the value of the collateral.

secured claim for the balance of the claim.[34] Thus, the level of adequate protection to which the creditor is entitled is based upon the "value" of the creditor's interest in the property.[35] The Code provides no standards for valuation even though valuation of the creditor's interest is a crucial assessment for obtaining adequate protection or relief from the automatic stay.[36]

Collateral may have a "going concern value" if a reorganization is intended or a "liquidation value" if foreclosure is planned.[37] Congress, in enacting the Code, realized that there is wide latitude between the forced sale liquidation value and the going concern value, yet it nonetheless failed to set forth the method or timing of valuation.[38] Although courts are left to determine value on a case-by-case basis, it is clear under section 506(a) that valuation varies according to the purpose of the valuation and the proposed use of the collateral.[39] For that reason, granting lost opportunity cost compensation to undersecured creditors is inconsistent with the goal of section 506(a).[40]

Section § 502(b)(2) expressly disallows postpetition interest. The only exception to that prohibition is found in section 506(b), which allows oversecured creditors to accrue interest to the extent of the value of their collateral.[41] It provides that if a creditor, at the initiation of a Chapter 11

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34. *Id.*

35. 2 QUITTNER & KRUGER, BANKRUPTCY REORGANIZATION 1986: THE SUBSTANTIVE PROCEDURAL BASICS (Practising Law Inst. 161 (1986)); *see* 11 U.S.C. § 506(a).

36. *See* S. REP. No. 989, 95th Cong., 2d Sess. 54 *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5840.

37. Fortgang & Mayer, *supra* note 29, at 1063.

38. The House Report stated that:

> It is expected that the courts will apply the concept [of adequate protection] in light of the facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result . . . . The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.

In re Ahlers, 794 F.2d 388, 394 (8th Cir. 1986) (quoting H.R. REP. No. 595, 95th Cong., 1st Sess. 338, 339, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6295).

39. Under § 506(a), the determination of value for the purpose of adequate protection does not also indicate the collateral's value for purpose of the Code's "cram-down" provisions used in plan confirmation. LUREY, LENDING TRANSACTIONS AND THE BANKRUPTCY ACT 636 (Practising Law Inst. 1986).

40. United Savings Assoc. of Tex. v. Timbers of Inwood Forest, 108 S. Ct. 626, 630 (1988) concluded that "the 'interest in property' protected by § 362(d)(1) does not include a secured party's right to immediate foreclosure." The Court stated that the meaning of Section 362(d)(1)'s "interest in property" phrase should be afforded the same construction as similar terminology in section 506(a), where the creditor's interest in property is interpreted to mean "the value of the collateral." *Id.*

41. 11 U.S.C. § 506(b). Section 506(b) provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the

proceeding, has a claim secured by collateral in excess of the value of the debt, the creditor is entitled to postpetition interest on that collateral.[42] An allowed secured claim includes any reasonable fees (including attorney's fees), costs, or charges provided for in the agreement under which the claim arose.[43] The Code does not sanction postpetition interest payments for the undersecured creditor. To allow such compensation contravenes the express prohibition found in section 502(b)(2).[44]

III. Case Interpretation of Adequate Protection

Court decisions have not provided a uniform interpretation of the adequate protection concept because the parameters of adequate protection have not been defined. The circuit courts are split regarding what constitutes adequate protection and how that protection is sufficiently given.[45] Some courts hold that the preservation of the value of the collateral is the focus of adequate protection,[46] while others expand the adequate protection concept by requiring that it include compensation for undersecured creditors for the delay in enforcing their rights against the collateral.[47]

A. *The Theory of Lost Opportunity Cost Compensation*

The first case to require that opportunity cost compensation be included as a part of the adequate protection provisions of the Code was *In re Anchorage Boat Sales, Inc.*[48] The court interpreted section 361 to mean that the debtor must propose adequate protection under subsections (1) or (2) or "meet the standards set forth in section 361(3)."[49] *In re*

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amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose.

42. *Id*; *see In re* Best Repair Co., 789 F.2d 1080 (4th Cir. 1986); 3 Collier on Bankruptcy § 506.05 (15th ed. 1988).

43. 11 U.S.C. § 506(b).

44. If Congress had intended to give undersecured creditors interest on the value of their collateral, such intention would have been explicitly set forth in section 506(b). *Timbers*, 108 S. Ct. 626, 631.

45. The Fourth and Ninth Circuits are among those courts that have held that adequate protection requires the debtor to compensate the undersecured creditor for lost opportunity costs with respect to the creditor's investment in the collateral. *See, e.g.*, Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); *In re* American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984). The leading case holding that undersecured creditors should only be compensated for a reduction in value caused by the debtor's continued use of collateral is *In re* Timbers of Inwood Forest Assocs., 808 F.2d 363 (5th Cir. 1987).

46. *See, e.g., In re* Shriver, 33 Bankr. 176 (N.D. Ohio 1983); *In re* Pine Lake Village Apt. Co., 16 Bankr. 750 (S.D.N.Y. 1982); *In re* South Village, Inc., 25 Bankr. 987 (D. Utah 1982).

47. *See, e.g., American Mariner*, 734 F.2d 426; *In re* Virginia Foundry Co., Inc., 9 Bankr. 493 (W.D. Va. 1981); *In re* Anchorage Boat Sales, 4 Bankr. 635 (E.D.N.Y. 1980).

48. 4 Bankr. 635 (E.D.N.Y. 1980).

49. *Id.* at 643. Although the court stated that the undersecured creditor was entitled to

Virginia Foundry Co.,[50] the first district court case to consider the issue, emphasized that compensation for lost opportunity cost is necessary to ensure that the creditor is given "essentially what he bargained for."[51] In *Virginia Foundry*, the creditor bank had been deprived of a valuable right because it could not foreclose immediately upon its demand note and have the use of its money at a current or market interest rate.[52] In order to protect the economic value of the bank's right to receive payment on demand, the court required the bank to be paid for lost opportunity cost.[53]

In re American Mariner Industries, Inc.,[54] has had the most significant impact in developing the theory of lost opportunity cost compensation. American Mariner received a loan that was secured by a perfected security interest in " 'basically all of the American Mariner's assets.' "[55] When American Mariner filed a petition for reorganization under Chapter 11, its debt to the creditor amounted to $370,000, including accrued interest.[56] That debt was secured by collateral worth $110,000.[57] The creditor sought adequate protection in the form of monthly interest payments equal to the return it would have realized had it liquidated the collateral and invested the proceeds at the market rate.[58] The United States Court of Appeals for the Ninth Circuit reversed the bankruptcy panel decision and held that the creditor was entitled to adequate protection for the present value of its interest in the collateral.[59]

The *American Mariner* court interpreted the legislative history of section 361 to support its holding that the secured creditor's interest in the

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relief under section 362(d)(1), the creditor was eventually granted relief under section 362(d)(2) when it was evident that there was no possibility of an effective reorganization.

50. 9 Bankr. 493 (W.D. Va. 1981).

51. *Id.* at 498 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 338, 339, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6295).

52. *Id.* This "valuable right" stems from state law which allows a secured party to repossess and sell the property securing its claim if the debtor defaults on the underlying obligation. *See, e.g.*, VA. CODE ANN. § 8.01-511 (Repl. Vol. 1984). This contractual right sanctioned by state law is temporarily suspended by the Code's imposition of the automatic stay.

53. *Virginia Foundry*, 9 Bankr. at 498.

54. 734 F.2d 426 (9th Cir. 1984).

55. *Id.* at 427.

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.* at 435. In *American Mariner*, this compensation took the form of monthly interest payments at the market rate on the liquidation value of the collateral. Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436, 1441 (4th Cir. 1985) defined "market rate" as "the prevailing rate for the same type of loan at issue, and not the lowest (or highest) market rate for various types of other loans." *Grundy* agreed with *American Mariner* that there should be maximum flexibility in fixing interest so that the creditor is given the value of his bargained-for rights. If the contract rate of interest is lower than the *current* market rate, then the interest payments may be based on the contract rate.

collateral should be protected.[60] The court asserted that the Congressional goal of giving the creditor the benefit of its bargain supported its holding.[61] The decision also relied on the "indubitable equivalent" language used in section 1129(b)(2)(A)(iii) and in *Murel* as evidence of Congress' intent to provide lost opportunity costs under section 361.[62]

B. *Case Authority Refuting the Lost Opportunity Cost Theory*

The line of cases holding that the creditor is entitled only to compensation for the depreciation in value of the collateral began with *In re Pine Lake Village Apartment Co.*[63] The court noted that the methods of adequate protection listed in section 361 are "not exclusive of other means"[64] and rejected the argument that adequate protection must constitute the "indubitable equivalent" of the creditor's interest in the property.[65] The fact that section 506(b) entitles only oversecured parties to postpetition interest supported the court's conclusion.[66] A creditor's proper remedy for undue delay in enforcing its rights is to file a motion to dismiss the Chapter 11 case or convert it to a Chapter 7 case.[67]

In re South Village Inc.[68] elaborated on a creditor's remedies for delay provided under the Code. The Code limits the time in which the debtor has the exclusive right to file a plan of reorganization and permits confirmation of a Chapter 11 plan which provides for liquidation of the debtor's assets.[69] If the debtor has not filed a plan within 120 days after it requests relief under Chapter 11, then any party in interest (including a creditor) may file a plan.[70]

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60. *American Mariner*, 734 F.2d 426, 430 (9th Cir. 1984).

61. *Id.*

> Secured Creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section [§ 361] recognizes the availability of alternate means of protecting a secured creditor's interest.

Id. at 431 (quoting H.R. REP. No. 595, 95th Cong., 1st Sess. 338, 339, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6295).

62. *Id.* at 433.

63. 19 Bankr. 819 (S.D.N.Y. 1982). The majority of lower courts that considered the lost opportunity cost issue prior to *American Mariner* held that a secured creditor is entitled only to protection against a decline in the value of its collateral through depreciation. *See, e.g., In re* Sun Valley Ranches, Inc., 38 Bankr. 595, 598 (D. Idaho 1984); *In re* Saypol, 31 Bankr. 796, 800 (S.D.N.Y. 1983); *In re* Alyucan Interstate Corp., 12 Bankr. 803, 808 (D. Utah 1981).

64. H.R. REP. No. 595, 95th Cong., 1st Sess. 338, 344, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6300.

65. *Pine Lake Village*, 19 Bankr. at 824, 827.

66. *Id.* at 828.

67. *Id.*

68. 25 Bankr. 987, 1000-02 (D. Utah 1982).

69. *See* 11 U.S.C. § 1121(b)(1982).

70. *Id.* § 1121(c).

In juxtaposition to *American Mariner*, the Court of Appeals for the Fifth Circuit has recently denied the payment of lost opportunity costs to undersecured creditors. In support of its decision in *In re Timbers of Inwood Forest Associates*,[71] the court reviewed the legislative history of adequate protection, including the enactment of the Family Farmer Bankruptcy Act of 1986.[72] The court stated that the Congressional overruling of *American Mariner* did not constitute a Congressional adoption of it in Chapter 11.[73] *Timbers* viewed section 1205 as a Congressional response to the urgent problem of farm bankruptcies and as legislation limited to the scope of farm reorganizations.[74]

Timbers emphasized that Congress has provided a wide range of remedies for the secured creditors of a debtor who cannot feasibly reorganize or who unreasonably delays in its attempt at reorganization.[75] The key to achieving an equilibrium between the debtor's right to reorganize and the creditor's need for protection is "early and stringent judicial management of the case."[76] At the outset of a Chapter 11 filing the bankruptcy judge must assess whether the goal of reorganization can be efficiently met.[77] Ideally, Chapter 11 should benefit creditors by preserving going-concern values and avoiding liquidation of the collateral at forced-sale prices.[78] If going-concern values are maintained, then all creditors benefit from the reorganization. In the event that reorganization is not pragmatic, it is the responsibility of the bankruptcy court to effectuate the remedies provided by the Code.[79]

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71. 808 F.2d 363 (5th Cir. 1987) (en banc), *aff'd*, 108 S. Ct. 626 (1988).

72. 11 U.S.C. §§ 1201-1231 (Supp. IV 1986).

73. *Timbers*, 808 F.2d at 369.

74. *Id.* Timbers states that "the 1986 enactment [of Chapter 12] was farm bankruptcy legislation, not a comprehensive overhaul of the provisions of the Bankruptcy Code." *Id.* at 370.

75. *Id.* at 372.

76. *Id.* at 373.

77. *Id.* Whether the debtor is seriously pursuing reorganization is a threshold issue which is determined by evaluating whether the debtor has exerted a "tangible effort" at reorganization. *See, e.g., In re* Mikole Developers, Inc., 14 Bankr. 524 (E.D. Pa. 1981). The plan must also be a feasible one. *See In re* Clark Technical Assocs., 9 Bankr. 739 (D. Conn. 1981) (holding that an attempt to revive a factory business which is based on a prospective market improvement and no available financing is insufficient to retain the stay). 11 U.S.C. § 1112(b)(1) permits dismissal of a bankruptcy case upon proof of "absence of a reasonable likelihood of rehabilitation" and "continuing loss" to the estate.

78. *Timbers*, 808 F.2d at 373.

79. *Id.* at 372.

C. *The U.S. Supreme Court's Affirmation of* Timbers

The U.S. Supreme Court recently affirmed the Fifth Circuit's decision in *In re Timbers of Inwood Forest Associates*,[80] denying an undersecured creditor the right to lost opportunity cost compensation. The Court relied heavily on statutory analysis to determine that the *Timbers* creditor was not entitled to compensation for the delay it experienced in foreclosing on its collateral.

Statutory interpretation cannot support the lost opportunity cost compensation theory because it impliedly contravenes section 506(b), which denies an undersecured creditor postpetition interest on its claims.[81] The Court analogized the "interest in property" phrase found in section 362(d)(1) to a similar phrase in section 506(a). The result of such an analogy is that an undersecured creditor's "interest in property" does not encompass the right to immediate possession of its property upon the debtor's default.[82]

Under section 552(b), an undersecured creditor who possesses a perfected security interest in postpetition rents or profits from collateral may use such "proceeds" to satisfy its claim, giving the creditor holding the perfected security interest priority over unsecured claims.[83] If an undersecured creditor were granted compensation for the "use value" of its collateral under section 362, section 552(b) would be nullified, since an undersecured creditor could realize the "use value" of its collateral without holding a perfected security interest in that collateral.[84] Furthermore, should section 362(d)(1) be interpreted to include lost opportunity cost compensation, then the construction given section 362(d)(2) would be manipulated to the point of "nonsense."[85]

The Supreme Court also cited the inapplicability of the "indubitable equivalent" language found in *In re Murel Holding Corp.*[86] and in section 1129 to an analysis of section 361(3).[87] The context in which the indubitable equivalent language is used is important because it is ultimately based on a distinction between the reorganized debtor and the debtor in process of reorganization.[88]

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80. 108 S. Ct. 626 (1988).

81. *Id.* at 631.

82. *Id.* at 630; *see supra* note 41.

83. 11 U.S.C. § 552(b) (1982); *see also Timbers*, 108 S. Ct. at 631.

84. *Timbers*, 108 S. Ct. at 632.

85. *Id.* If Section 362(d)(1) considered an undersecured creditor's inability to immediately foreclose as always justifying relief from the automatic stay, then section 362(d)(2) is a "practical nullity." *Id.* Under such circumstances, an undersecured creditor would only seek relief under section 362(d)(2) if "its collateral was not depreciating . . . and it was receiving market rate interest on its collateral, but nonetheless wanted to foreclose." *Id.*

86. 75 F.2d 941 (2d Cir. 1935).

87. *Id.* at 633-34.

88. "The organized debtor is supposed to stand on his own two feet. The debtor in process of reorganization, by contrast, is given many temporary protections against the normal operation of the law." *Id.* at 634.

In affirming the Fifth Circuit's decision, the Supreme Court gave no merit to the creditor's reliance on the legislative history of sections 361 and 362(d)(1) to contend that lost opportunity cost compensation is valid recompense for delay imposed by the automatic stay.[89] The Court was straightforward, insisting that the "plain textual indication" in the Code is to *not* grant undersecured creditors lost opportunity cost compensation.[90]

D. *The Equilibrium: In re Briggs*

Tempering the extremes of the two theories of adequate protection espoused in *In re American Mariner Industries*[91] and *In re Timbers of Inwood Forest Associates*[92] is *In re Briggs Transp. Co.*[93] *Briggs* rejected the notion that lost opportunity cost is an essential and inflexible element of adequate protection as articulated in *American Mariner*.[94] Interest payments, however, may be permitted within the discretion of the bankruptcy court.[95] *Briggs* insisted that courts must approach the question of adequate protection on a case-by-case basis in order to best determine which interests of the creditor should be protected during the pendency of the stay.[96] The court accepted the debtor's contention that adequate protection focuses on the value of the collateral itself and not the value of the creditor's whole bargain.[97]

Among the factors to be considered in determining the right to opportunity cost payments are: (1) the quality of the collateral; (2) the duration of the stay; (3) whether the value of the collateral is appreciating, depre-

89. *Id.* The legislative history of sections 361 and 362(d)(1) contains "not a hint" that undersecured creditors should be granted post petition interest. Furthermore, Chapter 11 of the Bankruptcy Code does not sanction an absolute right to foreclose. *Id.*

90. *Id.* at 634-35. A drastic change in the Code would not be made without supporting provisions in the text or explanatory comments in the legislative history. *Id.*

91. 734 F.2d 426 (9th Cir. 1984).

92. 108 S. Ct. 626 (1988).

93. 780 F.2d 1339 (8th Cir. 1985).

94. *Id.* at 1350-51. *American Mariner* had held that lost opportunity cost compensation to undersecured creditors was required as a matter of law. *American Mariner*, 734 F.2d at 435.

95. *Briggs*, 780 F.2d at 1348-51.

96. *Id.* at 1349.

97. *Id.* at 1342. The court supported this conclusion by explaining that secured creditors do not have a constitutional claim for more than is required to preserve the value of their collateral. *Id.* The temporary delay in foreclosure imposed by the stay is not an unlawful taking under the Fifth Amendment. Wright v. Union Central Life Ins. Co., 311 U.S. 273, 278 (1940).

ciating or stable; (4) whether taxes and other payments designed to keep the collateral free of statutory liens are being paid; and (5) the prospects for reorganization.[98] In sum, *Briggs* requires that adequate protection always compensate for depreciation, but compensate for lost opportunity costs only when reorganization becomes unlikely.

IV. The Impact of the Family Farmer Bankruptcy Act of 1986 on the Adequate Protection Analysis

The most recent Congressional "statement" with respect to the adequate protection provisions of the Code is in the context of the Family Bankruptcy Act of 1986.[99] The Act states that the adequate protection provisions of section 361 do not apply to Chapter 12 family farmer reorganization cases.[100] Section 1205 gives separate examples of adequate protection for those filing under Chapter 12.[101] Although it restates much of section 361, section 1205 adds rental value as a form of adequate protection for Chapter 12 cases.[102] Therefore, the debtor whose collateral is farmland may provide adequate protection by paying "the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property."[103]

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98. *Briggs*, 780 F.2d at 1349.

99. 11 U.S.C. §§ 1201-1231 (Supp. IV 1986).

100. *Id.* at § 1205(a).

101. *Id.* Section 1205 provides that:

> (a) Section 361 does not apply in a case under this chapter.
>
> (b) In a case under this chapter, when adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
>
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease, under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;
>
> (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;
>
> (3) paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property; or
>
> (4) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will adequately protect the value of property securing a claim or of such entity's ownership interest in the property.

102. *Id.* at § 1205(3).

103. *Id.* For a discussion of the possible economic inefficiencies which could result from the rental value provision under § 1205(3), see Herbert, *Once More Unto the Breach Dear, Friends: The 1986 Reforms of the Reformed Bankruptcy Reform Act*, 16 Cap. U.L. Rev. 325, 345-46 (1987).

Most significant for the purpose of this analysis is the fact that section 1205(b) makes clear that an undersecured creditor may not receive compensation for a delay in enforcing its rights in the property during a Chapter 12 proceeding.[104] Section 1205 eliminates the "indubitable equivalent" language of section 361(3) and requires that the value of the collateral and not the value of the creditor's "interest" in that collateral be protected.[105] A farmer must provide protection of the creditor's "ownership interest in the property,"[106] the "value of property securing a claim,"[107] or, if the collateral is farmland, the "reasonable rent customary in the community."[108]

In light of the legislative history of Chapter 12, section 1205(b) cannot be interpreted as allowing for lost opportunity costs.[109] The conference report states that there is "a separate test for adequate protection in Chapter 12 cases . . . [that] eliminates the need of the family farmer to pay lost opportunity costs." The rationale underlying the expressed prohibition of lost opportunity costs is that farmland values have dropped dramatically and that mandating the payment of lost opportunity costs could seriously hinder farm reorganization.[110]

Section 1205 makes no distinction between oversecured and undersecured creditors.[111] While it is recognized under section 502(b)(2) that oversecured creditors may receive postpetition interest in a Chapter 11 proceeding,[112] there is no such provision in Chapter 12. A matter for debate has been whether Congress, in enacting section 1205, intended to endorse the *American Mariner* rule in Chapter 11 cases. Appropriately, *In re Timbers of Inwood Forest Associates*,[113] resolved this question in the negative. The impact of mandatory lost opportunity cost payments is such that they cannot be considered a matter of law based on inferences drawn from Chapter 12. Congress has repeatedly emphasized the flexibility with which the concept of adequate protection must be applied.[114] Section 1205 is not a wholesale approval or prohibition of the payment of lost opportunity costs under Chapter 11. In limiting the parameters of adequate protection under Chapter 12, Congress responded to an urgent situation where the indiscriminate application of lost opportunity cost

104. 2 COLLIER ON BANKRUPTCY ¶ 362.07 (15th ed. 1988).
105. 11 U.S.C. § 1205(b)(1) - (3); *see In re* Rennich, 70 Bankr. 69, 72 (D.S.D. 1987).
106. *See* 11 U.S.C. § 1205(b)(1)-(3).
107. *Id.* § 1205(b)(1)-(2).
108. *Id.* § 1205(b)(3).
109. CONF. REP. No. 958, 99th Cong., 1st Sess. 49, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 5246, 5250.
110. *Id.*
111. *See* 11 U.S.C. § 1205.
112. *See id.* § 506(b)(2); *see In re* Best Repair Co., 789 F.2d 1080 (4th Cir. 1986).
113. *See supra* notes 72-74 and accompanying text.
114. *See supra* note 39.

compensation could be devastating. The important point to be gleaned from Congress's statement in the Act is that adequate protection cannot be based on an unyielding rule. The analysis scheme set forth in *In re Briggs*[115] is necessary to effect a fair remedy to the inherently complex questions faced in each bankruptcy case.

V. ADEQUATE PROTECTION: THE NEED FOR CONSISTENCY WITHOUT RIGIDITY

Although some courts have held that adequate protection is a matter of law, the purpose of adequate protection will only be served if it is recognized as a question of fact.[116] The debtors must be permitted "maximum flexibility in structuring a proposal for adequate protection."[117] Courts have taken a more active role in fashioning protection for creditors,[118] rather than simply modifying a debtor's adequate protection proposal.[119]

The "maximum flexibility" which Congress intended to grant the debtor derives from the varying needs and circumstances of the parties, depending on the characteristics of the loan transaction and the established relationship between the creditor and the debtor.[120] An accurate assessment of adequate protection hinges largely upon the type of collateral sought to be protected. The rapid depreciation of equipment may be sufficiently countered by periodic cash payments to the creditor.[121] Real estate, on the other hand, is usually less subject to rapid depreciation through use or aging. A junior lienholder in a real estate case is generally most concerned about losing his recoverable value during a bankruptcy case.[122] In floating collateral cases,[123] the greatest threat to a creditor's recoverable value is dissipation or consumption of the property, such as

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115. *See supra* note 85 and accompanying text.

116. *In re* Briggs Transp. Co., 780 F.2d 1339, 1348 (8th Cir. 1985); *In re* Martin, 761 F.2d 472, 474 (8th Cir. 1985); *In re* George Ruggiere Chrysler-Plymouth Inc., 727 F.2d 1017, 1019 (11th Cir. 1984).

117. *In re* American Mariner Indus., Inc., 734 F.2d 426, 435 (9th Cir. 1984).

118. *See In re* Alyucan Interstate Corp., 12 Bankr. 803 (D. Utah 1981).

119. *See In re* Irving A. Horns Farms, Inc., 42 Bankr. 832, 838 (D. Iowa 1984) (stating that it is not the court's duty to fashion adequate protection, but merely to modify that which the debtor has proposed).

120. For example, in *In re* Wheeler, 12 Bankr. 908 (D. Mass. 1981), the court's willingness to retain a stay was linked in part to the debtor's prior good record of making payments on the loan, coupled with a willingness to continue full payment after filing for bankruptcy.

121. *See* Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1, 19 (1983).

122. *See id.* at 41.

123. "Floating collateral," also referred to as "floating security," would include inventory, accounts and other property expected to be sold or otherwise dissipated over a relatively brief period of time. BALLENTINE'S LAW DICTIONARY 481 (3d ed. 1969).

the sale of an item of inventory or the collection of the account.[124] In such cases, cash payments alone may not be sufficient to provide the creditor with protection.

A standard rule of adequate protection is not possible because the type of collateral which is the subject of the loan transaction varies from case to case. In *American Mariner*, the creditor's interest in floating collateral put it at greater risk of having its interest extinguished. It must be noted, however, that during a creditor's negotiation of a loan, the potential creditor knows the possibility of debtor default.[125] The interest rate charged to the debtor is evidence of that knowledge. An undersecured creditor has set its own terms; so, if it had initially bargained for sufficient collateral, then the debt would be protected by the value of that collateral.[126] Furthermore, the detailed rules of Article 9 of the Uniform Commercial Code provide more than sufficient guidelines for the secured creditor. The secured creditor must receive notification if other parties attach the debtor's property.[127] The creditor is then solely in control of deciding whether to suspend, continue, or extend its existing bargain with the debtor.

VI. The Ultimate Question: Debtor Rehabilitation Versus Creditor Maximization

The issue of whether adequate protection encompasses lost opportunity cost compensation is one of policy and economics. Bankruptcy law is designed to distribute the costs of default among those at risk, and to provide an orderly system for the division of the debtor's estate.[128] In *Bankruptcy Policy*, Elizabeth Warren adeptly describes the primary conflict in bankruptcy as a creditor-versus-creditor rather than a creditor-versus-debtor scenario.[129] Blanket compensation for lost opportunity costs merely acts to prevent creditors from sharing in the debtor's "asset pool." Furthermore, the realization of the creditor's interest in the present value of the collateral imposes a greater strain on an already financially insolvent party. Requiring opportunity cost payments as a matter of law runs counter to Chapter 11's reorganization policy. The goal of Chapter 11 is to "relieve the debtor of its pre-petition debts, to free cash

124. The creditor's lien typically transfers to proceeds of these dispositions of the collateral, but if proceeds are cash, may be commingled, and the creditor's interest is then subject to extinction. *See* U.C.C. § 9-306 (1978).

125. Note, *Adequate Protection of Time Value for Undersecured Creditors During the Automatic Stay in Bankruptcy: Where Are We After* American Mariner? 2 Bankr. Devs. J. 341, 359 (1985).

126. *Id.*

127. *See* U.C.C. § 9-312 (1978).

128. Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 790 (1987).

129. *Id.* at 785.

flow to meet current operating expenses, and ultimately to permit the debtor to 'restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.' "[130] In general, the lost opportunity cost theory thwarts that goal.

The symbiotic relationship that exists between a debtor and its creditors makes the balancing of each party's interests even more complex and crucial to the economic health of all involved. The scope of a bankruptcy's impact is not limited to the creditor and debtor. A host of other parties are involved, such as employees, customers, and suppliers. A bankruptcy also affects property values and state and local tax bases.[131] The interests that reorganization promotes benefit the nation's employment, gross national product, and American business as a whole.[132] All of these factors must be considered when evaluating whether a creditor should be paid lost opportunity costs.

Supporters of the lost opportunity cost theory maintain that collectivism is the policy goal underlying the Bankruptcy Code.[133] Collectivism is best served, however, by allowing both unsecured and secured creditors to share in the assets of the bankrupt's estate. The dissent in *In re Timbers of Inwood Forest Associates*,[134] which argues that requiring postpetition interest payments will promote prompt agreement to a plan, is an anomalous assessment. If a creditor receives lost opportunity cost compensation and is allowed to foreclose if the debtor defaults, then the creditor's incentive to negotiate a Chapter 11 plan certainly dissipates.

Lost opportunity cost payments could also result in an undersecured creditor receiving more than its oversecured counterpart.[135] Under section 506(b), the accrual of interest is limited to the value of the property exceeding the amount of the claim.[136] (This is referred to as the creditor's "equity cushion."). Section 506(b) allows the interest to accrue, but it is not immediately paid out.[137] The lost opportunity cost theory, however, does not limit an undersecured creditor to its equity cushion and requires

130. *In re* American Mariner Indus., Inc., 734 F.2d 426, 431 (9th Cir. 1984) (quoting H.R. REP. No. 595, 95th Cong., 2d Sess., 220, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6179).

131. Warren, *supra* note 128, at 788.

132. *See* 124 CONG. REC. 32,392 (1978); 124 CONG. REC. 33,990 (1978) (discussing the policies underlying the Bankruptcy Code to protect communities from the impact of bankruptcy).

133. *See, e.g*, Baird, *Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

134. 808 F.2d 363, 383 (5th Cir. 1987) (en banc) (Jones, J., dissenting), *aff'd*, 108 S. Ct. 626 (1988).

135. *See* M. BIENENSTOCK, BANKRUPTCY REORGANIZATION 199-200 (1987).

136. 11 U.S.C. § 506(b) (1982).

137. *Id.*

the immediate payment of interest. Oversecured creditors would become a rare commodity if such an interpretation were uniformly adopted.

Inextricably connected to the grant of lost opportunity costs are the questions of the timing of and the method by which valuation is determined.[138] These are complex issues for which Congress has provided no guidelines.[139] A practice of automatically awarding undersecured creditors lost opportunity cost compensation may not be in the best interest of those creditors. In a situation in which the liquidation value of the collateral is substantially less than its going concern value, creditors will benefit more from working toward the goal of reorganization.[140] A policy of maximizing the return to creditors seems worthy on its face. However, such a policy cannot be effectively realized in the context of a bankruptcy proceeding. The theory becomes that of maximization of profits for the few, with devastating repercussions on other creditors, the debtor, and our nation's economy.

VII. CONCLUSION

The adequate protection provisions of the Bankruptcy Code of 1978[141] set forth an amorphous set of guidelines to be applied on a case-by-case basis. A uniform model or rule cannot be constructed when it is vital that each case be considered in light of its unique set of circumstances. Varying standards are unavoidable in order to achieve the rehabilitative goal of bankruptcy policy. For this reason, Congress crafted the concept of adequate protection to serve as a flexible model. Congress, however, did not neglect to provide a detailed scheme for plan filing and confirmation and remedies to a creditor suffering from a delay in those proceedings. Adequate protection was not fashioned as a creditor's sole remedy—it must be viewed with reference to the other provisions contained in the Code.

The United States Supreme Court's affirmation of *In re Timbers of Inwood Forest Associates* acknowledged that the creditor had never sought relief from the automatic stay under section 362(d)(2) of the Code on any ground other than lack of adequate protection.[142] Relief, therefore, is by no means precluded when section 362(d)(1) is unsuccessfully sought as relief from the stay.

A bankruptcy filing is not an optimum situation for any of the parties involved. Creditors should not be permitted to construe adequate protec-

138. *See supra* notes 35-39 and accompanying text.
139. *See* Fortgang & Mayer, *supra* note 29, at 1068-69.
140. M. BIENENSTOCK, *supra* note 135, at 196-99.
141. Pub. L. 95-598, 92 Stat. 2549 (1978).
142. United Savings Assoc. of Tex. v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626, 635 (1988).

tion as their panacea to a debtor's default. When *In re American Mariner Industries, Inc.*[143] held that undersecured creditors are entitled to lost opportunity cost compensation as a matter of law, the court considered one group's interests as distinct from the interconnected and dependent interests of all the parties to the bankruptcy proceeding.

A balance can be achieved between debtor rehabilitation and protection of the creditors' rights. Lost opportunity cost compensation may be justified in certain circumstances. The payment of lost opportunity cost, however, will be the exception, rather than the rule. Any conclusions regarding whether a creditor is adequately protected may follow only after careful examination of the factors set forth in *In re Briggs Transportation Co.*[144]

Amy S. Ashworth

143. 734 F.2d 426 (9th Cir. 1984).
144. 780 F.2d 1339, 1349-50 (8th Cir. 1985).