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## Valuation of Assets in Bankruptcy Proceedings: Emerging Issues

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# VALUATION OF ASSETS IN BANKRUPTCY PROCEEDINGS: EMERGING ISSUES

**Kaarán E. Thomas\***

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## I. INTRODUCTION

"Value is a word of many meanings," noted Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*.<sup>1</sup> The concept of value, which includes market value, value to owner, utility cost, fair price, intrinsic value or justified price, and normal value,<sup>2</sup> is critical to all parties in interest

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1. 262 U.S. 276, 310 (1923) (Brandeis, J., dissenting).

2. J. BONBRIGHT, THE VALUATION OF PROPERTY, ch. II (1937).

in a bankruptcy proceeding. The value of property of the estate<sup>3</sup> provides adequate protection for holders of secured claims,<sup>4</sup> funds for payment of administrative claims,<sup>5</sup> distribution to holders of unsecured claims,<sup>6</sup> and it also provides the hope of reorganization for debtors.<sup>7</sup> Therefore, knowing which concept of value a court will apply at a given stage in a bankruptcy proceeding is imperative. Property, which is an asset and, thus, of great value to the debtor/owner, may have a market value far less than the debt owed against it. Conversely, the original cost of the property may vastly exceed its current market value. Finally, property that is worthless in the secured creditor's hands may have immense utility value in the hands of the debtor/owner.

The Bankruptcy Code requires a case-by-case valuation of property at several points during a bankruptcy proceeding.<sup>8</sup> For example, the same property may be found to have the following values: 1) a fair-market value for purposes of determining the debtor's pre-filing solvency;<sup>9</sup> 2) a value incidental to determining "adequate protection";<sup>10</sup> 3) a secured-claim valuation;<sup>11</sup> 4) an "indubitable equivalence" value for plan confirmation;<sup>12</sup> and 5) a liquidation value for plan confirmation.<sup>13</sup> Clearly, a court does not determine all of these "values" on the same basis or under the same value definition.<sup>14</sup> Instead, a court applies different value standards in each of the above situations, and prior determinations are unlikely to constitute *res judicata* in subsequent determinations.<sup>15</sup>

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3. Property of the estate is defined in 11 U.S.C. § 541 (1988).

4. The term "secured claim" is not defined in the Code. The Code describes the treatment of "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest." 11 U.S.C. § 506(a) (1988). The term "lien" is defined in the Code as a "charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(33) (1988). The term "adequate protection" is not defined. 11 U.S.C. § 363 (1988). For a discussion of adequate protection see *infra* Part III of this paper.

5. The holders of claims for reasonable and necessary costs of administration are entitled to reimbursement according to 11 U.S.C. § 503 (1988).

6. Unsecured claims are those arising before the debtor commences a bankruptcy case, which are not secured by a lien as defined in 11 U.S.C. § 101(33) (1988). See also 11 U.S.C. § 506 (1988).

7. See *infra* Part VIII.

8. H.R. REP. NO. 595, 95th Cong., 1st Sess. 339, 356 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6295, 6312.

9. 11 U.S.C. § 101(29) (1988).

10. 11 U.S.C. §§ 361 to -363 (1988).

11. 11 U.S.C. § 506 (1988).

12. 11 U.S.C. § 1129(b)(2)(A)(iii) (1988).

13. 11 U.S.C. § 1129(a)(7) (1988).

14. See *infra* text accompanying notes 16-17.

15. See *infra* Part VII.

One reason for the disparate results of different valuation hearings is that various statutory provisions require a court to value property at different times. For example, property that was valuable before the bankruptcy filing—the time at which value was determined for proving solvency under the preference statute<sup>16</sup>—either may have lost much of that value by the time of the adequate-protection hearing or may have increased in value.<sup>17</sup> More important, a court may apply a different value test under each separate section of the Code.

The Code directs a court to determine pre-petition solvency for preference purposes by using the fair-valuation standard. For example, a statutory provision mandating this standard<sup>18</sup> states that an entity is “insolvent” when the entity’s “financial condition [is] such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation.”<sup>19</sup>

Appraisers and courts generally define the term “at a fair valuation” to mean the value that could be made available for payment of debts within a reasonable period of time, assuming a willing buyer and a willing seller exist.<sup>20</sup> However, the adequate-

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16. 11 U.S.C. § 547 (1988). The Code requires, as a precondition, that the debtor be insolvent at the time of the transfer that is sought to be avoided. Accordingly, equity in the property may serve to disprove the insolvency requirement of 11 U.S.C. § 547(b)(3) (1988). Thus, a court’s determination of value may deprive the estate of the property in question or, in the alternative, deprive a secured creditor of its right to foreclose upon the property at any of the stages in a bankruptcy proceeding. For example, in preference proceedings, if the value the court ascribes to the debtor’s property deems the debtor insolvent prior to the debtor’s petition (and more importantly prior to the granting of the lien), a trustee or a debtor-in-possession may avoid the lien under the preference provisions of the Code. 11 U.S.C. § 547 (1988). If a secured creditor retains its lien, however, an estate then must provide adequate protection if it intends to use, sell, or lease the collateral of the secured creditor. 11 U.S.C. § 363 (1988). If the debtor is unable to provide adequate protection, the secured creditor can petition the court to lift the automatic stay and to foreclose on the collateral. Occurring under section 362, this process allows the secured creditor to repossess and to dispose of the collateral in satisfaction of the debt. Moreover, the equity cushion, which protects a secured creditor’s lien from avoidance under the preference statutes, will not necessarily protect an estate from modification of the automatic stay.

17. See, e.g., *In re Wells*, 52 Bankr. 368 (Bankr. E.D. Pa. 1985). In *Wells*, the debtor commenced a valuation hearing under 11 U.S.C. § 506(a) (1982) to determine the value of her homestead. At the hearing, the debtor’s expert appraised the homestead at \$7,500 as of May 25, 1985, while the creditor’s expert valued the homestead at \$8,900 as of July 26, 1985. *Id.* at 368. The bankruptcy court found that the debtor had made substantial repairs between May 25 (the date of filing of the petition) and July 26 (the date of the creditor’s evaluation) and that “[f]or the purpose of lien avoidance under § 506 the size of the debt and value of the property are determined as of the date of the filing of the petition.” *Id.* at 369 (citing *Brager v. Blum*, 39 Bankr. 441 (Bankr. E.D. Pa. 1984)).

18. 11 U.S.C. § 101(31) (1988).

19. *Id.*

20. *First Nat’l Bank v. Perdue Hous. Indus., Inc.*, 437 F. Supp. 36 (W.D. Okla. 1977); *In re O’Neill Enters., Inc.*, 359 F. Supp. 940 (W.D. Va. 1973).

protection provision<sup>21</sup> of the Code imposes no such value definition. Indeed, the Code imposes no valuation standard for determining any post-petition value issues. The drafters of the Code left these valuation standards undefined, intending that courts would apply the valuation concepts "in light of [the] facts of each case and general equitable principles."<sup>22</sup> Unfortunately, courts have construed this flexibility as providing them with *carte blanche* to avoid imposing any legal standards on valuation. These lack-of-value standards cause difficulty for practitioners and judges alike. Therefore, this article will explore the emerging issues and ambiguities that have evolved from court attempts to deal with valuation issues.

## II. EMERGING AMBIGUITIES: PRESENT VALUE, RISKS, AND THE DILEMMA OF "INDUBITABLE EQUIVALENCE"

Courts do not review valuation evidence in a vacuum. Therefore, they must design legal standards or tests against which the valuation evidence may be measured. To date, the "legal standards," which have emerged from bankruptcy and appellate courts, are ambiguous, at best. Courts have difficulty defining and balancing valuation issues. The most significant of these issues are: 1) whether a court should value a secured creditor's interest in collateral as something apart from the value of the collateral itself in arriving at a "value" for adequate protection or plan-confirmation purposes; 2) whether a court may take into account risks to which a secured creditor's collateral may be subjected, because of delays in recouping on its investment in the collateral, or other problems when fashioning "indubitable equivalence," under section 361(3) or at confirmation; and 3) whether delays in payment, which cause decreases in the present value of collateral, that is, a cognizable decrease, constitute either a "taking" under the fifth amendment or trigger the need for adequate-protection payments under the Bankruptcy Code.

Bankruptcy courts have delegated the task of resolving the ambiguities related to valuation issues to trial lawyers and bankruptcy judges. In order to accomplish their mission, these lawyers and judges must develop some familiarity with the evolution of valuation issues beginning with two oft-quoted pre-Code cases.

In the first of these cases, *Wright v. Union Central Life Insur-*

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21. 11 U.S.C. § 363 (1988).

22. H.R. REP. NO. 595, 95th Cong., 1st Sess. 339 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6295.

ance Co.,<sup>23</sup> a debtor/farmer filed bankruptcy under a now-superseded provision of the Bankruptcy Act and attempted to exercise his right of redemption with respect to a tract of land. The “narrow issue” was whether a court must give a debtor an opportunity “to redeem the property at the reappraised value” or “at a value fixed by the court” before the court can order a public sale of the property.<sup>24</sup>

The Court held that authorizing the debtor to redeem the property would not result in the debtor receiving the property at less than its actual value.<sup>25</sup> In assessing the rights of the secured creditor in a forced sale, the Court noted that the Bankruptcy Act provided “[s]afeguards . . . to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property.”<sup>26</sup> The Court added, however, that a creditor has “no constitutional claim . . . to more than that.”<sup>27</sup>

The Court in *Wright* failed to comment on the second pre-Code case that is most often quoted on contemporary valuation issues—*Metropolitan Life Insurance Co. v. Murel Holding Corp.*,<sup>28</sup> a Second Circuit Court of Appeals decision. Such failure to comment, however, may be explained because of the different issues presented to the respective courts and did not imply the Court was overruling *Murel*.<sup>29</sup>

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23. 311 U.S. 273 (1940).

24. *Id.* at 276. Union Central Life Insurance Company (Union Central), the lienholder on the tract of land, filed a petition with the bankruptcy court praying that the bankruptcy proceeding be dismissed or, in the alternative, that the property be immediately sold. *Id.* Union Central alleged:

that the debtor's financial condition was beyond all reasonable hope of rehabilitation, that he had failed to comply with the order of the court requiring two-fifths of the crops to be delivered to the trustee, that he had made no offer of composition, and that he had failed to pay taxes and insurance and had made no payment on principal since 1925 and none on interest since 1930.

*Id.*

The Court found error in the denial of an opportunity to redeem the land at the value fixed by the bankruptcy court before ordering a public sale. The Court reasoned that the Bankruptcy Act must be “liberally construed to give the debtor the full measure of the relief afforded by Congress . . . lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act.” *Id.* at 279. The Court also stated that the “debtor and creditor alike” could be afforded equal protection “only by holding that the debtor's request for redemption [could not] be defeated by a request of a secured creditor for a public sale.” *Id.*

25. *Id.* at 277-78.

26. *Id.* at 278.

27. *Id.*

28. 75 F.2d 941 (2d Cir. 1935).

29. To illustrate such differences, *Murel* involved an appeal of an order allowing a foreclosure. Metropolitan Life Insurance Company (Metropolitan) held a mortgage upon an apartment house in the amount of \$400,500. *Id.* The two corporate owners of the apartment

*Murel* involved an appeal from an order allowing foreclosure on an apartment house.<sup>30</sup> The *Murel* court declined to continue the stay against foreclosure.<sup>31</sup> In making its determination, the court reviewed the debtor's proposed "plan" to determine whether the plan offered "adequate protection" to Metropolitan's interest, the first lienholder.<sup>32</sup> The *Murel* court noted that the grant of equitable power to a bankruptcy judge to award "adequate protection" was a grant of "constitutional" significance.<sup>33</sup> In other words, the *Murel* court implied that if an undersecured creditor does not receive adequate protection, then the loss the creditor incurs may constitute a "taking" under the fifth amendment, because, as the court stated, "payment ten years" from now "is not generally the equivalent of payment now."<sup>34</sup> Thus, the court exhorted:

[W]e are to remember not only the underlying purposes of the [adequate-protection] section, but the *constitutional limitation to which it must conform*. It is plain that "adequate 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 [or her] principal will scarcely be content with that; [the creditor] wishes to get his [or her] money or at least the property. We see no reason to suppose that the statute was intended to deprive [the creditor] of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.<sup>35</sup>

The *Murel* court held that to compel a mortgagee "to forego all

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house were Murel Holding Corporation (*Murel*) and Abmar Holding Corporation (*Abmar*), petitioners in bankruptcy. *Id.* Metropolitan had "filed a bill of foreclosure in the Supreme Court of New York on December 8th, 1934," and obtained appointment of a receiver for the rents. *Id.* Both *Murel* and *Abmar* immediately filed petitions to obtain an *ex parte* stay of the foreclosure. *Id.* "When the bill [of foreclosure] was filed the defaults on the mortgage amounted to nearly \$100,000; about \$20,000 of taxes and assessments, \$43,000 of interest and \$36,000 of amortization payments." *Id.* at 942. Assessed at \$540,000, the properties were accruing rentals at the rate of \$3,600 a month. *Id.* The debtors proposed a "plan of reorganization," which provided that "the second mortgagee was to provide \$11,000, to be used by the debtors to alter [certain] apartments in the building." *Id.* This proposed advance by the second lienholder was to have "priority over all liens but the" tax arrearages. *Id.* The debtors assumed they could lease these apartments readily and could accrue about \$59,346 in rentals with expenses of only \$20,400 per year, "leaving a yearly surplus of \$38,946." *Id.* The debtor's plan proposed a ten-year stretch out—a familiar concept to bankruptcy practitioners in the 1980s—which *Metropolitan*, the first mortgage holder, declined to accept. *Id.*

30. *Id.* at 941-42.

31. *Id.*

32. *Id.* at 942.

33. *Id.*

34. *Id.*

35. *Id.* (emphasis added).

amortization payments for ten years and take its chances as to the fate of its lien at the end of that period, though it is now secured by a margin of only ten per cent" was not "adequate protection."<sup>36</sup>

The *Wright* and *Murel* cases are the cases most frequently cited by appellate courts in determining and valuing interests of secured creditors under the Bankruptcy Code. Furthermore, the two cases continue to have significant contemporary influence in defining "adequate protection," "indubitable equivalence" and what "interest" may be protected from a decrease in value in bankruptcy cases even though the cases differ analytically and factually.<sup>37</sup> An example of such difference is that in *Wright* a secured creditor requested a denial of a debtor's rights to redeem property.<sup>38</sup> The creditor was not being asked to countenance any significant delay in the exercise of its rights.<sup>39</sup> *Murel*, on the other hand, concerned a "stretch out," a classic, long-term, low-interest rate "balloon payment" restructure of the lender's original note of a type familiar to contemporary practitioners.<sup>40</sup>

The enactment of the Code<sup>41</sup> with its express statutory automatic-stay and adequate-protection provisions, including the "indubitable equivalence" provision taken from *Murel*,<sup>42</sup> gave rise to a series of appellate decisions construing *Murel* and *Wright*. The first of note, *Crocker National Bank v. American Mariner Industries, Inc.*,<sup>43</sup> addressed "whether an undersecured creditor who is stayed by a bankruptcy petition from repossessing its collateral is entitled, under the concept of 'adequate protection,' . . . to compensation for the delay in enforcing its rights against the collateral."<sup>44</sup>

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36. *Id.* at 942-43.

37. See *supra* notes 23 and 28.

38. *Wright*, 311 U.S. 273 (1940).

39. *Id.*

40. *Murel*, 75 F.2d 941 (2d Cir. 1935). Indeed, the facts of *Murel* are not dissimilar from the facts of *United Savings Ass'n v. Timbers of Inwood Forest Assoc., Ltd.*, 793 F.2d 1380 (5th Cir. 1986). See *infra* note 63.

41. Pub. L. 95-598, 92 Stat. 2549-2688 (currently codified at 11 U.S.C. §§ 101 to -1330 (1988)).

42. 11 U.S.C. § 361(3) (1988).

43. 734 F.2d 426 (9th Cir. 1984) [hereinafter *American Mariner*]. *Timbers I* resulted from a dispute between United Savings Association of Texas, (United) the lender, and Timbers of Inwood Forest Associates, Ltd., a limited partnership, whose sole asset was an apartment project pledged to United to secure its debt. The monthly cash flow from the apartment project was "tens of thousands of dollars less than the monthly debt service payments [to United]." *In re Timbers of Inwood Forest Assoc.*, 808 F.2d 363, 375 n.1 (5th Cir. 1987) (en banc) *affd.* 484 U.S. 365 (1988). The debtor's counsel conceded in oral argument before the Fifth Circuit that the likelihood of the debtor's ability to reorganize was virtually nonexistent. *Id.*

44. *American Mariner*, 734 F.2d at 427. The collateral was worth \$110,000. The se-  
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In ruling “adequate protection” authorized such compensation, the *American Mariner* court decided the following:

- 1) that the interest protected pursuant to section 361 includes a secured creditor’s right “to take possession of and sell [its] collateral” and “the creditor’s equitable right to reinvest the proceeds of the sale”;<sup>45</sup>
- 2) that the term “indubitable equivalent” as used in section 361 is derived from *Murel* and contemplates adequate protection under section 361 of the present value of the secured creditor’s interest;<sup>46</sup>
- 3) that the secured creditor “is entitled to compensation for the delay in enforcing its rights during the interim between [the filing of] the petition and confirmation of [a] plan” of reorganization.<sup>47</sup>

Relying heavily on *Murel*, the *American Mariner* court was especially persuaded by Judge Learned Hand’s interpretation of adequate protection, which emphasized two factors: 1) that adequate protection, “to be ‘completely compensatory’ . . . must compensate for present value,” that is, “payment ten years hence is not generally the equivalent of payment now,”<sup>48</sup> and 2) that “adequate protection must insure the safety of the principal.”<sup>49</sup>

Eighteen months after *American Mariner*, in *In re Briggs Transportation Co.*,<sup>50</sup> the Eighth Circuit Court of Appeals determined that adequate protection did not entitle “undersecured creditors as a matter of law to interest payments from a debtor to compensate the creditors for lost opportunity costs due to the delay in reinvesting the collateral’s liquidated value caused by [the] automatic stay.”<sup>51</sup> Finding that such payments were “permissible but not required to provide adequate protection,” the *Briggs* court remanded the case to the bankruptcy court for further findings.<sup>52</sup>

The *Briggs* court determined that adequate protection safeguarded “the rights of secured creditors, throughout the proceedings, to the extent of the value of their property,” and that a secured creditor had “no constitutional claim . . . to more than

cured creditor’s debt, including accrued interest, was approximately \$370,000. *Id.*

45. *Id.* at 431.

46. *Id.* at 432-33.

47. *Id.* at 435.

48. *Id.* at 433.

49. *Id.*

50. 780 F.2d 1339 (8th Cir. 1985).

51. *Id.* at 1340.

52. *Id.*

that.”<sup>53</sup> The court reviewed the legislative history of the adequate-protection provisions of the Code and concluded that the “statutory scheme indicates that adequate protection is intended to encompass a broad range of creditor interests and does not mandate an interpretation of the creditors’ interests as the whole of the economic bargain.”<sup>54</sup>

The *Briggs* court also examined various ways of providing adequate protection for the creditor’s interests and concluded that payment of “economic depreciation” was appropriate.<sup>55</sup> Disagreeing with the creditor’s interpretation of “indubitable equivalence” as used in *Murel*, the court distinguished *Murel*, pointing out it had “dealt with confirmation of a plan opposed by creditors, rather than the temporary interim protection of an automatic stay.”<sup>56</sup> The court’s interpretation of *Murel* is not entirely accurate, because *Murel*, in fact, involved an appeal from an order denying a motion to vacate a stay of the prosecution of a foreclosure suit—not an appeal from an order confirming a plan of reorganization.<sup>57</sup>

Based on this interpretation of *Murel*, the *Briggs* court declined to find *Murel* precedent for construing the term “indubitable equivalence,” as used in section 361(3), as mandating payment of lost opportunity costs to the creditors. Instead, *Briggs* espoused a broad, flexible approach, concluding that the creditors had “no right to be placed in the same economic position as if there had been no bankruptcy filing.”<sup>58</sup> After reviewing the legislative history of the Code, the *Briggs* court decided to balance the interests of debtors and creditors on a “case-by-case basis.”<sup>59</sup> Therefore, the court declined to fashion a rule mandating strict requirements for adequate protection.<sup>60</sup> The court did provide certain guidelines for what might constitute adequate protection in a given case, however, suggesting that the question might turn on the following issues: 1) whether the creditor had been “greatly oversecured”; 2) the “quality of the collateral”; 3) “the length of the stay”; 4) the parties’ “reasonable expectations” upon entering into their bargain; 5) “whether the collateral’s lien value is demonstrated to be appreciating, depreciating or remaining relatively stable”; 6)

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53. *Id.* at 1342.

54. *Id.* at 1345.

55. *Id.* at 1345-46.

56. *Id.* at 1346.

57. See *supra* notes 28-36 and accompanying text.

58. *Briggs*, 780 F.2d at 1346-47.

59. *Id.* at 1349.

60. *Id.*

"whether taxes and other payments designed to keep the collateral free of statutory liens are being paid or will be paid"; and 7) whether in cases in which the chance of reorganization is slight, "liquidation values, including lost opportunity costs, might be deemed protectable."<sup>61</sup> Finally, the *Briggs* court emphasized that its "shopping list" of adequate protection was "not exclusive, but merely indicative of the particular risk and reliance factors shown in the nature and history of the credit transaction which a court may take into account in making adequate protection determinations."<sup>62</sup>

In July 1986, in *In re Timbers of Inwood Forest Associates, Ltd.* (*Timbers I*),<sup>63</sup> the Fifth Circuit Court of Appeals reversed the bankruptcy court and held that undersecured creditors may not receive periodic "interest" payments during a bankruptcy proceeding, as compensation for lost opportunity costs,<sup>64</sup> thereby declining to follow *American Mariner*.<sup>65</sup> In arriving at its decision, the Fifth Circuit attempted to determine

whether Congress in 1978, in codifying the principles which had developed under the common law to ensure that a secured creditor's interest in the value of its collateral would be adequately protected during the pendency of a reorganization proceeding, intended that an undersecured creditor would be entitled to receive during the proceeding periodic cash interest payments on the value of the collateral, even though a claim for interest on the debt would not be allowed at the conclusion of the proceeding.<sup>66</sup>

Seeking relief from the automatic stay of section 362, United, the secured creditor, alleged that it did not have adequate protection for its "interest" in the collateral.<sup>67</sup> United argued that the debtor's promise to pay United's loan in the future was of less value than present payment and that the perceptible decrease represented United's "interest" in its collateral for which United was entitled to compensation—an argument with significant legal precedent.<sup>68</sup> United argued and the district court held that the con-

61. *Id.*

62. *Id.* at 1349-50.

63. 793 F.2d 1380 (5th Cir. 1986).

64. *Id.* at 1382.

65. 734 F.2d 426 (9th Cir. 1984). For a more complete discussion of *American Mariner*, see *supra* note 43 and accompanying text.

66. *Timbers I*, 793 F.2d at 1381.

67. *Id.* at 1383.

68. *Id.* Indeed, United's position was based upon Judge Learned Hand's opinion in *Murel*, in which he stated: "'[A]dequate protection' must be completely compensatory; and . . . payment ten years hence is not generally the equivalent of payment now." *Murel*, 75 F.2d 941, 942 (2d Cir. 1935). The justices who heard oral argument in another bankruptcy

cept of "adequate protection" required the estate to compensate United for the decrease in value caused by the delay.<sup>69</sup> The bankruptcy court agreed with United and assessed a "charge," which was roughly equivalent to the interest accruing on United's loan, incident to this delay.<sup>70</sup>

In 1987, the Fifth Circuit, in an en banc opinion, affirmed *Timbers I* in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.* (*Timbers II*).<sup>71</sup> In *Timbers II*, the court held that the adequate-protection provisions of the Code do not require the estate to reimburse an undersecured creditor for the losses it suffered because of lost interest payments or, in other words, lost opportunity costs, as a result of "the delay of the Chapter 11 reorganization proceeding during the pendency of the automatic stay."<sup>72</sup> United contended that this "interpretation of the adequate protection provisions" effectively "preclud[ed] an undersecured creditor" "from ever obtaining relief from the automatic stay."<sup>73</sup>

valuation case, *Norwest Bank Worthington v. Ahlers*, \_\_\_\_ U.S. \_\_\_, 108 S. Ct. 963 (1988), echoed that same position. In this connection, the following questions from the justices before whom *Ahlers* was argued are instructive.

QUESTION: Suppose [Mr. Ahlers] promised to give money? What is the difference between promising to give his labor and promising to give money in the future?

MR. NEEDLER: If Mr. Ahlers confirmed a plan on a promise, Justice Scalia, and one month into the plan he did not deliver on the promise, then Mr. Conn would run into court under § 1112(B) and the case is dismissed.

QUESTION: So it works for money too?

MR. NEEDLER: It works for anything.

QUESTION: So it's not just sweat equity, it is even non-sweat equity?

You say that if the debtor comes in, the debtor who has already defaulted on one promise to pay money, if he comes in and says I promise to pay more money in the future, the court has to allow a reorganization on the basis of that new promise?

.....

QUESTION: Okay. So you are not just arguing sweat equity, you are arguing that you don't have to put up money. It is enough that you promised to put up money. And if and when you don't make good on that promise, then we'll undo the reorganization, but meanwhile we let it go.

Transcript of Proceedings at 26-27, *Ahlers*, (No. 86-958).

The *Ahlers* Court, after asking the foregoing questions of Mr. Ahlers' attorney, ruled unanimously that a promise to pay money was not "value" that Mr. Ahlers, a farmer, could use as consideration for retaining his interest in his farm. *Id.*

Interestingly, the questions the Court posed in *Ahlers* are similar to those posed in *Timbers III*—that money given in consideration at the time of reorganization does not have the same value today that it will have at a later date.

69. *Timbers I*, 793 F.2d at 1383-84.

70. *Id.*

71. 808 F.2d 363 (1987).

72. *Id.* at 364.

73. *Id.* at 370.

In response, the *Timbers II* court pointed to section 362(d)(2), “which entitles a secured creditor to obtain relief from [an] automatic stay” when “the debtor does not have an equity” in the collateral and the collateral “is not necessary to an effective reorganization.”<sup>74</sup> Bankruptcy courts—in determining whether collateral is necessary for an effective reorganization under section 362(d)(2)—apply the “‘reasonable possibility of successful reorganization’ standard.”<sup>75</sup> This standard allows “somewhat more indulgence” under these circumstances than if the issue had been raised during a “full-blown hearing that attends a motion to dismiss or convert the case brought under [section] 1112.”<sup>76</sup> The *Timbers II* court, however, exhorted bankruptcy judges to give “meaning” to the “effective reorganization” standard<sup>77</sup> in automatic-stay hearings. As is apparent from the two holdings, the *Timbers II* and *American Mariner* courts differed enormously in their interpretations of how a debtor should make cash payments to undersecured creditors pursuant to section 361.<sup>78</sup> The major differences between the two circuits’ analyses focused on the following: 1) the definition of the secured creditor’s interest to be protected under section 361, and 2) the definition of the term “indubitable equivalence.”

First, the *Timbers I* court espoused a limited definition of the secured creditor’s interest to be protected—the value of the collateral securing the creditor’s claim.<sup>79</sup> The court construed any other payments sought by a creditor during the pendency of a case with respect to collateral that was not decreasing in value to be “interest” payments, which the Code expressly prohibits unless a creditor is oversecured.<sup>80</sup>

Second, the *Timbers I* court, after examining *Murel* and the legislative history behind the indubitable-equivalence section of the Code,<sup>81</sup> concluded that the term indubitable equivalence—as used in *Murel* and in the Code—“refers to a substitute for a particular interest; it does not define the interest.”<sup>82</sup> Interestingly, both the *Timbers I*<sup>83</sup> and *Briggs*<sup>84</sup> courts argued that *Murel* dealt with confirmation of a plan of reorganization and, thus, was irrele-

74. *Id.*

75. *Id.* at 371.

76. *Id.*

77. *Id.*

78. See *American Mariner*, *supra* note 43.

79. *Timbers I*, 793 F.2d at 1389.

80. *Id.* at 1385-87.

81. 11 U.S.C. § 361(3) (1988).

82. *Timbers I*, 793 F.2d at 1389.

83. *Id.*

84. *In re Brigg Transportation Co.*, 780 F.2d 1339, 1346 (8th Cir. 1985).

<https://scholarship.law.umt.edu/mlr/vol51/iss1/4>

vant to issues of adequate protection.

According to *Timbers I*, the *American Mariner* court erroneously construed section 361(3) as effectively granting a creditor the same rights the creditor would have if the creditor were permitted to foreclose and liquidate its collateral and then reinvest the proceeds to obtain present value. *Murel* failed to mandate any protection against a decline in value of the creditor's collateral,<sup>85</sup> according to the *Timbers I* court. The court urged that *Murel* addressed post-plan interest payments to secured creditors. Therefore, according to *Timbers I*, construing an indubitable-equivalence standard as mandating pre-confirmation interest payments would change settled law. Finding no such intent in the legislative history of the Code,<sup>86</sup> the *Timbers I* court, instead, stated that the protections of the fifth amendment ensure an undersecured creditor "only that the value of the secured position of a creditor be maintained during the stay."<sup>87</sup>

*Timbers I* extracted four "factors" from the common law that govern the exercise of courts' equitable powers to grant or to lift a stay: 1) whether continuing the stay "would result in an undue risk of material harm to the secured creditor"; 2) whether a "reasonable possibility of reorganization or rehabilitation" existed; 3) whether the debtor needed the property in question or whether the property was required for rehabilitation; and 4) whether the property had equity from which a debtor or creditor might realize a benefit.<sup>88</sup> The *Timbers I* court stated that it was "properly reluctant to place significant weight on the unexplained [congressional] action" of including the "'indubitable equivalent language' [in section 361(3)], particularly when the mute change would alter settled law."<sup>89</sup>

In the 1988 case of *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.* (*Timbers III*),<sup>90</sup> the Supreme Court overruled *American Mariner* by holding that an undersecured creditor is "not entitled to interest on its collateral during the [duration of the automatic] stay." Just as in *Timbers I* and *Timbers II*, the Supreme Court in *Timbers III* failed to address the issue of how to balance any detriment attributable to a decrease in the time-value of the secured creditor's collateral when

85. *Id.* at 1389, 1401.

86. *Id.* at 1399-1401.

87. *Id.* at 1390 (citing *Wright, supra* note 23).

88. *Id.* at 1391.

89. *Id.* at 1400.

90. 484 U.S. 365, 382 (1988).

the loan is undersecured, against the potential "benefit" that a secured creditor may realize from a successful reorganization. The *Timbers II* court noted only that a successful reorganization benefits a secured creditor, because the "secured claim is valued on a going-concern basis . . . , and the secured creditor is not compelled to liquidate its collateral at forced-sale prices."<sup>91</sup> However, none of the *Timbers* decisions provides any justification for denying the secured creditor the right to make the choice between immediate liquidation of its collateral and potential greater recovery through a reorganization. The Bankruptcy Code does not contemplate inserting such judicial determinations of a creditor's "best interest" into an adequate-protection hearing. Moreover, all three *Timbers* holdings appear to overlook significant valuation issues concerning the discount rates, or decreases, that should be applied to determine the present-value of collateral that the bankruptcy estate is using. The *Timbers* decisions deny to undersecured creditors the right to receive "periodic cash interest payments on the value of the collateral."<sup>92</sup> Ironically, the *Timbers* decisions also state that the protections of the fifth amendment ensure an undersecured creditor "that the value of the secured position . . . be maintained during the stay."<sup>93</sup>

If interest is indeed the common measure of the difference between payment now and payment ten years (or ten weeks) hence, as Judge Hand noted,<sup>94</sup> the various *Timbers* holdings pose a dilemma: How can the present value of an undersecured creditor's collateral be maintained as required by the fifth amendment without periodic cash payments on the value of the collateral? By not allowing some compensation for decrease in present value as a part of "adequate protection," it would seem that the *Timbers* holdings are on a collision course with the "taking" clause of the fifth amendment of the constitution.

The Supreme Court in *Timbers III* denied undersecured creditors the right to interest on their claims, relying on the language of section 506 of the Code to the effect that only oversecured creditors are entitled to such interest.<sup>95</sup> This holding appears to confuse the meaning of "interest" as used in section 506 of the Code with "interest" as used by Judge Hand in *Murel*. Interest paid on a claim pursuant to section 506 constitutes payment of a

91. *Timber II*, 808 F.2d at 373.

92. *Timbers I*, 793 F.2d at 1381.

93. *Id.* at 1390.

94. *Murel*, 75 F.2d at 942.

95. *Timbers III*, 484 U.S. 365, 382 (1988).  
<https://scholarship.law.umt.edu/mlr/vol51/iss1/4>

claim—while “interest” requested by an undersecured creditor as adequate protection has little to do with payment of its claim. This second type of payment—nominally called “interest”—is not a “right to payment” as defined in section 101(4) of the Code—but rather is compensation for the delays incident to bankruptcy proceedings.

Adequate protection has its roots in the due-process clause of the fifth amendment.<sup>96</sup> When the present value of a secured creditor’s collateral is used to enable a debtor to reorganize, such use of the present value of the secured creditor’s collateral may constitute a taking without compensation. The Supreme Court previously has indicated that money a debtor promises to pay in the future normally is worth less than the money a debtor pays today.<sup>97</sup> Arguably, the loss the secured creditor suffers, therefore, may represent a “taking” under the fifth amendment.

Valuation issues and ambiguities arise most frequently at two points in a bankruptcy case: 1) when a secured creditor seeks to modify the automatic stay pursuant to section 362 of the Bankruptcy Code; and 2) when a secured creditor seeks to challenge the treatment of a claim under a proposed plan of reorganization. These ambiguities cause lawyers and clients problems, because to prevail at trial, the lawyers must provide proof of the appropriate valuation standards.

### III. VALUATION IN ADEQUATE-PROTECTION ACTIONS

After a bankruptcy case starts, the court gives “adequate protection” to secured parties, or any other party with a cognizable “interest” in property of the estate who requests such protection.<sup>98</sup> The bankruptcy court gives such protection by “prohibiting” or “conditioning” the debtor’s use, sale, or lease of the subject property during the pendency of a bankruptcy case. The Code, however, does not require protection of the *value* of that *collateral*. Instead, the Code imposes the concept of “adequate protection” for the *value* of a person’s *interest* in the property.<sup>99</sup> Moreover, unless a court requires the estate to protect the collateral adequately, the estate may use, sell, or lease the property in the ordi-

96. See *Wright*, *supra* note 23; *Louisville Joint Stock Land Bank v. Radord*, 295 U.S. 555 (1935) and H.R. REP. No. 595, 95th Cong., 1st Sess. 339 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6295.

97. See *supra* notes 35 & 68.

98. 11 U.S.C. § 363 (1988) addresses adequate protection for parties with an interest in property of the estate, not merely for holders of secured claims.

99. *Id.*

nary course of business without notice or a hearing and regardless of the property's value.<sup>100</sup> Cash collateral represents the only exception to this rule.<sup>101</sup> Before a secured creditor may use cash collateral, the creditor must obtain the debtor's consent or court approval.<sup>102</sup>

When an entity having an interest in property being used, sold, or leased by the estate requests adequate protection for its interest, the court must "prohibit" or "condition" such use, sale, or lease as is necessary to provide adequate protection of such interest. If the interest holder requests protection under section 363 by seeking modification of the automatic stay, the court then may require the estate to provide adequate protection under section 362(d)(1). The court also may require the debtor to demonstrate equity in the property or the need for the property for an effective reorganization under section 362(d)(2). If the estate fails to meet these requirements, then the estate will lose the property to a secured creditor.<sup>103</sup>

Not surprisingly, these adequate-protection and equity determinations involve a wide variety of value determinations. If no equity exists in the property, the debtor must show that the property is necessary to an effective reorganization<sup>104</sup>—a concept that would appear similar to utility value. Under such circumstances, then the creditor may choose to concede that the property has utility value and focus its efforts instead on whether the estate can provide adequate protection for its interest.<sup>105</sup>

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100. 11 U.S.C. §§ 361, 363(e) (1988).

101. 11 U.S.C. § 363(c)(2) (1988) (which defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in the estate and an entity other than the estate has an interest and includes the proceeds, products, offspring, merits, or profits of property subject to a security interest").

102. 11 U.S.C. § 363(f) (1988).

103. Under 11 U.S.C. § 362(g) (1988), the party requesting relief from the automatic stay has the burden of proof on the issue of the debtor's equity in property, and the party opposing such relief has the burden of proof on all other issues. An interesting situation arises when the moving party (presumably a secured creditor) presents a case that consists of proving its debt and the validity of its security interest in the property and proving that the property is worth less than the present amount of its debt. Assume that the secured creditor's interest vests and that the debtor presents no evidence. In such an event, it is unclear whether the movant would have met its "burden of proof" on the issue of lack of adequate protection. Courts have not yet determined whether the movant must prove as part of its case in chief that the collateral in question is decreasing in value or whether the burden of proof and burden of going forward to demonstrate that either the collateral is not decreasing in value or that any such decrease in value is being protected vests with the debtor.

104. See *infra* Part VIII.

One must further examine the adequate-protection section of the Code to understand the dilemma secured creditors and bankruptcy courts face after the *Timbers* holdings. Although the Code provides examples of how an estate may provide adequate protection,<sup>106</sup> only two examples in section 361 require protection for a decrease in value. First, for example, section 361(1) may require a trustee “to make a cash payment or periodic cash payments to such entity, to the extent that the stay under [s]ection 362 . . . results in a *decrease* in the value of such entity’s interest in such property.”<sup>107</sup> Second, the trustee may provide an entity with an additional or replacement lien, pursuant to section 361(2), “to the extent that such stay, use, sale, lease, or grant results in a *decrease* in the value of such entity’s interest in such property.”<sup>108</sup>

In addition to these two explicit examples of adequate protection, section 361(3) states that the court may provide adequate protection by “granting such other relief” that will result in the entity’s realizing the “indubitable equivalent” of its interest in the property.<sup>109</sup> The indubitable equivalence language of section 361(3) was the impetus for the Ninth Circuit’s granting adequate protection to undersecured creditors for lost opportunity costs in *American Mariner*.<sup>110</sup> However, when the Supreme Court addressed indubitable equivalence in *Timbers III*, it not only failed to reconcile the three alternatives provided by section 361, but it also failed to address when or whether compensation to a secured creditor in the form of an “indubitable equivalent” would be appropriate or when, if ever, a court may consider the harm a creditor suffers from inherent delays and risks of a bankruptcy proceeding.<sup>111</sup>

106. 11 U.S.C. § 361 (1988).

107. 11 U.S.C. § 361(1) (1988) (emphasis added).

108. 11 U.S.C. § 361(2) (1988) (emphasis added).

109. 11 U.S.C. § 361(3) (1988).

110. See discussion, *supra* notes 43-49.

111. The Supreme Court attempted to discuss and to justify its reversal of the district court’s interpretation of 11 U.S.C. § 361(3) (1988) by noting that the “indubitable equivalent” language in 11 U.S.C. § 361(3) (1988) also appears in 11 U.S.C. § 1129(B)(2)(A)(iii) (1988). Apparently, the Court took the position that the “indubitable equivalent” language only entitled a secured creditor to receive the present value of its security in connection with a plan of reorganization. See discussion of indubitable equivalence found in *Timbers III*, 484 U.S. 377-79. The Court further noted that no “merit” existed in “petitioner’s suggestion that ‘indubitable equivalent’ in [11 U.S.C.] § 361(3) [(Supp. V 1987)] connotes reimbursement for the use value of collateral because the phrase is derived from *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935) where it bore that meaning.” *Id.* at 378. The Supreme Court justified its distinction stating that “[i]n rejecting the plan, *Murel* used the words ‘indubitable equivalence’ with specific reference not to interest (which was assured), but to the jeopardized principal of the loan.” *Id.* The author finds the Supreme Court’s attempt to “explain” and “distinguish” the definitions of “indubitable equivalence” as used in *Murel* and in 11 U.S.C. § 361(3) (1988) to be virtually unintelligible.<sup>112</sup>

### A. Adequate Protection After the *Timbers Holdings*

Secured creditors bemoan the elimination of lost opportunity costs as a result of the three *Timbers* decisions. So far, however, secured creditors have not labeled such elimination a "taking" under the fifth amendment. Their failure to recognize the elimination of "lost opportunity costs" as a "taking" may lie in the nature of the lost opportunities that *Timbers* has forced secured creditors to forego. When lenders foreclose in a depressed economy, the vast majority realize expense—not profit—from their collateral. The lenders' lost opportunities may include an inability to possess an asset after buying it at a foreclosure sale and not being able to transfer the asset to a purchaser on a non-recourse pay-as-you-can note.

Inevitably, under the current *Timbers* analysis of disallowing a secured creditor to recoup lost opportunity costs, a secured creditor may suffer lost opportunity costs of such magnitude that the creditor could raise a serious due-process challenge. In such an instance, the secured creditor will demand that the Supreme Court redefine the role of "indubitable equivalence" in adequate-protection hearings.

### B. Valuation After the *Timbers Holdings*

Although the *Timbers* holdings eliminated lost opportunity costs—which raises a potential fifth-amendment "taking" issue—the most disturbing aspect of these holdings is their silence on critical valuation issues. Such issues pertain not only to the type and degree of proof required to establish a "decrease in value" under sections 361(1) and (2) but also to the extent to which the "indubitable equivalence" provisions of section 361(3) survive after *Timbers III*.

Secured creditors may be able to show at least a risk of significant decreases in the value of their collateral through a drop in market prices, straight-line depreciation, deferred maintenance or other methods, assuming such proof is admissible and relevant evidence after *Timbers III*.

Secured creditors must demand that bankruptcy courts redefine "indubitable equivalence," so that they can reliably assess the risks they face in bankruptcy and develop their own procedures to control their risk of loss. Such redefining may require the help of expert witnesses such as economists and investment bankers who

can put more meaning into the term.<sup>112</sup>

#### IV. THE IMPORTANCE OF RISK IN VALUATION AND ADEQUATE PROTECTION

Bankruptcy courts commonly require a bankruptcy estate to insure its property against the risk of fire and other hazards. Moreover, courts wrestle with the difficulty in factoring other types of risk into valuation of collateral and in taking risk into account when designing adequate protection. Yet, anyone who has witnessed real-estate markets in Texas and the farm belt in the past five years would note—without humor—that the risk of a market decline is equal to, if not greater than, the risk of fire, flood, or other natural catastrophes.

Currently, actual decrease in value is the appropriate valuation standard in adequate-protection hearings when the term is used in connection with automatic-stay or confirmation hearings. However, when the risk of decrease in value is the appropriate “valuation standard” or when such risks are relevant as a component of “indubitable equivalence,” then perhaps courts also should require debtors to insure against *risk* of a decline in value as a part of adequate protection. However, requesting insurance against such decline may prove futile if courts interpret *Timbers III* as a mandate to ignore risk of any kind when fashioning adequate protection. Courts also may view creditor risk as a component of lost opportunity, which *Timbers III* specifically disallowed.

On the other hand, if risk analysis were considered a legitimate valuation technique, then statisticians may replace appraisers as the witnesses of choice in adequate-protection hearings. Under such circumstances, a previous market decline may be relevant to proving the risk of future decreases in value, while previous market performance may be irrelevant to the issue of actual future decrease in value.

Unfortunately, *Timbers I* failed to discuss whether a court may take risk into account when determining whether a secured creditor is receiving the indubitable equivalence of its claim. However, the court noted that risk of material harm resulting from continuation of an automatic stay is one of the four factors mentioned earlier in determining whether a court may grant or lift a stay.<sup>113</sup>

In a 1985 valuation case, *Brite v. Sun Country Development.*,

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112. See *infra* Part IX.

113. *Timbers I*, 793 F.2d at 1391.

*Inc.*,<sup>114</sup> the Fifth Circuit Court of Appeals was willing to put some "risk of ownership" on secured creditors when a debtor offered to exchange property for debt under a plan of reorganization. In *Sun Country*, the court cursorily upheld the bankruptcy's court finding that a lender could tender twenty-one notes, secured by twenty-one parcels of real property, as the "indubitable equivalence" of the lender's first lien on a tract of land.<sup>115</sup>

The *Sun Country* ruling caused bewilderment and consternation to creditors and trial judges alike, because it appeared to eliminate risk entirely from valuation cases and consequently to permit dollar-for-dollar exchange of property for debt without any discount for the hazards involved in foreclosing or otherwise realizing on the property.<sup>116</sup> Bankruptcy Judge Wesley Steen opined that *Sun Country* merely held "that a creditor who receives promissory notes with a value equal to his [or her] claim has received the indubitable equivalent of his claim."<sup>117</sup> The bankruptcy judge ruled that a property-for-debt transfer requires "a surplus of value," or, in other words, "a margin for allowance of error, so that the realization of equivalence would be indubitable."<sup>118</sup>

Reversing the bankruptcy court on appeal, the Fifth Circuit Court of Appeals in *In re Sandy Ridge Development Corp.*<sup>119</sup> overlooked a golden opportunity to discuss the role of risk in valuing property interests and to alleviate the concerns caused by *Sun Country*. Treating "the specific value" of the property "as irrelevant,"<sup>120</sup> the *Sandy Ridge* court held that the debtor could tender the collateral to the creditor as the indubitable equivalent of its

114. 764 F.2d 406 (5th Cir. 1985).

115. *Id.* at 409. Although bankruptcy courts impose a clear-and-convincing standard of proof on the proponent of a reorganization plan, (*In re Agawam Creative Mktg. Assoc., Inc.*, 63 Bankr. 612, 619 (Bankr. Mass. 1986); *In re National Awards Mfg., Inc.*, 35 Bankr. 691, 693 (Bankr. S.D. Ohio (1983))), the *Sun Country* court found sufficient appraisal evidence concerning the value of the lots securing the notes by recent performance history of the 21 borrowers. *Sun Country*, 764 F.2d at 409. And the lender lost, even though his fears concerning the increased burdens and risks involved with collecting on 21 notes were "unsupported." *Id.*

116. *In re Sandy Ridge Dev. Corp.*, 77 Bankr. 69, 73 (Bankr. M.D. La. 1987) *rev'd on appeal*, 881 F.2d 1346 (5th Cir. 1989). The bankruptcy judge ruled that a property-for-debt transfer requires "a surplus of value, [and] a margin for allowance of error, so that the realization of equivalence would be indubitable." *Id.* The secured creditor had argued that the bankruptcy court should abandon the property and let the process of foreclosure set the value of the creditor's secured claim. *Sandy Ridge*, 881 F.2d at 1354. The Fifth Circuit reversed the bankruptcy court on appeal. *Id.* at 1346.

117. *In re Sandy Ridge Dev. Corp.*, 77 Bankr. 69, 73 (Bankr. M.D. La. 1987), *rev'd on appeal*, 881 F.2d 1346 (5th Cir. 1989).

118. *Id.*

119. 881 F.2d 1346 (5th Cir. 1989).

120. *Id.* at 1353.

secured claim,<sup>121</sup> reasoning that the collateral was necessarily the indubitable equivalent of the secured claim.<sup>122</sup> Ironically, the court acknowledged that the valuation issue may become important, because a bankruptcy court may be required to value the secured creditor's deficiency unsecured claim.<sup>123</sup>

The *Sandy Ridge* court delegated the task of coming up with a "give back" value—and hence an unsecured deficiency claim—to a bankruptcy judge.<sup>124</sup> Faced with a creditor's concerns that abandonment or foreclosure "is necessary to protect" a creditor's "interests in the face of a declining real estate market,"<sup>125</sup> the court mandated that such "market factors must be taken into account when valuing collateral."<sup>126</sup>

Not surprisingly, *Sun Country* and *Sandy Ridge* have added to the confusion concerning appropriate and relevant valuation evidence by intimating that risk may not be relevant to value determination. In *Sun Country*,<sup>127</sup> the Fifth Circuit avoided a sophisticated analysis of the risk factor and chose instead to rest its holding on a finding of fact.<sup>128</sup> The *Sun Country* decision did suggest, however, that the lender should shoulder some of the risks entailed by delay; nonetheless, the court declined to indicate how this "shouldering" affected the value of the lender's interest in its collateral for purposes of determining whether the lender received its indubitable equivalent.<sup>129</sup> The *Timbers* holdings and *Sun Country* decision apparently indicate that courts are willing to place more of the risk inherent in reorganization proceedings on secured lenders than they had previously shouldered.<sup>130</sup>

121. *Id.* at 1354.

122. *Id.*

123. *Id.* at 1353.

124. *Id.* at 1353-54.

125. *Id.* at 1354.

126. *Id.*

127. *Sun Country*, 764 F.2d 406 (5th Cir. 1985). The *Sun Country* court appeared to place the burden of proof for risk and value issues and the burden of going forward on these issues on the lender. See *id.* at 409.

128. *Id.*

129. In justification of its decision to avoid any ruling on the proper valuation standard, the *Sandy Ridge* court relied upon 11 U.S.C. § 506 (1988), which states that "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," and concluded "[i]t seems contemplated that this determination is to be made by the court." *Sandy Ridge*, 881 F.2d at 1354 (quoting 11 U.S.C. § 506(a) (1988)).

130. On the other hand, these cases may be construed as merely ignoring valuation issues and speaking to burdens of proof and standards of review on appeal. Creditors in other circuits should look for ways to adduce evidence to convince the courts that the risk of decrease in value has reached such a level as to entitle the creditor to adequate-protection

Arguably, the depressed status of markets lends credence to secured creditor's cries that courts should protect them from further risks of decreases to collateral. Unfortunately, expert testimony that a given real-estate market has "hit bottom" probably will fall on jaded ears of bankruptcy judges who have been hearing similar opinions for the past several years.

## V. PROVING VALUE AND DECREASE IN VALUE

Proving "decrease in value" under the adequate-protection provisions of the Bankruptcy Code<sup>131</sup> requires two steps. First, the moving party must establish a starting point—or the present value of the property. Second, the moving party must demonstrate the amount by which the property will decrease in value from its starting point during the period for which adequate protection payments are required.

To complete the first step of the "decrease in value" test, generally one must prove a decrease in present value, which may be measured by a decrease in: 1) fair-market value, 2) "foreclosure sale" value, or 3) "going-concern" value. The moving party must establish a "bench mark" of present value.<sup>132</sup> Having established that bench mark, the moving party then must address which standards to use to prove the appropriate "decrease in value" of the secured party's collateral. For example, the secured party may be able to prove that the debtor, an on-going business, soon will run out of operating capital and that this fact may result in the debtor's liquidation. Accordingly, the moving party may wish to argue that the present "going-concern value" of its collateral will shortly be converted to a "liquidation value" and that the difference constitutes a "decrease in value" entitling the secured creditor to adequate protection.<sup>133</sup>

In the alternative, a court may hold the moving party to the same value test for present and future valuation. In other words, the court may require the secured party to prove that the fair-mar-

payments and should seek an explicit ruling as to the burden of proof that the trial court is imposing on both parties.

131. 11 U.S.C. § 361(1) & (2) (1988).

132. For a discussion of burdens of proof and burdens of going forward with respect to proving value and decrease in value, see *supra* Part VI.

133. At least one court has tacitly approved the moving party's introduction of such evidence. The bankruptcy court in *In re Beker Indus. Corp.*, 58 Bankr. 725 (Bankr. S.D.N.Y. 1986) acknowledged that different valuation standards may apply to adequate protection and indicated willingness to consider proof of a sufficient value under an appropriate valuation standard. The court acknowledged that those asserting a different theory may cross-examine and impeach the testimony, thereby showing a different value.

ket, liquidation, or ongoing-concern values of collateral are decreasing rather than attempting to prove that the collateral is decreasing because the debtor's business is changing from going-concern to liquidation.

Establishing the appropriate bench mark or starting point for fair-market, going-concern, or liquidation values is no easy task. For example, in *Citibank, N.A. v. Baer*,<sup>134</sup> the Tenth Circuit attempted to determine the "going-concern" value of a company whose value consisted of significant, non-producing Canadian Arctic oil and gas interests. Pointing out that any attempt to appraise these interests would constitute little more than a guess, the *Citibank* court quoted the trial court, which stated:

[T]o say that you can forecast—that you can appraise the values in the Canadian Arctic is to say that you can attend the County Fair with your crystal ball, because that is absolutely the only possible way you can come up with a result. And I question that any result that I come up with in the Canadian Arctic is but little more than what I hope is an informed guess.<sup>135</sup>

Every bit as frozen as the Canadian Arctic, real-estate markets in many states are notably lacking in current comparable sales from which real-estate brokers can determine real-estate values. In the absence of comparable sales, appraisers often use the "income approach" in calculating a value for income-producing property. This approach involves capitalizing the net income that a property generates. To value real estate by this approach, one must determine an appropriate capitalization rate, a loan-to-value ratio, and, ideally, a cross-verification through actual sales.<sup>136</sup> Slow markets with the resulting lack of comparable market sales make each of these processes difficult. Some experts criticize using income capitalization as a method for determining value. They argue that the approach is inconclusive of true market value unless the income from the property is derived from the intrinsic nature or the "highest and best" use of the property itself.<sup>137</sup> These experts recognize that the highest and best use of property under some circumstances may not be as income-producing property, and that in such a case the income approach may not be truly indicative of value.<sup>138</sup>

134. 651 F.2d 1341 (10th Cir. 1980).

135. *Id.* at 1347.

136. The anticipated future stream from a property, such as an apartment project, is subjected to various algebraic formulas, which are supposed to reveal the value of the property to a potential purchaser.

137. See, e.g., 27 AM. JUR. 2D *Eminent Domain* § 286 (1966).

138. *Id.*

The problem of determining whether a property will be capable of generating income in the future is even more difficult in radically depressed economies. In such economies the highest and best use of real property may be changing. When cities are tearing down apartment projects and replacing them with parks and parking lots, appraisers and other experts who value a ten-year old, half-vacant apartment by an income-capitalization method are making a questionable assumption about the future of the economy at best and a leap of faith at worst. The future income produced by these properties may be zero. Yet such assumptions are rarely even expressed, and even more rarely questioned when determining what constitutes adequate protection or what basis exists for modifying an automatic stay.

## VI. EVIDENCE OF DECREASE IN VALUE

A wide variety of evidence may be selected to support or contest valuation determinations. The following outlines some of those different types of evidence and then discusses why courts should provide guidance as to their use.

### A. *Previous Decline in Market Value*

The market value of assets—such as oil and gas reserves and improved and unimproved real estate—has declined drastically in many states during the past five years. Previous decline, however, may not automatically translate into future decline. Real-estate appraisers are qualified to give expert testimony regarding the present value of real property although they may not be qualified as experts to predict future decline in the market or even as to the risk of future decline.<sup>139</sup>

Predicting future decreases or increases in value for an adequate-protection hearing, the purpose of which is to provide short-term protection for secured creditors prior to the conclusion of the bankruptcy case, may prove difficult, if not impossible. First, such short-term protection is difficult to relate to the market. Second, one may not be able to ascertain market-value indicators until sev-

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139. In both *Sun Country* and *Sandy Ridge*, appraisal testimony was used by the debtor and upheld by the Fifth Circuit on appeal. Although both *Sun Country* and *Sandy Ridge* involved issues relating to future values of the property (in *Sun Country*, the value of the 21 lots at some future time when the 21 noteholders might default; in *Sandy Ridge*, the value of the property at such time as the creditor might look to the property to satisfy its claim), the court took no notice of this fact when reviewing and examining the appraisal evidence. Nor were issues relating to the qualifications of the appraisers to testify as to these future values raised on appeal by the creditors.

eral months after they occur. Third, in a depressed economy—having few, if any, sales—such information is absent. Under such circumstances, perhaps courts will admit testimony regarding risk of future declines in value in proving the need for adequate protection.<sup>140</sup>

### B. Depreciation

Courts may construe depreciation<sup>141</sup> as a form of decline in market value. Indeed, appraisers traditionally take into account depreciation when valuing an asset.<sup>142</sup> An appraiser can calculate an annual and a monthly depreciation figure that approximates the actual deterioration of the collateral. Straight-line depreciation may be adjusted by taking substantial deferred maintenance into account. Such deferred maintenance will cause improvements to depreciate at a more rapid rate, which also can be estimated. The elements of depreciation, which are subject to variance in calculation and standard in type, include physical, curable, physical deferred, physical incurable, and economic obsolescence.<sup>143</sup> Moreover, even the National Commercial Finance Conference stated that the Bankruptcy Code should provide for “[p]eriodic payments to the secured creditor . . . of amounts sufficient to cover deterioration, consumption, depletion or depreciation resulting from use.”<sup>144</sup>

140. The *Timbers I* court suggested that a replacement lien, rather than cash payment, may be the appropriate method of adequate protection for this type of “uneven” decrease in value. *Timbers I*, 793 F.2d at 1388.

141. Depreciation is defined as:

A loss of utility and hence value from any cause. An effect caused by deterioration and/or obsolescence. Deterioration or physical depreciation is evidenced by wear and tear, decay, dry rot, cracks, encrustations, or structural defects. Obsolescence is divided into two parts, functional and economic. Functional obsolescence may be due to poor plans, mechanical inadequacy or over-adequacy, functional inadequacy or over-adequacy due to size, style, age, etc. It is evidenced by conditions within the property. Economic obsolescence is caused by changes external to the property, such as neighborhood infiltrations of inharmonious groups to the property uses, legislation, etc. It is also the actual decline in market value of the improvement to land from time of purchase to time of resale.

AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, SOCIETY OF REAL ESTATE APPRAISERS, REAL ESTATE APPRAISAL TERMINOLOGY, 75 (Rev. ed. 1981).

142. See, e.g., ALEXANDER, A PRACTICAL APPROACH TO THE APPRAISAL OF DEPRECIABLE PROPERTY, AMERICAN SOCIETY OF APPRAISERS, APPRAISAL AND VALUATION MANUAL, VOL. 3 (1958).

143. Manuals also show how to depreciate improvements. Because experts use and reasonably rely on these manuals, they are admissible in court. FED. R. EVID. 703.

144. *Bankruptcy Act Revision: Hearings on S.235 and S.236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. (1975) (statement of National Commercial Finance Conference).

### C. Value Loss Because of Loss of Rental Income

Calculating decreases attributable to loss of rental income is another means of determining decreases in value. The rental-income-loss approach involves constructing a "stabilized" income model and then deducting various factors, such as mismanagement, leasing commissions, and absorption period from that model value.

Furthermore, in *Timbers I*, the Fifth Circuit recognized that loss and expenditure of income is relevant to the determination of adequate protection.<sup>145</sup>

### D. Rental Value

The Bankruptcy Code permits the estate to continue to pay post-petition rent after filing when debtors lease non-residential real property.<sup>146</sup> Rental value generally is recognized as an indication of both projected depreciation of the leased property and a return on the lessor's investment.<sup>147</sup> The adequate-protection provision of Chapter 12 of the Bankruptcy Code<sup>148</sup> states that secured creditors may obtain rental payments.<sup>149</sup>

The concept of rental value as adequate protection is especially important when the secured creditor's collateral is unimproved real estate. Because no improvements exist to depreciate, and because decline in market value may be difficult to prove in a slow economy, the secured creditor with a lien on unimproved or non-income-producing real estate may be unable to prove any other decrease in value for purposes of adequate protection. Congress evidenced no intent to exclude adequate-protection payments

145. Criticizing *Briggs*, the Fifth Circuit noted:

*Briggs* is far narrower than *American Mariner*. *Briggs* would require post-petition "interest" payments depending on the facts of the case, including the length of the stay, the "quality of the collateral," whether the "collateral's lien value is demonstrated to be appreciating, depreciating or remaining relatively stable," and "whether taxes and other payments designed to keep the collateral free of statutory liens are being paid or will be paid by the debtor." (citation omitted). Of these factors, only the first, length of the stay, has anything whatever to do with accruing interest or "opportunity costs." There can be no doubt that the other factors mentioned should be taken into account by any court making a § 362(d)(1) adequate protection determination.

*Timbers I*, 793 F.2d at 1416.

146. 11 U.S.C. §§ 365(d)(3), 503(b) (1988).

147. COLLIER ON BANKRUPTCY § 365.03.

148. 11 U.S.C. § 1205 (1988).

149. For example, the Code states that a debtor must pay the secured creditor "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." 11 U.S.C. § 1205(b)(3) (1988).

for secured creditors with liens on unimproved land. Furthermore, failing to allow adequate-protection payments to secured creditors for unimproved real estate while mandating administrative-rent payments to lessors for the same type of property seems anomalous.

## VII. EFFECT OF RES JUDICATA ADEQUATE-PROTECTION FINDINGS

A bankruptcy court's valuation process during an adequate-protection hearing has little, if any, *res judicata* effect on subsequent value determinations in a bankruptcy case.<sup>150</sup> Emphasizing the limited *res judicata* effect of a value determination, the legislative history of the Code states: "[A] valuation early in the case in a proceeding under sections 361 to 363 would not be binding upon the debtor or creditor at the time of confirmation of the plan."<sup>151</sup> Adequate-protection determinations are not binding on confirmation in a Chapter 11 case.

Presumably, the debtor who survives automatic-stay/adequate-protection hearings—by showing that a secured creditor has adequate protection because of the present value of the collateral—may take a contrary position when valuing a secured creditor's claim in order to cram down a plan of reorganization under section 1129(b). The super-priority claim afforded the secured creditor<sup>152</sup> presents the estate's only legal risk in taking these contrary positions.

## VIII. VALUATION IN CONNECTION WITH PLANS OF REORGANIZATION

Valuation of collateral may be as unnecessary for confirmation of a plan under 11 U.S.C. section 1129 as it is for the debtor to conduct its ordinary business under section 363. Valuation is relevant only if impaired creditors or classes of creditors reject the plan. This is not to say that valuation does not play a key role in determining the strategy and tactics debtors and creditors employ that lead to the proposal, negotiation, and confirmation of a Chapter 11 plan of reorganization. The valuation process outlined in section 506 determines the dollar amount of the secured claim,

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150. *In re Ahlers*, 794 F.2d 388, 398 (8th Cir. 1986) (citing S. REP. NO. 989, 95th Cong., 2d Sess. 68 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5854), rev'd on other grounds, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). See also 11 U.S.C. § 506(a) (1988).

151. S. REP. NO. 989, 95th Cong., 2d Sess. 68 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5854 (discussing the current provisions codified at 11 U.S.C. §§ 361 to -363 (1988)).

152. 11 U.S.C. § 507(b) (1988).

which the plan treats. The value of a secured creditor's collateral determines the amount of its secured claim, which the plan proponent must either treat as unimpaired pursuant to section 1124 or treat in accordance with section 1129(b)(2)(A) if the creditor insists. The value of any unsecured deficiency claim also is important, because the holder of the deficiency claim who rejects the plan may succeed or fail to block approval of the plan depending on the size of the deficiency.<sup>153</sup>

If the unsecured deficiency claim resulting from the valuation is large in relation to other unsecured claims, the secured-claim holder may be able to use its unsecured "deficiency" claim to block acceptance of the plan by the required class of unsecured creditors and possibly prevent confirmation of the plan entirely.<sup>154</sup> The court deems a class to have accepted a plan only if members of the class holding at least two-thirds of the total dollar amount and one-half of the total number of allowed claims in such class vote to accept the plan.<sup>155</sup> If a deficiency claim represents more than one-third of the dollar amount of all unsecured claims in a class, the lender holding such a deficiency claim unilaterally can block acceptance of the plan by the class of unsecured claims that includes the deficiency. Moreover, because the Code requires at least one impaired class of claims to accept the plan,<sup>156</sup> the effect of blocking acceptance by a class of unsecured creditors could be to block confirmation of the plan entirely if the class of unsecured creditors is the only impaired class involved in the proceeding.<sup>157</sup> Hence, a low valuation of the secured creditor's collateral can represent a strategic benefit to the creditor who is intent on preventing confirmation of a disadvantageous plan. Valuation also is important in determining the treatment of secured claims. The Code sets out three treatments a debtor may use to render a plan "fair and equitable" to a dissenting class of impaired secured claims.<sup>158</sup>

The first treatment outlined in the Code has two elements: a) The holder of a claim in an impaired secured class must retain all liens securing such claims regardless of whether the debtor retains

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153. 11 U.S.C. § 1129(b)(2)(B) (1988). For an example of the value of a secured creditor's unsecured deficiency claim, see *In re Ahlers*, 794 F.2d at 400-01, in which a secured creditor was able to use its unsecured claim to prevent a farmer from keeping his farm in a Chapter 11 case.

154. See *Ahlers*, 794 F.2d at 400-01.

155. 11 U.S.C. § 1126(c) (1988).

156. 11 U.S.C. § 1129(a)(10) (1988).

157. In *Ahlers*, 794 F.2d at 393, the bankruptcy court was able to determine at an early stage in the bankruptcy (upon the bank's motion for relief from stay) that confirmation of a plan over the rejection of the deficiency claim would be impossible.

158. 11 U.S.C. § 1129(b)(2)(A) (1988).

or transfers the collateral property to another entity. b) The holder of the claim must receive "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."<sup>159</sup>

The second treatment outlined in the Code in section 1129(b)(2)(A) provides that the collateral securing the claim may be sold free and clear of all liens, and the liens securing the secured claim must be transferred to the proceeds of the sale.<sup>160</sup> Obviously, in this context the issue of valuation will rarely arise, because the sales price of the property is *prima facie* evidence of its value.

The third treatment outlined in the Code requires that the holder of a claim receive "the indubitable equivalent of such claims."<sup>161</sup> The Code provides that a plan of reorganization may provide for indubitable equivalence so that the holder of a claim in an impaired and secured class is treated fairly and equitably. Moreover, ever since the Code's enactment, the phrase "indubitable equivalence," derived from *Murel*,<sup>162</sup> has been the subject of much legal discourse.

Extensive dicta in both *Timbers I* and *Timbers II* is devoted to distinguishing valuation for adequate-protection purposes from valuation in a plan-confirmation context. Clearly, the prohibition enunciated in *Timbers I* and *II* concerning payment of lost opportunity costs does not apply to payments proposed under a plan of reorganization.<sup>163</sup> Indeed, many of the cases denying confirmation of a plan focus on the unfairness of long delays in payments to secured creditors.<sup>164</sup>

However, the *Sandy Ridge* and *Sun Country* decisions<sup>165</sup> demonstrate that valuations for confirmation of a plan over the objection of a secured creditor (the so-called "cram down") under section 1129(b) suffer from the same problems as valuations in the context of adequate protection and include the uncertainty of the

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159. 11 U.S.C. § 1129(b)(2)(A)(i) (1988).

160. 11 U.S.C. § 1129(b)(2)(A)(ii) (1988).

161. 11 U.S.C. § 1129(b)(2)(A)(iii) (1988).

162. *Metropolitan Life Insurance Co. v. Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

163. See *Timbers I*, 793 F.2d at 1402.

164. *In re Georgetown Apartments*, 468 F. Supp. 844 (D. Ct. M.D. Fla. 1979) (five-year moratorium on payments to secured creditor does not provide adequate protection); *In re Stoffel*, 41 Bankr. 390 (Bankr. D. Minn. 1984) (debtor's plan not fair and equitable when plan would defer payment of debt for four and one-half years while debtor continued to use land).

165. See discussion of *Sandy Ridge* and *Sun Country*, *supra* Part IV.

market, the lack of comparables, and the inability of designing valuation methods that provide for the contingencies of an uncertain future. Although courts may be more careful in making value decisions in the context of reorganization plans than in the interim adequate-protection phase, courts may use only the valuation methods available.

## **IX. RELEVANCE AND ADMISSIBILITY**

### *A. Expert Testimony in General*

Both attorneys and expert witnesses must understand bankruptcy concepts and the expectations of bankruptcy courts when preparing testimony on value and decrease in value. Too often, the expert witness misunderstands what is expected in a bankruptcy hearing and offers expert opinion only on fair-market value as of a given date. A typical appraiser will be taken by surprise if asked whether the property in question is presently decreasing in value or will decrease in value in the future, because this question is not within the scope of a typical appraisal.

Indeed, testimony concerning future value and decrease in value may be beyond the expertise of appraisers or other expert witnesses. Therefore, the attorney should discuss with the expert whether he or she feels qualified to offer expert testimony concerning a future value or whether such testimony would merely be personal opinion outside the scope of his or her expertise.

Hearings in bankruptcy courts are governed by the Federal Rules of Evidence. Federal Rule of Evidence 401 defines relevant evidence as: "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."<sup>166</sup> Unsubstantiated opinions of future value, whether of the expert, the debtor, or the lender may not fall within the broad scope of Rule 401.

Rule of Evidence 701 deals with opinion testimony by lay witnesses and provides:

If the witness is not testifying as an expert, the witness' testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue.<sup>167</sup>

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166. FED. R. EVID. 401.

167. FED. R. EVID. 701.

Although courts permit lay witnesses to testify as to the present value of property under Rule of Evidence 701,<sup>168</sup> the courts may not permit lay testimony as to future values or as to future decrease or increase in value.

Federal Rule of Evidence 702 provides for testimony by experts. The rule provides: "If scientific, technical, or other specialized knowledge will assist the trier-of-fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."<sup>169</sup> The party calling an expert must show that the expert possesses scientific, technical, or other specialized knowledge with regard to the opinion offered. Overall, the court must determine whether expert testimony will assist the trier of fact to understand the evidence or to determine a fact in issue.<sup>170</sup> The court also should determine whether the subject matter of the expert's testimony is based on "a reliable body of scientific, technical, or other specialized knowledge."<sup>171</sup> Bankruptcy courts should carefully scrutinize the opinion testimony of both lay and expert witnesses concerning future decrease in value prior to trial to determine whether the testimony meets the standards required by the Federal Rules of Evidence.

### B. The Court-Appointed Expert

Bankruptcy courts themselves could begin to take the initiative to protect debtors and creditors alike by using the Federal Rules of Evidence to appoint an expert to give a neutral opinion regarding the standards and measures of decrease in value. In addition, using experts in this manner also further distances a bankruptcy judge from the two-hatted role of being bargain-maker as well as judge.<sup>172</sup> Moreover, it would avoid the extreme differences in value that occur in a typical hearing.

### C. Appraisers as Expert Witnesses

Appraisers have become expert witnesses in bankruptcy cases almost by historical accident. Bankruptcy lawyers who frequently

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168. See, e.g., *In re Damron*, 8 Bankr. 323, 325 (Bankr. S.D. Ohio 1980).

169. FED. R. EVID. 702.

170. See *Ellis v. K-Lan Co.*, 695 F.2d 157 (5th Cir. 1983).

171. RUSSELL, BANKRUPTCY EVIDENCE MANUAL, § 702.3 (1987).

172. The Federal Rules of Evidence allow a court to make "its own motion," and to "enter an order to show cause why expert witnesses should not be appointed," and a court "may appoint expert witnesses of its own selection." FED. R. EVID. 706. All of the Federal Rules of Evidence "apply in cases [arising] under the [Bankruptcy] Code." BANKR. R. 9017.

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develop their acquaintance with bankruptcy law through general-litigation practice are familiar with using appraisers in valuation hearings. The types of valuation hearings that arise in a non-bankruptcy context generally are vastly different from the types of valuation hearings that a bankruptcy court conducts. For example, non-bankruptcy litigation typically focuses on the present or past value of property. Valuation hearings in bankruptcy cases, on the other hand, frequently focus on the future value of property. Bankruptcy courts expect expert witnesses to assist them in determining a future decrease in value of property.

Lawyers frequently make the following common errors when hiring an appraiser as an expert witness. First, lawyers may fail to inform the appraiser of the type of evidence and the most effective method of presentation of evidence in a bankruptcy court. Instead, the lawyer will simply contact the appraiser and request an appraisal. Typically, this results in an appraisal of the fair-market value of the property in question as of a certain date. Second, lawyers may not inform their appraisers that the appraisers are expected to testify concerning future value and future decrease in value until the appraisers are sitting on the witness stand in an adequate-protection hearing.

A lawyer's failure to inform expert witnesses and, in turn, the breakdown of communication between expert witnesses and the trial court often results in a poor record on appeal. The *Timbers I* court appeared to endorse the present state of the art of appraisal testimony when it remanded the case to the district court for further proceedings rather than suggesting appropriate testimony to determine the decrease in value, if any, of the secured creditor's claim.<sup>173</sup> Ironically, testimony by other "experts," such as economists, accountants, investment bankers, or brokers, may have been more relevant to the *Timbers* issues than was the appraisal testimony.<sup>174</sup>

## X. CONCLUSION

Neither lawyers nor judges can perform the difficult valuation task which the Code has imposed upon them in a legal vacuum. Valuation issues are emerging from the complexities of bankruptcy cases that demand legal standards against which to measure the facts admitted into evidence. Valuation issues, even findings of fact which form the basis for a value ruling, are predicated upon legal

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173. See *Timbers I*, 793 F.2d at 1416.

174. See *Timbers II*, 808 F.2d 363.

standards of relevance and admissability that lie within the powers of appellate courts to correct.<sup>175</sup>

This paper has briefly traced the emergence of some of the more significant valuation issues from their "origins" in *Wright* and *Murel* to their current influence on contemporary bankruptcy issues, although their influence impliedly has waned in the advent of the *Timbers* holdings.

In tracing the evolution of bankruptcy law, one must note that *Wright* and *Murel* involved two radically different situations. For example, in *Wright* an appellate court approved a short-term delay in a lender's right to obtain a foreclosure so as to permit a debtor to come up with the cash needed to redeem its property. In *Murel*, on the other hand, an appellate court declined to stay a foreclosure in view of the debtor's proposed "plan" to stretch out the secured creditor's loan over ten years. Although the facts of these decisions differ radically, courts, and especially the Fifth Circuit, have used *Timbers I* and *Timbers II* almost interchangeably as bearing on the issue of adequate protection. In other words, courts have interpreted these decisions to mean that adequate protection does not entitle an undersecured creditor to compensation for the delay between when a debtor files bankruptcy and when a court confirms a plan of reorganization.

The result of these rulings has been that lenders that now fail to receive compensation, during what can be lengthy periods of delay before a court approves the debtor's plan of reorganization, are closing their doors. To prevent more banks from going out of business and to aid lenders in their plight, the *Timbers* holdings should have outlined a means of determining value when a secured creditor raises the issue of indubitable equivalence<sup>176</sup> in substitution for the now-overruled measure of lost opportunity costs. In the alternative, these holdings should have formulated a solution that balanced the considerations outlined in *Wright* and *Murel* and provided some measure for determining when a delay in enforcement of a creditor's rights triggers the need for "valuing" the interest of the creditor whose rights are being delayed. Instead, the *Timbers* holdings place the burden of determining such standards on already overburdened bankruptcy judges, which will result in disparate, rather than uniform treatment.<sup>177</sup>

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175. *Ahlers*, 794 F.2d at 398 (quoting *Bose Corp. v. Consumer Union of United States, Inc.* 466 U.S. 485, 501 (1984)).

176. 11 U.S.C. § 361(3) (1988).

177. *Timbers II* stated that bankruptcy judges need to exercise "early and on-going judicial management of Chapter 11 cases." 808 F.2d at 373. Such statement would appear to

The Supreme Court's failure to articulate any rule or standard in *Timbers III* means practitioners must now find appropriate valuation evidence in a legal vacuum, as noted. Such evidence is complex and frequently involves several different value concepts, making reversal of a case on appeal more likely. No doubt appellate courts are mindful of Congress's express intent to fashion section 361 of the Code in generalities to permit flexible application on a case-by-case basis. However, a great difference exists between preserving the flexibility of the concept of adequate protection on the one hand and in preserving the current ambiguous state of the law governing application of valuation standards on the other.

Issues emerging from the complex task of defining standards of valuation, adequate protection, and indubitable equivalence continue to plague practitioners, expert witness and bankruptcy judges alike. Until governing rules of law emerge, bankruptcy practitioners should take care to enunciate clearly at trial, for purposes of preserving on appeal, the valuation standards, burden of proof, and rules of evidence, which they believe govern the matters to be heard by bankruptcy judges in their petitions.

The unwillingness of appellate courts to establish rules of law governing bankruptcy valuation has been disappointing. During the years since *Timbers I*, the Fifth Circuit has been plagued with the failure of countless financial institutions. The fate of many of these institutions may have been tied to their inability to realize significant value from collateral that was tied up in bankruptcy proceedings. For these institutions and for the public in general concepts such as "indubitable equivalence" and "adequate protection" have taken on a certain poignancy in hindsight. Bankruptcy courts have afforded lenders "protection" that fails to ensure the lenders' own survival, and the result has been the closing of many

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contradict the legislative history behind 11 U.S.C. §§ 361 to -363. When enacting 11 U.S.C. § 361, Congress evinced a clear intention to *remove* the Bankruptcy Court from the role of administrator:

This section specifies the means by which adequate protection may be provided. *It does not require the court to provide it.* To do so would place the court in an administrative role. Instead, the trustee or debtor in possession will provide or propose a protection method. If the party that is affected by the proposed action objects, the court will determine whether the protection provided is adequate. The purpose of this section is to illustrate means by which it may be provided and to define the contours of the concept.

H.R. REP. NO. 595, 95th Cong., 2d Sess. 338 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6295 (emphasis added).

The legislative history reflects Congress's concern that the concept of adequate protection remain flexible. This concept of flexibility is important to permit courts to adapt to varying circumstances and changing modes of financing. *Id.*

banks in Texas, for example. The opportunity costs that were lost may have been the opportunity to keep the banks' doors open for depositors.

Perhaps only the collapse of so many lending institutions into the Federal Deposit Insurance Corporation and the Resolution Trust Corporation<sup>178</sup> prevented a major fifth amendment challenge to the current application of adequate protection to undersecured creditors. However, as discussed above, the possibility of a "taking" issue hides behind the ambiguities plaguing bankruptcy valuations. Appellate courts should exercise every opportunity to clarify bankruptcy valuation issues so as to avoid such problems.

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178. The Resolution Trust Corporation is the successor to the Federal Savings and Loan Insurance Corporation.