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Adequate Protection Under the Bankruptcy Act of 1978

BY DONALD PRICE*

INTRODUCTION

In 1970, Congress created the Commission of the Bankruptcy Laws of the United States. Its purpose was to study and recommend changes in the existing bankruptcy law which had been enacted in 1897 and which, except for the Chandler Act of 1938, had resisted major revisions. The Commission's work resulted in the new Bankruptcy Act of 1978 (Act) which effected fundamental substantive and procedural changes in bankruptcy laws.

Despite the changes, the classic confrontation between trustee and secured creditor continues because of two basic conflicts. The first and most fundamental conflict occurs when the trustee, through his or her avoidance powers, attempts to invalidate the transfer of security from the debtor to the creditor. The second conflict occurs when the trustee proposes to retain and use the collateral in which the secured party has an interest.

Successful invalidation of the transfer precludes the second conflict. However, for the purposes of this Article, it will be assumed that the trustee's attempts to invalidate or avoid the transfer of security from the debtor to the creditor were unsuccessful so that the creditor now has a lien valid in bankruptcy. The creditor will expect to enforce the lien and to realize the expectations he had when he entered into the secured transaction, specifically the rights to repossess the collateral and foreclose upon its lien.5

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5 Article Nine of the Uniform Commercial Code [hereinafter cited as U.C.C.] embodies the creditor's expectations that he will be able to repossess the collateral and foreclose
In many chapter 11 and chapter 13 reorganization plans, the debtor must be able to use the collateral in order to be rehabilitated, and it is here that the battle lines are drawn. The filing of the bankruptcy petition by the trustee triggers the automatic stay of section 362, which prohibits the secured creditor from repossessing and authorizes the trustee to retain and use the collateral under section 363. The continuation of the stay and the retention and use of the collateral are conditioned upon the trustee's ability to provide adequate protection of the interests of the secured creditor.

This Article will examine the policy considerations behind the adequate protection concept, the legislative intent embodying that policy and the judicial treatment of both.

I. LEGISLATIVE POLICIES AND INTENT REGARDING ADEQUATE PROTECTION

The Commission of the Bankruptcy Laws faced two major problems when it was formed in 1970. First, the existing statutory scheme was inadequate to administer the increasing number of cases. Second, there was a perceived inadequacy of relief for

upon the lien. See § 9-503 wherein a creditor's right to repossess is set forth and §§ 9-504 and 9-505 which set forth the creditor's right to dispose of the collateral after repossession and foreclose the debtor's interest.

6 Chapter 11 of the Bankruptcy Act governs reorganizations.
7 Chapter 13 of the Bankruptcy Act governs adjustment of debts of an individual with regular income.
9 11 U.S.C. § 363 (Supp. V 1981) authorizes the trustee, within certain defined limitations, to use, sell or lease property of the estate. Such action would of course affect a secured creditor if its lien encumbered the property.
11 H.R. REP. No. 595, 95th Cong., 2d Sess. 4 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5965. Consumer credit became a way of life following the enactment of UCC Article Nine. This codification of a uniform, relatively simple set of laws governing the secured transaction gave creditors the protection they never had before, thereby permitting the number of these transactions to burgeon. The greatest protection, of course, is the right to repossess without notice which is set forth in § 9-305.
consumer debtors. The answer to the plight of the consumer debtor was the enactment of chapter 13 of the Act, which provides the consumer a fresh start but is meant to be used only as a last resort. The Act, however, contains strong protection for consumer creditors and the means to effectuate that protection. As such, the Act is not considered a "debtor's bill."

With respect to commercial credit, the Act reflects practical considerations. The policy clearly is to give a business the opportunity to work out its problems under the guidance of a trustee. If the business survives, the interests of owners, employees and creditors are served. At the same time, the drafters of the Act recognized the need to adequately protect the rights of secured creditors and thus keep the flow of credit open.

A. The Reasons for an Adequate Protection Requirement

In the world of commercial credit under the prior bankruptcy laws, the equities seemed to be balanced against the secured creditor, whose collateral was retained by the trustee for use in

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13 See note 7 supra.
15 H.R. Rep. No. 595, 95th Cong., 2d Sess. 118 (1978), reprinted in 1978 U.S. Code Cong. & Ad. News 6078. In fact, chapter 13 has become, if anything, the "Chapter of First Resort." Among other reasons, the more liberal discharge provisions of § 1328(a) (although not the "hardship" discharges under § 1388(G)) have made chapter 13 the primary avenue for consumer debtor relief and, consequently, the subject matter of much creditor and lender criticism. Congress is under increasing pressure to amend chapter 13 and to redesign its discharge provisions to match those of chapter 7, 11 U.S.C. § 727 (Supp. V 1981).
16 The most significant creditor protection section is § 1325(a)(5) of the Confirmation of Plan requirements. Here it is provided that the court will deny confirmation of the plan unless the debtor insures full payment to secured creditors of their "allowed secured claims." Hence, even though chapter 13 permits modifications of secured claims without creditor consent, the actual impact on the creditor is minimal. Furthermore, § 1322(c), in all but extraordinary situations, prohibits plans to extend beyond three years. The cumulative effect, the guarantee of full payment to a secured creditor in three or fewer years, is not likely to differ dramatically from the contractual obligation as unaffected by bankruptcy.
18 Id.
reorganizational proceedings. The lack of a specific statutory provision protecting the secured creditor's interest necessarily resulted in ad hoc court decisions providing little guidance to creditors, debtors or trustees. The Commission's response was section 363 of the Act which specifically authorizes the use, sale or lease of the secured creditor's collateral, but only upon a showing that the creditor's interest is "adequately protected." Since the use of collateral is an inherent aspect of nearly all chapter 11 and 13 proceedings, the enactment of section 363 was perceived as fundamental to the effectuation and operation of the Act's broad reorganization provisions.

In addition to the practical concerns leading to a statutory standard of protection, the concept of adequate protection is derived from the due process clause of the fifth amendment. That clause protects against the abridgment of property rights without just compensation despite the public purpose of the taking. When faced with the impairment of a mortgage lien in bankruptcy, the United States Supreme Court, in *Louisville Joint Stock Land Bank v. Radford*, stated:

The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment. Under the bankruptcy power Congress may discharge the debtor's personal obligation, because unlike the States, it is not prohibited from impairing the obligation of contracts . . . . But the effect of the Act (Bankruptcy) here complained of is not the discharge of Radford's personal obligation. It is the taking of substantive rights in specific property . . . .

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Notwithstanding any other provision of this section (363), at any time on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. In any hearing under this section, the trustee has the burden of proof on the issue of adequate protection.


23 Id. at 589-90 (citations omitted).
The Court further stated "the Fifth Amendment commands that, however great the Nation's need, private property shall not be thus taken even for a wholly public use without just compensation." 24

B. The Nature of the Interest to be Protected

The principle that a secured creditor holds a property interest which must be afforded protection is no longer disputed. However, the extent to which the secured creditor must be afforded protection has been the subject of argument.

Section 361 requires protection for "an interest of an entity in property." 25 Although it did not specifically define what an interest is, Congress provided some insight into the meaning of the section. 26 Congress recognized that the secured creditor should be guaranteed the "benefit of his bargain" while also recognizing that doing so would sometimes produce results inimical to chapter 11 and 13 proceedings and the broad-based policies of the Act. The "benefit of the bargain" would, at a minimum, include the right to repossess and enforce the lien in the property. Permitting the exercise of this right would result directly in what section 362 seeks to prevent—the piecemeal decimation of the debtor's estate. 27 Congress foresaw the impracticality of this result and stated: "Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for." 28 Judge Conrad Cyr, in In re American Kitchen Foods, 29 followed this intent when he made it clear that the value of the secured lien, not the amount of debt, is what is at stake when a creditor seeks protection of its interest. An undersecured creditor, to the extent the debt exceeds the value of the collateral, is afforded no greater protection than the creditor without security. 30

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24 Id. at 602.
27 Id.
28 Id. (emphasis added).
30 Congress, anticipating confusion, specifically eliminated the concept of the "secured creditor" by focusing instead upon the nature of the claim, secured or unsecured.
The United States Bankruptcy Court for the District of Utah in *In re Alyucan Interstate Corporation*, as part of an excellent analysis of the meaning of adequate protection, also discussed the extent of the property interest requiring protection. The creditor in *Alyucan* sought relief from a section 362(d) automatic stay. While the court found that the collateral value greatly exceeded the amount of the debt, it also found that value was quickly depreciating and thus allowed repossession. Quoting Justice Douglas in *Wright v. Union Central Insurance Company* that "there is no constitutional claim of a creditor to more than [the value of the interest in property]," the court in *Alyucan* went on:

Thus the "interest in property" entitled to protection is not measured by the amount of the debt but by the value of the lien. A mushrooming debt, through accrual of interest or otherwise, may be immaterial, if the amount of the lien is not thereby increased, while vicissitudes in the market, loss of insurance or other factors affecting the value of the lien are relevant to adequate protection. The purpose of adequate protection is to assure the recoverability of this value during the hiatus between petition and plan, or in the event the reorganization is stillborn, between petition and dismissal.

The amount of the obligation, therefore, is irrelevant for adequate protection purposes. The focus will always be on the collateral and the multiple variables affecting its value since the value of the lien is dependent upon the value of the collateral.

C. Adequacy of Protection—Valuation and Compensation

The nature of the creditor's interest and the requirement that the interest be protected are firmly established concepts. However,
the manner and adequacy of protection will continue to present major problems, given the infinite number of facts and circumstances that may arise. It is the facts of each case, thoughtfully weighed and not formulized, which determine adequate protection.\footnote{Id. at 813.}

Section 361\footnote{11 U.S.C. § 361 (Supp. V 1981). See text accompanying note 68 infra for the text of the statute.} of the Code defines three methods for providing adequate protection:\footnote{The House amendment to H.R. 8200 originally included a fourth method of providing adequate protection—affording the secured party an administrative expense priority. 11 U.S.C. § 507(a)(1) (Supp. V 1981). This is a first level priority expense and the first to be paid after secured creditors. Congress eliminated it because of the uncertainty of whether the estate will have sufficient proceeds to pay administrative expenses in every case. 124 CONG. REC. 11, 11089 (1978) (statement by Hon. Don Edwards); H.R. REP. No. 595, Pub. L. No. 95-598, 1978 U.S. CODE CONG. & AD. NEWS 5963, 6444. The concept remains embodied in § 507(b), which provides that if, in fact, the protection proves to be inadequate a claim resulting from the automatic stay is entitled to a first priority administrative expense.} 1) periodic cash payments, 2) replacement liens and 3) any other method which will adequately protect the interests in question. The first two methods are specific and definable and thus will be used whenever possible. However, Congress wisely enacted a catch-all provision in subsection 3 to give the courts wide latitude in effectuating the broad remedial policies of bankruptcy legislation. Congress intended section 361 to be illustrative only, not exclusive or exhaustive.\footnote{H.R. REP. No. 595, 95th Cong., 2d Sess. 338 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6295.} This Congressional policy and intent clearly shows that the courts must adopt a flexible attitude toward valuation of the protected interest, since implementation of adequate protection depends upon proper valuation.

Historically, valuation has been a vague and troublesome concept and has been the vehicle by which courts have reached the desired results. For example, by focusing upon the principle that a secured creditor's interest must be valued as if unaffected by bankruptcy, the court in In re American Kitchen Foods\footnote{9 COLIER BANKR. CAS. 537 (Bankr. N.D. Me. 1976). This case was decided under the old act; nonetheless, its principles apply to the new law.} salvaged a corporate reorganization plan. The creditor was secured
pursuant to Article Nine of the Uniform Commercial Code. According to Judge Cyr, an Article Nine creditor must dispose of the collateral in a commercially reasonable manner which would result in realization of fair market value. Thus valued, the collateral in the case has sufficient equity to support its continued use without impairing the lien under Article Nine and therefore satisfied the constitutional test which the trustee had to meet.

In enacting section 361, Congress recognized that a valuation standard cannot be absolute:

Neither is it expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes. In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations based on the facts of the case. It will frequently be based on negotiation between the parties. Only if they cannot agree will the court become involved.

It is important to note that in many reorganization cases, survival of the troubled concern is in the secured creditor’s best interest. Where the interests of the creditor and debtor thus coincide, the two should be able to agree to a valuation of the collateral and the protection it requires.

The thrust of the adequate protection requirement is to assure maintenance of the value of the lien; it is, therefore, compensatory in nature. Periodic payments and lien replacement certainly compensate for any decrease in the value of an interest in property. It has been argued that section 361(3), the catchall provision, is also compensatory in origin. Under this analysis, all

42 9 Collier Bankr. Cas. at 537. See U.C.C. § 9-504(3) (1972). The secured party must foreclose its lien in a commercially reasonable manner or be subjected to a penalty under U.C.C. § 9-507 (1972).


44 Id. at 6295-96.

45 In re Alyucan Interstate Corp., 12 Bankr. at 808.


47 In re Alyucan Interstate Corp., 12 Bankr. at 811 n.15.
forms and methods of adequate protection must be compensatory, thereby ruling out the controversial "equity cushion" as the sole means of adequate protection.

D. When Adequate Protection Is Required

The Act mandates at least three situations when the trustee or debtor-in-possession must afford adequate protection to an impaired lien holder. The first situation arises when the creditor is stayed from enforcing his lien. The mere filing of the petition triggers the automatic stay which prevents any act to enforce the lien of a creditor either through the judicial process or self-help repossession. The maintenance of this stay is contingent upon providing adequate protection under subsection 362(d)(1).

Although subsection 362(d)(1) plainly directs a court to modify or terminate a stay when the creditor shows a lack of adequate protection, subsection 362(d)(2) adds a confusing dimension to judicial considerations of the automatic stay. Section 362(d) in its entirety provides:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

This section distinguishes an "interest in property," protected by subsection 362(d)(1), from "a stay of an act against property," pro-

48 For a discussion of the concept of "equity cushion," see notes 80-151 infra and accompanying text.
51 Id.
tected by subsection 362(d)(2). The latter subsection was enacted to resolve the problem of real property mortgage foreclosures where the bankruptcy petition is filed on the eve of foreclosure. However, it has been noted that courts "have shown indifference on this score and have applied (d)(1), which refers to adequate protection of an 'interest in property,' to relief from stay actions concerning property." An important result of this judicial indifference is that secured creditors are denied relief in situations where the right to proceed under subsection (d)(2) with lien enforcement is clear. If, for instance, a debtor files a petition in bankruptcy a day or two prior to the foreclosure sale, it appears from the literal reading of subsection 363(d)(2) that the debtor's ability to afford substantial periodic payments and even a replacement or an additional lien would not be relevant in a hearing upon the creditor's petition to lift the automatic stay if 1) the debtor had no equity and 2) the collateral was not necessary to an effective reorganization. This argument could be applied with equal force to personal property collateral such as equipment or inventory.

The second instance in which the secured creditor is entitled to adequate protection occurs when the trustee exercises his or her fundamental rights under section 363 to sell or lease collateral in which the secured party has an interest. Congress has indicated that this provision applies with more force in reorganization cases in which the continuation of the concern is indispensible to the survival of the plan than in liquidation cases.

Prior bankruptcy law did not contain comparable provisions. However, section 363 which codifies and reaffirms case law, recognizes that if reorganization chapters are to provide viable, remedial relief, the trustee must have a great deal of discretion to deal with the property of the estate. This results in considerable

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55 In re Alyucan Interstate Corp., 12 Bankr. at 811 n.17. See note 92 infra for a review of some of the cases in which the distinction between subsections (d)(1) and (d)(2) of section 362 has been confused.
exposure for secured creditors when that property happens to be collateral for their loans. Recognizing this, Congress enacted section 363 as “protection for both the debtor in operation of his business, and the secured creditor, in its interest in the property used.”

Section 363 does make important distinctions between the types of collateral affected, between sales in and out of the ordinary course of business, and among types of interests protected. Whatever the type of collateral, proposed disposition or interest at stake, the entity affected is entitled to adequate protection under section 363(e).

The third circumstance under which an entity with an interest must be afforded adequate protection is contained in section 364 which provides in part:

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

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

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

(3) secured by a junior lien on property of the estate that is subject to a lien.

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64 11 U.S.C. § 363(e) (Supp. V 1981). This subsection provides: Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold or leased, by the trustee, the court shall prohibit or condition such use, sale or lease as is necessary to provide adequate protection of such interest. In any hearing under this section, the trustee has the burden of proof on the issue of adequate protection.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—
(A) the trustee is unable to obtain such credit otherwise; and
(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.66

The operative elements of this section contemplate a battle between an existing secured creditor and a prospective one for unused equity in the same collateral. Any new creditor would demand and receive a superpriority which the trustee could grant only if adequate protection is afforded to the existing creditor.67 Given the nature of the debtor's economic circumstances, the likelihood of excess equity is remote. Hence, the vulnerability of a secured creditor seems minimal.

II. COMMERCIAL REALITIES AND JUDICIAL INTERPRETATIONS OF ADEQUATE PROTECTION

The concept of adequate protection is defined in section 361 of the Act as follows:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
(1) requiring the trustee to make periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.68

Congressional policy underlying the enactment of section 361 is clearly reflected in subsection (3). That policy was to allow trustees, and ultimately the courts, almost unfettered discretion to carry out the broad purposes of the Act.69

A. The Effect of Commercial Realities

Unfortunately, from the perspectives of both the creditor and debtor, the realities of bankruptcy proceedings usually result in that which Congress intended to avoid—a dramatically limited ability to protect secured creditors whose interests will be affected by the bankruptcy proceedings. The secured creditor's argument is that his interest in the debtor's property can be adequately protected only by permitting enforcement of the lien. Any protection short of that will be regarded as inimical to his best interests. Conversely, the typical debtor will have unbounded faith in his ability to survive and thereafter prosper, a result which will protect the interests of all creditors. The truth lies somewhere between these two extremes.

Ideally, to protect the secured creditor, a debt should be repaid with periodic payments70 and the collateral securing the debt

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69 The legislative history states that it is the function of the debtor and trustee to propose the plan of adequate protection and that the court's role is to review only its adequacy. H.R. REP. No. 595, 95th Cong., 2d Sess. 338 (1978), reprinted in 1978 U.S. CODE CONC. & AD. NEWS 5963, 6295. Nothing in the legislative history suggests, however, that the court cannot supplement the plan with its own ideas in the interest of an equitable result which ultimately is the protection of all creditors, not only the secured creditor.
should be property in which the debtor has sufficient equity. Bankruptcy, however, simply does not present ideal situations. Rarely will a debtor have sufficient equity in collateral or be able to make periodic payments of any significance. This is especially so in chapter 11 reorganization proceedings where most assets are quickly depreciating equipment and inventory. In contrast, in a chapter 13 wage earner proceeding, where the largest secured creditor generally will be a residential mortgagee, there is a greater possibility of substantial equity. The prospect of this “cushion of equity” may in itself suffice as adequate protection.\(^7\)

Generally, an economically troubled debtor cannot make periodic payments large enough to compensate for the decreased value of the secured party’s interest resulting from the automatic stay or from the use of the collateral. The decrease in the value of the collateral is a natural result of depreciation, a factor considered by the creditor before extending credit and fixing the amortization schedule. Consequently, to compensate fully for the decrease in value, the payments will have to equal the contractual amount. Yet one of the primary circumstances forcing a debtor to seek relief in bankruptcy is inability to meet its contractual obligations as they mature. Although the creditor in most cases is not necessarily entitled to the contractual amount\(^7\) as adequate protection, the greater the divergence from the contract obligation by the debtor, the less likely it is that payment will be available as adequate protection.

A replacement or additional lien is a second method of adequate protection offered by section 361.\(^7\) However, the assets of the typical chapter 11 debtor will be so heavily encumbered that little or no equity remains to secure other liens. Only in rare cases\(^7\) will section 361(2) be used by the debtor or trustee.

\(^7\) For a discussion of the concept of “equity cushion,” see notes 80-151 infra and accompanying text.
\(^7\) See In re American Kitchen Foods, 9 COLLIER BANKR. CASES 537, in which Judge Cyr, dealing with the old act, discussed the concept of “impairment of lien,” a concept similar to the adequate protection of an “interest of an entity.” In the case, he was able to offer the creditors a valuable, totally unencumbered asset as additional collateral.
There remains, then, the "indubitable equivalent" alternative of section 361(3). This concept was first discussed by Judge Learned Hand in *In re Muriel Holding Corp.*:

It is plain that "adequate protection" must be completely compensatory . . . . [A creditor] wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

Judge Hand used the word "substitute" whereas section 361(3) speaks of "such other relief." Both reflect congressional policy and, in a sense, define the concept without limiting its application in any way. Thus, the debtor must devise ways under any or all of the three subsections of section 361 to protect interests of secured creditors as well as its own interests.

B. Adequate Protection and the "Equity Cushion"

Subsection (3) of section 361 is then of vital importance. It is here, if at all, that the trustee has the flexibility to maneuver and fashion arguments for the court's consideration. The trustee's response has generally been to rely on an "equity cushion," the amount by which the value of the collateral exceeds the debt.

Given the importance of this concept to the orderly functioning of reorganizational proceedings, it is vital for courts to develop minimal standards and guidelines regarding what constitutes an acceptable equity cushion.

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76 75 F.2d 941 (2d Cir. 1935).
77 Id. at 942.
79 It should be safe to assume that the Bankruptcy Commission, had it been able to devise other specific methods of adequate protection, would have listed them in § 361.
80 This "equity cushion" must be distinguished from equity in assets other than the secured creditor's collateral.
81 That Congress intended maximum flexibility is apparent from the legislative history which states: "It is expected that the courts will apply the concept [of adequate protection] in light of facts of each case and general equitable principles." H.R. REP. NO. 595, 95th Cong., 2d Sess. 339 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6295.
The standard for an acceptable equity cushion must incorporate two fundamental concepts: 1) maximum judicial flexibility; and 2) recognition of the difference between chapter 11 and chapter 13 proceedings. In chapter 13 proceedings, the collateral will generally be the debtor's residence. The secured party will be seeking to foreclose on the mortgage. The value of the collateral is readily fixed and controlled by a constant market; the amount of debt is always known. Chapter 11 reorganization plans, however, present a strikingly different picture. There are many types of collateral, and a single security agreement can have varying combinations of collateral. The reasons for retention and use of the collateral can vary with each plan. In contrast to the collateral of a chapter 13 debtor, the equity cushion is less readily determined because the value of the collateral is less controlled by a constant market. The determination of the adequacy of the equity for adequate protection purposes thus becomes an allocation of risk between the competing interests of the debtor and creditor and is perhaps the most crucial function the court performs, especially in the early stages of bankruptcy. Reaching an equitable resolution of this problem certainly maximizes the chances for survival of the plan. Absent such resolution, the trustee may be forced to relinquish the property, thereby jeopardizing the debtor's plan of reorganization and the interests of the remaining creditors.

Formulating any standards in bankruptcy must include a balancing of the interests of the secured creditor against the remedial purposes of the bankruptcy laws. The latter consideration suggests, especially early in the proceedings, a balancing of equities in favor of the debtor so as to effectuate the underlying bankruptcy policy of rehabilitation. Realistically, though, this process must also reflect the recognition that a creditor who is secured became so through a bargaining process resulting in an equity figure deter-

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82 Under 11 U.S.C. § 362(d)(2) (Supp. V 1981), if there is no equity and the property is not necessary for reorganization, the stay must be lifted. It can be argued that the residence of an individual debtor under 11 U.S.C. ch. 13 (Supp. V 1981) is always necessary for reorganizations; thus, the focus would always be upon the presence or absence of equity.


84 Massari, Adequate Protection Under the Bankruptcy Reform Act, ANNUAL SURVEY OF BANKRUPTCY LAW 174, 189 (1979).
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mined essentially by exigencies of the parties and of the market place. Bankruptcy intervenes when the creditor's secured interest is buffered by a collateral-to-debt ratio either the same as negotiated or reduced by external events over which the creditor theoretically had control. It is this interest, the collateral-to-debt ratio figure at the time of the hearing on the issue of adequate protection, which requires protection. It is not the business of the courts to protect a creditor from the uncertainties of the market place or from his own neglect in failing to police his collateral.

If, at hearing time, the collateral-to-debt ratio is in fact sufficient to protect the secured party's interest, then the stay should remain in effect. Where the ratio is not less than that "bargained for" plus a reasonable buffer, an equity cushion without more theoretically should afford adequate protection. Although this kind of protection is not compensatory in nature, it realistically offers the balanced protection between creditor and debtor which section 361 contemplates. Any equity of less than the "bargained for ratio" plus a reasonable buffer should be coupled with additional protection either by payments to reduce the debt or by providing additional collateral, if possible.

The equity question cannot be resolved without a valuation of the property. Valuation is an imprecise and somewhat arbitrary process usually involving consideration of conflicting expert appraisals which reflect the "wishes" of the parties rather than actual value. The result is often a compromise figure lying somewhere between the two conflicting appraisals, thus pleasing no one. Nonetheless, the compromise is itself an integral part of the balancing of interests since it generally is struck somewhere between a "going concern" value (fair market value) and a "forced sale" value (generally the value on sale by an economically depressed debtor).

56 Massari, supra note 84, at 189.
57 See In re Gaslight Village, Inc., 8 Bankr. 866, 871 (Bankr. D. Conn. 1981) and numerous other citations contained therein. While a few courts have subscribed to this concept, most require more than an equity cushion.
58 For a discussion of the concept of "indubitable equivalence," see text accompanying notes 75-79 supra.
59 Massari, supra note 84, at 187.
60 See In re American Kitchen Foods, 9 COLLIER BANKR. CAS. 537, for an excellent
Congress intended maximum flexibility in valuation as is reflected in the House Report:

This section [11 U.S.C. § 361 (Supp. V 1981)] does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development. It is expected that the courts will apply the concept in light of facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result. There are an infinite number of variations possible in dealing between debtors and creditors, the law is continually developing, and new ideas are continually being implemented in this field. The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.⁹¹

C. Judicial Treatment of the Equity Cushion and Adequate Protection

Legislative history notwithstanding, adequate protection will be whatever a given court concludes it is with respect to the facts at hand. The courts seem to be balancing interests of the debtor and creditor wherever possible, and to do so they must discuss the equity cushion because it is upon this cushion that the foundation of adequate protection is built.⁹² As a result, discussions of the


The courts in these cases blur the distinction between subsection (d)(1) and subsection (d)(2) of 11 U.S.C. § 362 (Supp. V 1981). For a discussion of this distinction, see text accompanying notes 54-56 supra. The court in In re Pleasant Valley, Inc., for example, discussed in detail the two conjunctive elements of 11 U.S.C. § 362(d)(2) (Supp. V 1981) even though the case apparently did not involve the “stay of an act against property.” Although the court was correct in saying that the equity cushion is a factor under both subsections (d)(1) and (d)(2) of 11 U.S.C. § 362 (Supp. V 1981), there appears to be no basis for considering the indispensability of property to the reorganization under subsection (d)(1) unless as an element of “for cause.” If it is such an element, the court did not
equity cushion as an integral part of adequate protection pervade court opinions. Even though courts occasionally conclude that the cushion, standing alone, can afford adequate protection,93 relatively few cases have not required more. An interesting illustration of a court's reluctance to regard the cushion as adequate protection without more is found in In re First Century Trust Co.94 The facts reveal equity sufficient to protect a second mortgage seeking to foreclose. The court, however, called the circumstances "unique," and instead of simply denying the mortgagee's request to lift the stay on the equity basis, denied the stay, saying that to do otherwise would imperil priority and unsecured creditors.95 In fact, there is nothing unique about protecting unsecured and priority creditors; it is one of the primary reasons for allowing chapter 11 reorganizations, although this protection is often couched within the language that the property is necessary for an effective reorganization.96

One factor which might explain why courts usually link other protection with the equity cushion is the language of section 361 which appears to mandate affirmative action of some kind: subsection (1) "requiring . . . cash payments"; subsection (2) "providing . . . such equity"; subsection (3) "granting" such relief.97 this language and the courts' application of it are consistent with the concept that adequate protection must be compensatory in nature and that equity alone is not enough.98

1. Decisions Finding Adequate Protection of Real Estate Collateral

Cases where the adequate protection of a creditor's interest have been found reveal nothing particularly startling or innovative.


93 Curtis v. Delaware Valley Sav. & Loan Ass'n, 9 Bankr. 110, 112 (Bankr. E.D. Pa. 1981) (citing five cases reaching the same conclusion). The court in Curtis found the equity cushion to be completely compensatory in nature. Id.


95 Id. at 209.


98 See text accompanying notes 45-48 supra for a discussion of this principle.
Some examples of adequate protection are: FHA insured mortgage and periodic payments to both the mortgagor and FHA; equity cushion, periodic payments and a federally insured mortgage; equity cushion and periodic payments upon the mortgage to the trustee under the plan and directly to the mortgagor; equity cushion and periodic payments.

Occasionally, a court has found adequate protection in the absence of an equity cushion, but usually upon stringent conditions or under unique circumstances. The court in *In re Pleasant Valley, Inc.*, took judicial notice of the impact of inflation upon real property values and conditioned the continuation of the stay upon payment of all taxes, insurance and interest, provision of additional security and a showing of reasonable dispensability of the collateral to the survival of the plan.

No equity cushion was involved in *In re El Patio, Ltd.* The collateral was an apartment complex undergoing condominium conversion. The creditor, a bank, had contracted with the debtor on an unsecured basis after zoning problems temporarily suspended the conversion. The court found adequate protection and continued the stay for 120 days, concluding that the creditor had "bargained to share the entrepreneurial risk for one year." (The 120 days concluded that one year.) Clearly the deciding factor was that the bank should be held to its own bargain and that the continuation of the stay added no risk beyond what was voluntarily assumed by the bank when the deal was struck.

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102 *In re Barkley-Cupit Enters., Inc.*, 13 Bankr. 86 (Bankr. N.D. Ga. 1981), aff’d, 677 F.2d 112 (Bankr. 5th Cir. 1982). Here, although there were sufficient equity and periodic payments, lifting the stay would have given the creditors a considerable windfall. The creditor, a lessor-optioner, would have been the beneficiary of a substantial equity from the defaulting debtor, a lessee-optionee, since the value of the real estate greatly exceeded the option purchase price specified in the lease. The equity cushion appeared to be less of a factor in the denial than the prospective windfall. 13 Bankr. at 92.

103 6 Bankr. at 13.


105 *Id.* at 523.
The court also found a creditor's interest protected absent an equity cushion in *In re Roselli.*106 There, the creditor was the mortgagee of a federally insured mortgage. However, since the court granted relief from the stay under section 362(d)(2)107 despite adequate protection, the weight of the finding of no cushion cannot be fairly assessed.

2. *Cases Involving Adequate Protection of Personal Property Collateral*

In each of the cases discussed above, the collateral was real estate which constituted the sole or primary asset of the business. While real estate can be leased or sold, it cannot be "consumed."108 The risks to a secured creditor are therefore known and relatively fixed. Equity is of paramount concern and depreciation is generally not a factor.

These factors change dramatically when the interest to be protected is in personal property. Typically the proceeding will be a chapter 11 reorganization. The collateral will be fixtures, stock, inventory, accounts or proceeds and, frequently, all of these will be the subject matter of the same secured transaction. The chance that the collateral will be consumed or lost will be constant and real. Here, rapid depreciation of equipment and fixtures, as well as consumption of inventory and proceeds, is of primary concern. When the vexatious question of valuation is added to the foregoing concerns, the issue of adequately protecting the creditor becomes troublesome indeed. Further, these kinds of collateral form the nucleus for many businesses and, thus, nearly always will be necessary for reorganization and will prevent granting relief from the stay under section 362(d)(2).109

All of these variables naturally attendant to moveable and consumable collateral render rigid formulae and inflexible standards

109 Again, if the petition to lift the stay is brought under 11 U.S.C. § 362(d)(1) (Supp. V 1981), the only issue is adequate protection, and not the indispensability to reorganization, unless considered as an element in the phrase "for cause."
meaningless. The approach the court should take is one of restraint and patience. Hasty action is likely to result in no benefit, and the probable death of a business when the possibility of a successful reorganization remains.\textsuperscript{110}

The circumstances under which courts have found adequate protection of a creditor's interest in personalty are as varied as the types of businesses involved; and although the concept of an equity cushion may be fleeting or even illusory, it nevertheless plays a vital role. \textit{In re Wheeler}\textsuperscript{111} presented the classic chapter 11 scenario. The collateral was a single piece of equipment, a log skidder. The debtor worked as a logger, and the equipment was essential to an effective reorganization. The equity cushion was negligible—less than \$1,000. Although the debtor had been making monthly payments sufficient to keep the creditor fully secured, the credit was concerned about depreciation of the asset and erosion of the equity cushion.\textsuperscript{112} The question before the court appeared to be whether the periodic payment had to equal the contractual amount, an amount equal to actual depreciation, or an amount somewhere in between. Rejecting the creditor's argument that adequate protection required the contractual payment, the court interpreted section 361 to mean:

that the debtor has given proper assurance to the creditor that the latter's interest in the collateral is protected while the right of possession is denied to the creditor . . . . Yet at the same time, adequate protection does not necessarily mean that the secured creditor is put in the same position it was in when it initially negotiated the transaction.\textsuperscript{113}

This last conclusion is vital with respect to personalty, the depreciation of which quickly erodes the equity which existed when the deal was struck. Consequently, affording adequate protection even though little or no equity exists is fundamental to the survival of chapter 11 as a viable alternative to liquidation.

The determination of the equity cushion where personal property is involved can be a tortured and convoluted process. The

\textsuperscript{111} Id.
\textsuperscript{112} Id. at 909.
\textsuperscript{113} Id. (citation omitted).
burden of proof on the issue belongs to the creditor. In re A & A Transport, Inc. is an interesting portrayal of how far a result-oriented court will go. The collateral in this instance was two trucks which the court indicated, without specifically finding, were necessary to reorganizational efforts. The debt on the date the petition was filed exceeded $24,000. The value of the collateral was $14,000 based upon the debtor's own stated values set forth under oath on its Schedule of Debts. The creditor relied upon the debtor's stated valuation, assuming he had met his burden of proof. The court, however, accepted the debtor's expert appraisal value of $34,000 and found a substantial equity cushion, concluding that the creditor failed to sustain his burden on the issue of equity. Dismissing the debtor's "stated value" as an arbitrary figure offered in haste to file the petition, the court concluded:

As a result, it is possible that the "scheduled value" and the actual "market value" may differ substantially. This court has always relied more heavily upon the appraisals of experts in valuing property than on debtors whose estimates may bear no relationship to reality. I have often said that there is no more elusive term in the English language than the word "value."

While the last comment may be somewhat hyperbolic, it does reflect the continuing uncertainty surrounding the issue of adequate protection, especially valuation. If precise value is unascertainable, then necessarily, so too is adequate protection. To compound matters, the court in In re A & A Transport, Inc. gratuitously offered its opinion why values stated even under oath should be disregarded, although apparently no evidence was before the court to support the conclusion that the stated values had no basis in fact. Certainly it was crucial to the debtor to keep the trucks and to do so, the higher appraisal values were necessary. It is arguable, however, that spontaneously stated values may well be

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115 10 Bankr. at 867.
116 The court could have dispensed with the equity issue if it had found the collateral was necessary for reorganization. Under 11 U.S.C. § 362(d)(2) (Supp. V 1981) only one of the two factors need be present to deny relief from the automatic stay.
117 10 Bankr. at 869-70.
118 Id. at 869.
more closely related to reality than values affixed after time for reflection. Faced with such convoluted reasoning, there should be little wonder why creditors regard the issue of adequate protection as a major problem throughout the life of the plan.

*In re A & A Transport, Inc.* is a case where the creditor presented no evidence of value. What about the situation where both parties present conflicting evidence of value? The court in *In re Heatron, Inc.*

faced this problem and concluded that, at least in the early stages of reorganization, the court should resolve the issue in favor of the debtor. Although the court cited no authority for its conclusion, its decision is consistent with the "no early death knell" policy set forth by the *Wheeler* court.

The *Heatron* court also faced the question of valuation, called it crucial and then subscribed to the "commercially reasonable" standard of Article Nine of the Uniform Commercial Code. This standard translates into the "fair market" or "going concern" value which was exhaustively analyzed by Judge Cyr in *In re American Kitchen Foods, Inc.*

In *Heatron* the collateral was equipment, fixtures, tools, accounts and inventory, existing and after acquired. The creditor claimed there was insufficient protection to permit the debtor to use cash collateral, a particularly sensitive prospect for creditors. The court disagreed and found a sufficient equity cushion in other collateral to support the debtor's use of cash collateral, but only under the following strict conditions: certified monthly statements; weekly reports of new accounts; running accounts of inventory and of equipment purchased or sold; periodic payments on principal; and payment of interest, taxes and rent.

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120 Id. at 496.
121 12 Bankr. at 910. See text accompanying notes 111-113 supra for a discussion of *Wheeler*.
122 6 Bankr. at 495.
123 9 Collier Bankr. Cas. at 537. See notes 41-43 supra and accompanying text for a discussion of *In re American Kitchen Foods, Inc*.
124 6 Bankr. at 493.
126 6 Bankr. at 496-97.
Courts must impose strict controls in instances where cash collateral is used in order to encourage the giving of credit and investment. It is natural for a creditor to become nervous when its debtor seeks bankruptcy relief. The anxiety increases when the creditor's collateral is sold and its replacement, cash or its equivalent, is diverted elsewhere. Congress recognized this by enacting section 363(c)(2) which prohibits the use of cash collateral without a hearing, absent creditor consent.

Other combinations of factors found to constitute adequate protection include the following: equipment necessary for reorganization; an equity cushion of between $61,000-$81,000 requiring a payment of $35,000 within sixty days; stock collateral necessary for reorganization; and an equity cushion sufficient to support the use of cash collateral for ninety days without payments to the creditor.

In re American Mariner Industries, Inc. is one of the few cases in which a court has summarily dismissed the discussion of equity as irrelevant. Instead, the court concluded that the collateral was indispensable to effective reorganization and ordered periodic payments to compensate for any depreciation or depletion of the collateral. The court was correct that lack of equity is irrelevant under section 362(d)(2) with respect to a stay of an act against the property where there is a specific finding of necessity for reorganization. However, the court spoke only in terms of relief based on inadequate protection, which is governed by section 362(d)(1) and under which the issue is adequate protection. Equity here is not only relevant, but crucial. The court's reasoning illustrates how the distinction between these two sections is blurred. The requirement of periodic payments, however, is

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131 In re Xinde Int'l, Inc., 13 Bankr. at 212.
132 10 Bankr. at 711.
133 Id. at 714.
136 See note 92 and text accompanying notes 55-56 supra for a discussion of this blurring of distinction.
consistent with a request for relief based on inadequate protection under section 362(d)(1)\textsuperscript{137}

3. **Decisions Finding Inadequate Protection**

The primary concern of the courts in cases finding inadequate protection is the question of equity since its absence indicates a lack of adequate protection. The court in *In re Accent Associates, Inc.*,\textsuperscript{138} found no equity whatsoever and no reasonable possibility of effective reorganization within a reasonable time. The court adopted the evidence of lower valuations, apparently influenced by the fact that no reasonable plan of reorganization had been offered. The court apparently concluded that, given the long delay in filing the reorganization plan and the bleak prospects for reorganization, a continuation of the stay would be inequitable and prejudicial to the creditor.\textsuperscript{139} Conversely, conflicts raised early in the proceedings are likely to be resolved in favor of the debtor and reorganization.\textsuperscript{140}

In *In re Presock*,\textsuperscript{141} the court found no equity cushion and lifted the stay despite a federally insured mortgage which, the court concluded, did not of itself equal adequate protection.\textsuperscript{142} Prompting the result in this case was the fact that the debtor had not made a single payment on the mortgage since its creation.\textsuperscript{143}

A debt of $606,000, partially secured by property valued at $350,000 coupled with no plan of reorganization resulted in a holding of inadequate protection in *In re High Sky, Inc.*\textsuperscript{144} The collateral there was a 435-acre tract of mountain land intended as an ecologically balanced private community. Although the speculative nature of the project troubled the court, its primary concern was the lack of equity cushion.\textsuperscript{145}

\textsuperscript{138} 8 Bankr. at 933.
\textsuperscript{139} Id. at 936-37.
\textsuperscript{140} See text accompanying notes 119-21 supra for a discussion of this principle.
\textsuperscript{142} See also *In re Heath*, 9 Bankr. 665 (Bankr. E.D. Pa. 1981).
\textsuperscript{143} 9 Bankr. at 678.
\textsuperscript{144} 15 Bankr. at 332.
\textsuperscript{145} Id. at 336-37.
An initial finding of sufficient equity was vacated by the court in *In re Gaslight Village, Inc.* because of a continuing erosion of the cushion caused by, among other factors, the debtor's failure to file a plan of reorganization for fourteen months. The debtor here offered additional "protection" in the form of junior liens on apartment complex equipment, including refrigerators. The court concluded that this junior lienholder status was "cold comfort" to the creditor.\(^{147}\)

In instances where the collateral is personal property, the focus also has been upon equity. The collateral in *In re Penn York Mfg., Inc.* was equipment and accounts. The court found not only a lack of equity, but also a deficiency. No payment had been made on the indebtedness since its inception, and therefore the debtor's proposal to pay the interest did not qualify as "periodic cash payments equivalent to a decrease in value."\(^{148}\) Also, there was no realistic prospect for a successful rehabilitation under chapter 11.

Finally, an automobile valued at $5,000 encumbered by a debt of twice that amount prompted a lifting of the stay in *In re Daws* when the only ray of hope was the debtor's promise to pay, a promise made previously but not kept. Similar cases where courts concluded protection was lacking show no significant digressions from the reasoning and conclusions of the above cases.\(^{151}\)

**Conclusion**

The bankruptcy process, by its nature, precludes creditors and debtors from a harmonious existence. The process with respect to them is adversarial; bankruptcy forces their diametrically opposed interests into direct conflict, thereby raising issues frequently incapable of equitable resolution. The Bankruptcy Court as a court of equity is charged by Congress, through the enactment of sect-

\(^{146}\) 8 Bankr. at 866.

\(^{147}\) Id. at 871.


\(^{149}\) Id. at 53.


tion 361,152 with the mandate to protect these competing interests while preserving the remedial nature of the proceedings. This is a formidable task indeed. The concept of adequate protection is amorphous and vague and, if applied capriciously or arbitrarily, will result in irreparable harm. Evidence indicates that the courts have handled the issue with a healthy degree of sensitivity to the interests of all. The results thus far argue well for the maintenance of a viable, effective bankruptcy process in which credit can be safely extended and expectations reasonably fulfilled.