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Limitations on the United States Trustee's Power to Appoint Committees: Lessons from PG&E

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From the Bankruptcy Courts

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Superpriority Status for Inadequately Protected Secured Creditors: Not Just for the Asking

The rights of secured creditors are affected immediately upon the filing of a bankruptcy petition by or against the debtor. In particular, the filing results in the automatic stay of the enforcement of liens against the debtor's assets.[1] The Bankruptcy Code also provides that the debtor may continue to use its property, including collateral securing prebankruptcy obligations, in the ordinary course of business.[2] However, the Code entitles the secured creditor to "adequate protection" of its security interest.[3] If the secured creditor's interest is not adequately protected, the court is required to grant its request for relief from the automatic stay or its request for an order prohibiting or conditioning use of the collateral necessary to provide adequate protection.[4]

A common example of a secured creditor not being adequately protected is when the value of collateral securing the creditor's claim is deteriorating or depreciating below the balance of the debt so that the passage of time will erode the creditor's lien, thereby increasing the unsecured portion of the debt. When the secured creditor seeks relief from the stay or an order prohibiting or conditioning use of the collateral, it is common for the trustee or debtor in possession to respond with an offer of adequate protection in the form of an additional lien on unencumbered assets or periodic cash payments.[5] If the secured creditor consents and the court approves the granting of the additional protection, or if in a contested proceeding the court finds that the additional protection is adequate, the trustee or debtor will likely continue to use the collateral in the ordinary course of business, thereby benefitting the estate.

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[1] *See* 11 U.S.C. §§362(a) (4) and (a)(5).

[2] *See* 11 U.S.C. §363(c).

[3] Although adequate protection is not defined in the Bankruptcy Code, Section 361 of the Code sets forth the manner in which it may be provided.

[4] *See* 11 U.S.C. §§ 362(d) and 363(e).

[5] *See* 11 U.S.C. §361.

But what happens if the protection the court found to be "adequate" later proves to be inadequate because of an unexpected further deterioration in the value of the collateral? To address this problem, Congress included in the Bankruptcy Code another form of protection for secured creditors, commonly called "superpriority" administrative expense treatment. That is, to the extent that the "adequate protection" provided subsequently falls short in protecting the collateral value, and the secured creditor has an administrative expense claim due to the postpetition use of the collateral, its administrative expense claim will be entitled to priority above all other administrative expenses. This extra protection for secured creditors is found in Section 507(b) of the Code, which provides:

> If the trustee, under section 362 [automatic stay], 363 [use, sale or lease of property of the estate], or 364 [postpetition financing] of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section [administrative expenses] arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim under such subsection.[6]

Suppose that a secured creditor moves for relief from the stay based on its belief that its collateral is depreciating below the amount of the debt balance. Suppose further that the court disagrees with the secured creditor, finds that the collateral is worth considerably more than the debt and is not depreciating significantly, and permits the trustee or debtor to continue to use the collateral in its business. However, later in the case, the court revisits the question of collateral value and finds that, notwithstanding its earlier decision, the collateral depreciated at an unexpectedly rapid rate and, in fact, the secured creditor became substantially unsecured as a result of the continuation of the automatic stay. Clearly, the court was wrong when it first decided that the secured creditor was adequately protected by its original collateral. So, is the secured creditor entitled to a "superpriority" administrative expense claim under Section 507(b) to the extent that it is harmed by the unexpected decrease in collateral value? This legal issue was addressed by the United States District Court for the Southern District of New York in *LNC Investments, Inc. v. First Fidelity Bank*,[7] a case involving a dispute between two non-debtors arising out of the Eastern Airlines bankruptcy.

The Eastern Airlines Financing

In 1986, Eastern Airlines engaged in a sale/leaseback transaction as a

[6] *See* 11 U.S.C. §507(b).

[7] 247 B.R. 38 (S.D.N.Y. 2000).

means of obtaining secured financing. Eastern sold 110 aircraft to a newly created trust that leased them back to Eastern. The trust issued three series of bonds—called equipment trust certificates with total principal value of $500 million—to raise the money needed to purchase the aircraft. Eastern was obligated to make lease payments in an amount sufficient to cover the principal and interest on the bonds. Title to the aircraft was held in trust as collateral for the bonds.

In March of 1989, when Eastern filed a chapter 11 petition, there were 104 aircraft remaining as collateral with an appraised value of approximately $682 million. Because the principal amount of the outstanding bonds was approximately $454 million, the bondholders were oversecured at that time to the extent of $228 million.

The collateral value declined significantly within the next year or so. On November 9, 1990, the appraised value of the 67 aircraft remaining in the collateral pool, together with funds set aside in a cash collateral account from the sales and leases of the 37 aircraft that were no longer in the collateral pool, was between $475 million and $590 million. This alarmed the trustees of the equipment trust who, one year and 8 months after the commencement of the Chapter 11 case, on November 14, 1990, filed a motion in the bankruptcy court requesting adequate protection under Section 363(e) of the Code, which requires the court to prohibit or condition use of collateral necessary to provide adequate protection to a secured creditor. Alternatively, the motion requested relief from the automatic stay under Section 362(d) for lack of adequate protection. The motion was pending when, on January 18, 1991, Eastern ceased all operations and stipulated to the return of the remaining aircraft and cash collateral to the trustee of the equipment trust.

The continued deterioration of the value of the aircraft (which was exacerbated by the termination of Eastern's business operations) left the bondholders undersecured with a large unsecured deficiency claim. The holders of the second and third series of bonds, which were subordinated to the holders of the first series, were left with only a general unsecured deficiency claim and—like all other general unsecured creditors—they received no recovery from the Eastern Airlines estate because the assets in the estate were not even sufficient to pay all administrative expenses. The unhappy bondholders then commenced an action against the trustees of the equipment trust claiming that the trustees breached their fiduciary duty by waiting too long before filing their motion for an order prohibiting or conditioning use of the collateral or for relief from the automatic stay.

The bondholders could not prevail in their action against the trustees of the equipment trust unless they could demonstrate that the delay in filing the adequate protection/lift stay motion caused them monetary harm.

The bondholders claimed that they were damaged by the delay because if the motion had been made very early in the case—which most likely would have been denied because of the high appraised collateral value at that time—the bondholders as secured creditors would have been entitled to superpriority status under Section 507(b).

In contrast, the trustees as defendants took the position that the delay in filing the motion did not harm or damage the bondholders. They argued that any motion for adequate protection or relief from the automatic stay early in the case would have been denied because the value of the bondholders' collateral at that time exceeded the debt balance by more than $200 million. Moreover, if the motion had been made and denied, the bondholders would not have been entitled to superpriority status under Section 507(b). The defendants argued that Section 507(b) applies only when an adequate protection or lift stay motion is granted—not denied—and additional protection is conferred which subsequently proves inadequate.

Accordingly, the legal issue in this dispute between two non-debtors was whether Section 507(b) superpriority treatment would have been applicable if an adequate protection/lift stay motion were made and denied based on a finding that the collateral was sufficient to adequately protect the secured creditor, and the collateral subsequently proves to be inadequate. The district court in *LNC Investments* commented that Section 507(b) and related sections of the Code have created "a complex maze of ambiguous statutory provisions and opaque, inconsistent case law,"[8] and noted that there were no decisions squarely on point or any dispositive legislative history with regard to this issue. The precise question presented "is an open one in the courts."[9]

Defendants' Plain Meaning Argument

Defendants supported their argument that a denial of an adequate protection/lift stay motion would not trigger superpriority status with a literal reading of the introductory phrases of Section 507(b), as it would be read in the context of a chapter 11 case with a debtor in possession: "If the *[debtor in possession], under* section 362, 363, or 364 of this title [title 11], *provides* adequate protection . . ."[10]

The defendants argued that the present tense form of the verb "provides" is consistent only with the view that adequate protection must be provided after the filing of a chapter 11 petition, "a temporal concept

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[8] 247 B.R. at 41-42, quoting from Baybank-Middlesex v. Ralar Distributors, Inc., 69 F.3d 1200, 1204 (1st Cir. 1995).

[9] 247 B.R. at 43.

[10] In a Chapter 11 case in which there is a debtor in possession, there is no trustee. Rather, the debtor in possession has the rights and powers of a trustee and would be entitled to the benefits of Section 507(b). Therefore, in the quoted phrase from Section 507(b), the words "debtor in possession" are substituted for the word "trustee." *See* 11 U.S.C. § 1107.

reinforced by the requirement that the protection covered by §507(b) must be provided by the 'debtor-in-possession,' a status which a debtor attains only after a petition is filed."[11] Defendants argued that Eastern Airlines was not a debtor in possession in 1986 when it provided "adequate protection"—i.e., title to its aircraft as collateral for the bonds—and, therefore, Eastern did not "provide adequate protection" within the meaning of Section 507(b). Moreover, Section 507(b) states that adequate protection must be provided "under" section 362, 363, or 364 of the Bankruptcy Code. These sections govern adequate protection granted in the context of a request for relief from the automatic stay, the use, sale or lease of property of the bankruptcy estate, or financing during the bankruptcy case. Defendants argued that in order to get adequate protection under Section 362, 363, or 364, a bankruptcy petition must have been filed already.

Bondholders' Policy Argument

Plaintiff bondholders responded by contending that the literal reading of Section 507(b) contravenes the relevant purpose of the Bankruptcy Code, which is to protect secured creditors. They cited *Holy Trinity Church v. United States,*[12] where the Supreme Court stated that if a literal construction of the words of a statute are "absurd," it must be construed in a way to avoid the absurdity. The district court in *LNC Investments* summarized the bondholders' policy argument as follows:

> "In the case at bar, the Bondholders argue that with respect to a secured creditor's ultimate loss, there is no principled difference between a bankruptcy court's ordering additional protection which later proves to be inadequate, and the court's denying that relief based upon the equally erroneous conclusion that the pre-existing protection is adequate. In both instances, the bankruptcy court's error and the adverse consequences to the secured creditor are precisely the same."[13]

In pursuing their damage claims against the trustees, the bondholders argued for a broad interpretation of Section 507(b). In their view, an oversecured creditor with a substantial equity cushion at the start of the case may obtain superpriority administrative expense status simply by filing a motion to lift the automatic stay or for adequate protection. Under the bondholders' view, the merits or denial of the motion are irrelevant; by filing the motion the secured creditor is guaranteed superpriority status in the event that the collateral later proves to be inadequate to protect the creditor's entire claim.

The district court commented that both parties advanced reasonable interpretations of an ambiguous statute and that both were correct when

[11] 247 B.R. at 46.

[12] 143 U.S. 457, 460 (1892).

[13] 247 B.R. at 46.

they argued that Congress could have expressed itself more clearly, "but the arguments cancel each other out."[14] The court was left with the task of choosing between "irreconcilable statutory constructions, each having a surface plausibility."[15]

The district court began its analysis of the statute by quoting language written by Justice Scalia when he wrote for the Supreme Court in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*:[16]

> "Statutory construction, however, is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law."[17]

District Court Adopts Narrower Construction

The district court, applying these interpretive aids, concluded that the narrower construction of Section 507(b) advocated by the defendant trustees is the better one. Accordingly, the court held that a secured creditor's claim is not entitled to superpriority administrative expense priority under Section 507(b) if the creditor files a motion for relief from the automatic stay or for adequate protection, the bankruptcy court denies the motion based on a finding that the creditor already is adequately protected, and the creditor's collateral subsequently proves inadequate to cover the claim.[18]

In reaching its decision, the district court found that the bondholders' reading of Section 507(b), although permissible, was a "stretching of language."

> "It is a stretch to read §507(b)'s reference to a 'debtor-in-possession' as including an entity that became a 'debtor' by means of the underlying transaction, at a time when becoming a 'debtor-in-possession' was the last thing anyone wanted.
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> It is equally a stretch to read §507(b)'s use of the present tense verb 'provides' as including a bankruptcy court's order denying an adequate protection motion on the ground that in the past, that is to say prepetition, a debtor had provided collateral ostensibly sufficient to secure the claim of the moving creditor... They [Bondholders] must argue that for purposes of qualifying for superpriority status under §507(b), a court's order denying adequate protection is the functional equivalent of a debtor-in-possession's providing that protection in response to a court order granting it. The semantic obstacles to that interpretation are apparent."[19]

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[14] 247 B.R. at 47.

[15] 247 B.R. at 47.

[16] 484 U.S. 365 (1988).

[17] *Id.* at 371.

[18] The district court indicated that, as a result of this decision, it will so instruct the jury, which will have to decide whether the plaintiff bondholders were damaged by the trustees' delay in filing a motion for relief from the stay or for adequate protection in the Eastern Airlines bankruptcy case.

[19] 247 B.R. at 47. Although the court repeatedly referred to the words "debtor-in-

The court also agreed with the defendants' argument that the reference in Section 507(b) to a debtor in possession who "under section 362, 363, or 364 of this title, provides adequate protection" demonstrates the limited nature of the superpriority benefit conferred on secured creditors.

> "That language conjures up the image of a debtor providing adequate protection to a secured creditor in obedience to the bankruptcy court's order granting a motion brought by the creditor under one of the three designated sections."[20]

The court also reasoned that, because the statutory language "inclines sufficiently in favor of the Trustees,"[21] the bondholders had the burden to show that the trustee's narrower interpretation is "absurd" in view of the objectives of the Bankruptcy Code—a burden the court concluded they failed to satisfy. The court noted that the Bankruptcy Code has many objectives, one of which is the rehabilitation of the debtor, and that Congress has a preference for reorganization as opposed to liquidation. In that context, the court observed that "a superpriority claim is the natural enemy of a reorganization,"[22] because the presence of a substantial superpriority claim "may chill the willingness of others to do business with a debtor-in-possession, dooming that resolution preferred by Congress, a successful reorganization, and leading to liquidation."[23] Although Congress has the power to enact a statute that would give an oversecured creditor maximum protection at the expense of the reorganization preference, the district court concluded that Congress did not do so in Section 507(b).

> "I think that the Code protects secured creditors up to a point, but not beyond, and the point of demarcation is reached when granting superpriority status would imperil other identifiable objectives of the Code, which include a preference for economically feasible reorganizations."[24]

The court cited no decisions that directly expressed this view, but it did find agreement in *Collier on Bankruptcy.*

> "If the property in question declines in value between the time that adequate protection is provided and the time that the property is returned to the creditor, the creditor will be entitled to a section 507(b) priority for the amount of the decline. It should be kept in mind, however, that the creditor is not automatically entitled to a priority for the decline in value but is so entitled only where the creditor has specifically been provided with adequate protection. If a court

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possession" in Section 507(b), those words do not actually appear in that subsection. As discussed in note 10, supra, the word "trustee" in Section 507(b) is read to include a debtor in possession by reason of Section 1107 of the Code which gives the debtor in possession the rights and powers of a trustee in a chapter 11 case.

[20] *Id.* at 49.

[21] *Id.* at 48.

[22] *Id.*

[23] *Id.* at 49.

[24] *Id.*

declines to grant relief from the stay because the court determines that no cause exists or that the creditor is adequately protected by the value of the collateral or by other factors, the creditor has not been granted adequate protection. If the court believes that the value of the property is not likely to decrease in value and declines to terminate the automatic stay on that basis, there is no grant of adequate protection and a creditor should not be entitled to assert a section 507(b) claim merely because the court's belief proves to be incorrect and the property actually does decline in value."[25]

Conclusion

The district court in *LNC Investments* held that, in order for a secured creditor's claim to be entitled to superpriority status under §507(b), adequate protection must have been previously provided by the trustee or debtor in possession during the bankruptcy case. The filing of a motion for relief from the automatic stay or for adequate protection, which is denied by the bankruptcy court, is not sufficient to trigger superpriority status if the collateral subsequently proves to be inadequate.

This narrow interpretation of Section 507(b) should serve as an important warning for creditors who are oversecured with what appears to be a comfortable equity cushion. Constant collateral monitoring, rather than just a sigh of relief, is key. At the first indication that collateral value has depreciated to the point where additional protection is warranted, a motion for relief from the stay or for an order prohibiting or conditioning the use of the collateral should be filed. Unless a motion is filed that results in the provision of adequate protection, under *LNC Investments*, the benefit of superpriority under Section 507(b) will be unavailable. As indicated in that case, a premature motion denied by the bankruptcy court will not result in superpriority entitlement.[26]

[25] L. KING, COLLIER ON BANKRUPTCY ¶ 507.12(1)(c)(ii) (15th ed. 1999).

[26] For other decisions construing Section 507(b), *see, e.g.*, Ford Motor Credit Co. v. Dobbins, 35 F.3d 860, 865 (4th Cir. 1994) (sets forth three-point test that must be passed for superpriority under Section 507(b): (i) adequate protection must have been provided previously and that protection ultimately must prove to be inadequate, (ii) the secured creditor must have a claim allowable under Section 507(a)(1), which means that it is an administrative expense under Section 503(b); and (iii) the claim must have arisen under Section 362, 363, or 364(d)); In re Smith, 75 B.R. 365 (W.D. Va. 1987) (the claimant seeking superpriority must have been provided with some form of adequate protection at some earlier time and that protection must later prove to be inadequate); Discount Family Boats, Inc., 233 B.R. 365 (Bankr. E.D. Tex. 1999), *In re* Greenwald, 205 B.R. 277 (Bankr. D. Colo. 1997); *In re* Lovay, 205 B.R. 85 (Bankr. E.D. Tex. 1997); *In re* James B. Downing & Co., 94 B.R. 515 (Bankr. N.D. Ill. 1988) (a superpriority claim is predicated upon the express granting of adequate protection to the creditor). *But see*, Center Wholesale, Inc., 759 F2d. 1440, 1451 n. 23 (9th Cir. 1985) (expressing the view that Section 507(b) permits courts to grant superpriority status despite the fact that the creditor was never provided with adequate protection initially; "although not literally within the provisions of section 507, [the creditor's injury] is clearly within its spirit and deserves to be remedied by granting its claim a superpriority.").