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From the Bankruptcy Courts: Puncturing the Equity Cushion-Adequate Protection for Secured Creditors in Reorganization Cases

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PUNCTURING THE EQUITY CUSHION—ADEQUATE PROTECTION FOR SECURED CREDITORS IN REORGANIZATION CASES

An important protection provided by the Bankruptcy Code is the automatic stay against lien enforcement which prevents the dissipation of the debtor's assets upon the filing of a petition. Section 362(d)(1) limits such protection by permitting parties to seek relief from the stay "for cause, including the lack of adequate protection of an interest in property." [1] In view of the confusion and uncertainty as to the meaning and requirements of the "adequate protection" concept, it is not surprising that lawyers and judges will tend to search for a concrete mathematical formula on which to rely for the application of this standard.

Until the recent case of *In re Alyucan Interstate Corp.*[2] the lodestar of the mathematical formula used by courts in determining what constitutes adequate protection for secured creditors was the so-called equity cushion. In fact, the *Alyucan* court interrupted abruptly a trend which may have resulted in adequate protection being almost synonymous with the presence of a meaningful equity cushion. The court in that case endeavored to puncture the equity cushion as a test for adequate protection in reorganization cases by analyzing several of the decisions built on this theory.

In re Pitts: Birth of the Equity Cushion

Singled out as the forerunner of the many cases which started along the "equity cushion" route was *In re Pitts*,[3] a Chapter 13 case where residential real property was valued at $125,000 with first and second mortgages as well as the costs and expenses of foreclosure aggregating $105,875. In its ad-

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[1] 11 U.S.C. § 362(d)(1). See Weintraub & Resnick, *Bankruptcy Law Manual* ¶¶ 1.09, 8.10 (1980).

[2] 7 B.C.D. 1123 (D. Utah 1981).

[3] 2 B.R. 476 (C.D. Cal. 1979). The *Alyucan* court also cited other cases which have relied on an equity cushion analysis. See, e.g., *In re* Rogers Dev. Corp., 2 B.R. 679 (E.D. Va. 1980); *In re* Lake Tahoe Land Co., Inc., 5 B.R. 34 (D. Nev. 1980); *In re* Tucker, 5 B.R. 180 (S.D.N.Y. 1980).

versary complaint to modify the automatic stay and seeking foreclosure, the plaintiff (holder of the second mortgage) contended that there was a lack of adequate protection in the differential between these two amounts and, therefore, the plaintiff was not adequately protected. The debtor argued to the contrary "that the cushion between the encumbrances and costs of sale, $105,875, and $125,000, requires a finding that the plaintiff is adequately protected." [4]

As we all do, the courts first looked to the Bankruptcy Code to ascertain the meaning of adequate protection and, upon such inquiry, the court found only three specific examples of adequate protection in Section 361, namely, periodic payments, a substituted lien and the "indubitable equivalent." [5] The search was not very helpful for solving the instant problem and the court found it necessary to consult the legislative history which revealed that the examples in Section 361 were "neither exclusive nor exhaustive. They all rely, however, on the value of the protected entity's interest in the property involved." [6]

Relying on the portion of the House Report which deals with Section 361, the court noted that "[t]here may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws." [7] However, "[t]hough the creditor might not receive his bargain in kind, the purpose of the section is to ensure that the secured creditor receives in value essentially what he [bargains] for." [8]

The court in *Pitts* then analyzed the problem of adequate protection in terms of the presence of an equity cushion:

> The base figure in any realistic analysis of the secured creditor's position must be the aggregate of (i) the amount of principal, interest, and other permissible charges to date of sale, plus (ii) the costs of foreclosure and sale. The difference between this base figure and the anticipated sales price may be referred to as the cushion. In the case at bar, the cushion consists of the difference between $125,000 (the value of the property) and $105,875 (the aggregate of $62,260, the first lien; $34,615, the second lien; and $9,000, the cost of foreclosure and sale). This cushion is equal to $19,125.[9]

The court then proceeded to mention many variables which could destroy or increase the cushion: "termite costs, structural defects, title problems unforeseen, attorneys' fees, upswing or depression of land values, fluctuation of interest rates affecting the availability to purchasers of mortgage funds and matters of similar import." [10] Also mentioned was the

[4] *In re* Pitts, note 3 *supra*, at 477.
[5] 11 U.S.C. § 361.
[6] H. Rep. No. 595, 95th Cong., 1st Sess. 339 (1977).
[7] *Id.*
[8] *Id.*
[9] *In re* Pitts, note 3 *supra*, at 478.
[10] *Id.*

fact that the plaintiff, a second mortgagee, was currently sustaining the burden of making payments to the first mortgagee in order to keep it from foreclosing. Moreover, interest of approximately $1,000 per month was accruing on the debts secured by the encumbrances which also could reduce the cushion during the life of the automatic stay.

Although the court recognized that the cushion was fragile and precarious, its existence at that time could not be denied. The mere presence of a minimal cushion, in and of itself, was enough to justify continuation of the stay.[11] However, the court also noted that adequate protection required, "at a minimum, a periodic and careful surveillance of the facts and circumstances and the structuring of relief calculated to avoid dissipation of whatever protection the cushion affords."[12] Accordingly, the court adjourned the hearing for approximately forty-five days at which time it would consider further evidence concerning valuation and a reanalysis of the cushion.[13]

The *Alyucan* Court's Analysis

Despite its "practical appeal and ease of application,"[14] the equity cushion analysis as a means of determining adequate protection was expressly rejected by the *Alyucan* court. The debtor in that case was a real estate construction company with realty valued at $1.425 million on the date that a Chapter 11 petition was filed, which value did not erode as of the hearing date. The court fixed the amount of the secured debt at $1,297,226 as of the petition date, but with interest accruing at approximately $8,000 per month, the debt balance increased to $1,330,761 as of the time of the hearing.

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[11] *Id.* at 478-479. The *Alyucan* court while giving historical accommodation to the *Pitts* court for being the first to articulate the cushion concept nevertheless indicated a flaw in the decision: "[t]he fact that plaintiff was a junior lienholder and therefore would be 'squeezed' as the senior lien accrued interest was not stressed, nor have later opinions discussed the significance of this point in terms of the cushion analysis or adequate protection." *In re* Alyucan, note 2 *supra*, at 1127, n. 14.

[12] *In re* Pitts, note 3 *supra*, at 478-479.

[13] In adjourning the matter for a period of more than thirty days, the court may have violated suggested Interim Bankruptcy Rule 4001(a) which provides, in essence, that the stay expires thirty days after a final hearing is commenced pursuant to 11 U.S.C. § 362 (e)(2) unless within that time the court determines that the stay be continued.

> To the extent that Rule 4001 purports to preclude this court from proceeding with the conduct of this hearing in the manner indicated, it is invalid. The imposition of a thirty-day maximum within which the court must finally determine the rights of the parties and the conditions upon which the stay is regulated unduly restricts the discretion of the court and its power to deal with substantive rights of the parties under the Code.

Id. at 479.

[14] *In re* Alyucan, note 2 *supra*, at 1127.

Thus, the equity cushion on the date of the petition was $127,774, or approximately 9 percent of the value of the collateral, but decreased to $94,239, or 6.5 percent, as of the hearing date. Furthermore, a continuation of interest accumulation without further payments would result in the dissipation of the entire cushion within a year.

The court began its discussion by commenting that the absence of a definition of "adequate protection" in the Code "was probably deliberate." [15] Congress was "aware of the turbulent rivalry of interests in reorganization. . . . This problem required, not a formula, but a calculus, open-textured, pliant, and versatile, adaptable to 'new ideas' which are 'continually being implemented in this field' and to 'varying circumstances and changing modes of financing.'" [16] In a footnote, the court added that "[n]ot only is the concept kaleidoscopic, but also the circumstances to which it applies will change from creditor to creditor, and from hearing to hearing, or even as to the same creditor in different hearings." [17]

The court premised its approach to adequate protection by observing that "[r]elief from the stay cannot be viewed in isolation from the reorganization process." [18] The reorganization process, which is procedural in nature, is designed to prevent a seizure of the debtor's assets by creditors, thereby avoiding preferential treatment of levying creditors while encouraging rehabilitation. This does not mean that creditors are remediless during the interim protection afforded by the automatic stay, but may seek relief pursuant to Section 362 (d) "fashioned to suit the exigencies of the case." [19]

Four Factors Affecting Adequate Protection

In breaking down the factors which affect an "adequate protection" determination under Section 362(d), the court focused on four fundamental questions which must be asked in each case:

(1) *What is the interest in property being protected?* "This classification is important because adequate protection depends upon the interest *and* property involved." [20] The interest of a lessor may be treated differently than that of a secured creditor. A senior lienor's interest may be treated differently than that of a junior lienor. A secured party who has repossessed is not necessarily treated the same as one who is not in possession.

(2) *What aspects of the interest in property require protection?* Emphasizing that adequate protection is concerned with the *value* of the interest in property, the court

[15] *Id.* at 1124.

[16] *Id.* The court was quoting, in part, from H. Rep. No. 595, note 6 *supra.*

[17] *In re* Alyucan, note 2 *supra,* at 1124, n.3.

[18] *Id.* at 1124.

[19] *Id.*

[20] *Id.* at 1125.

noted that 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." [21]

(3) *From what is the interest in property being protected?* "The short answer is from any impairment in value attributable to the stay." [22] However, it is important to realize that not all harm or decline in value of the collateral is caused by the stay. Impairment of collateral which would have resulted even in the absence of the stay, such as when creditors acquiesce in some harm to the collateral for business or other reasons, may not be attributable to the stay.

(4) *What is the method of protection?* Section 361 sets forth three illustrative methods for providing adequate protection. The *Alyucan* court was critical of those courts which have not looked beyond such alternatives or which have insisted on a showing of indubitable equivalence. "These approaches miss the mark. . . . Indeed, something 'indubitable' is more than 'adequate'; 'equivalent' is more than 'protection'; hence, the illustration may eclipse the concept." [23] The court also pointed out that in some cases no steps are required to afford adequate protection either because the value of the interest in property is not declining or because the decline is not attributable to the automatic stay.

Applying this analysis to the instant case, the court concluded that the plaintiff, a secured creditor with a first lien on the debtor's realty, has ample collateral to protect it and that neither the collateral nor the lien are declining or are subject to sudden depreciation in value. Accordingly, relief from the stay at that juncture was unnecessary. Moreover, the court noted that the property is essential to reorganization, and that foreclosure and liquidation of the realty would run counter to this need and would deprive the debtor and other creditors of going concern value. Indeed, if liquidation takes place it should be under the aegis of the bankruptcy court which appears to be a more satisfactory forum. Furthermore, the secured creditor has other remedies; a trustee has been appointed and it can work with him or the creditors' committee to negotiate a sale, seek a conversion to Chapter 7, or propose a plan. "In short, the application of adequate protection to the facts of this case avoids the trauma of relief from the stay and maintains the equilibrium of interests in this reorganization." [24]

Turning now to the concept of "equity cushion," which the court

[21] *Id.* at 1125-1126.
[22] *Id.* at 1126.
[23] *Id.*
[24] *Id.* at 1127.

defined as "the difference between outstanding debt and the value of the property against which the creditor desires to act," [25] the court observed that there is a trend toward defining "adequate protection" in terms of such a cushion. "As interest accrues, or depreciation advances, and the margin declines, the cushion weakens and the stay may be lifted." [26] Moreover, the emerging view is that the stay should be lifted when the cushion may be absorbed through interest, commissions, and other costs of resale. The judge also indicated that courts have disagreed on what is the minimum acceptable margin.[27]

Four Reasons to Reject the Equity Cushion

The *Alyucan* court set forth four reasons for rejecting the equity cushion analysis, concluding that the presence of a cushion is not essential for providing adequate protection. First, the focus on the debt-to-collateral ratio obscures the purpose of adequate protection which is to protect against impairment of the lien. For example, if the secured creditor had been undersecured on the date of the petition, the lack of a cushion would have required relief from the stay despite the usual appreciation in the value of realty and the fact that the stay did not impair the lien. "This blurring of objectives may produce improper results." [28]

Second, the equity cushion analysis is inconsistent with the illustrations of adequate protection found in Section 361 which are primarily compensatory. These illustrations do not speak in terms of preserving equity, but deal only with compensation for the decrease in the value of the lien. The illustrations in Section 361, which provide for periodic payments and replacement liens, "contemplate that value from other assets held by debtors may be appropriated to supply any needed protection." [29] In contrast, focusing merely on the ratio of the debt to the value of the collateral ignores other sources of protection, including capitalization of earnings which could show significant income potential.

Third, an equity cushion analysis is inconsistent with the statutory scheme of Section 362(d) of the Bankruptcy Code. Section 362(d)(2) expresses a "legislative judgment" that a lack of equity, absent a further showing that the collateral is unnecessary to an effective reorganization, does

[25] *Id.*

[26] *Id.*

[27] See *In re* Tucker, 5 B.R. 180 (S.D.N.Y. 1980) (7.4 percent cushion believed to be inadequate); *In re* Castle Ranch of Ramona, Inc., 3 B.R. 45 (S.D. Cal. 1980) (8.6 percent cushion held inadequate); *In re* Rogers Dev. Corp., 2 B.R. 679 (E.D. Va. 1980) (17 percent cushion is adequate); *In re* San Clemente Estates, 5 B.R. 605 (S.D. Cal. 1980) (noting that 17 percent cushion would be "precariously close to being inadequate" under the particular circumstances of that case).

[28] *In re* Alyucan, 7 B.C.D. 1123, 1127 (D. Utah 1981).

[29] *Id.* at 1128.

not warrant relief from the stay. In fact, the dual requirement (lack of equity and unnecessary for reorganization) "emphasizes the role of equity, when present, not as a cushion, but to underwrite, through sale or credit, the rehabilitation of debtors." [30]

Fourth, the cushion analysis "has no basis in the historical development of relief from stay proceedings." [31] The court relied upon the leading literature dealing with the rehabilitation chapters of the former Bankruptcy Act to buttress its position that the role of an equity cushion analysis was extremely limited prior to the enactment of the Code. Warning that a measure of the debtor's equity in collateral may be a red herring in the determination of whether relief from a stay should be granted, one commentator added:

> It is submitted that the real determinants should be and probably are the factors just suggested. For example, if a debtor badly needs the property and its vital signs are strong, the size of its equity shouldn't have much bearing on the situation, although a large equity does make a decision favorable to the debtor more palatable for all concerned.[32]

Another commentator relied upon by the court is Professor Kennedy, who was quoted as writing:

> The existence of an equity is not . . . and should not be, indispensable to the continuation of a stay. Congress explicitly authorized the bankruptcy court to enjoin lien enforcement when appropriate in the pursuit of the objective of rehabilitation under Chapter XI. If the secured creditor is adequately protected from injury resulting from the stay, the collateral is essential to the reorganization, and a reorganization in the interest of unsecured creditors is a realistic possibility, the absence of an equity should be immaterial.[33]

Conclusion

The *Alyucan* case is enlightening as an in-depth examination of the equity cushion approach to solving adequate protection problems. It recognizes that the presence or absence of a cushion is only one factor among many, and it emphasizes the importance of the relationship between the collateral and the reorganization process. It is significant that the court dismissed the complaint seeking relief from the stay despite the fact that the equity cushion at the time of the hearing was only 6.5 percent, a figure which probably would have resulted in termination of the stay under the weight of applicable case law despite the finding that it would be a year before the cushion would be dissi-

[30] *Id.*

[31] *Id.* at 1127.

[32] Festersen, "Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle," 46 Am. Bankr. L.J. 311, 333 (1972).

[33] Kennedy, "The Automatic Stay in Bankruptcy," 11 U. Mich. J. L. Ref. 175, 247 (1978).

pated.[34] The most important lesson, however, is that there is no simple mechanism which could be used by the courts on these issues. "The facts of each case, thoughtfully weighted, not formularized, define adequate protection." [35]

[34] See note 27 *supra.*

[35] *In re* Alyucan, note 28 *supra,* at 1129.

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In calculating worth, Dr. Harry Mosen, professor of anatomy at the University of Illinois College of Medicine, added up the costs of body minerals. He said at least one expert has placed a $6 million value on a living adult by pricing body components like hemoglobin, insulin and genetic material."

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