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From the Bankruptcy Courts: The Danger of Relying on Idioms: "Undersecured" and "Oversecured" Creditors

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THE DANGER OF RELYING ON IDIOMS: "UNDERSECURED" AND "OVERSECURED" CREDITORS

The use of the terms "undersecured" and "oversecured" creditor was taken to task by the Court of Appeals for the Ninth Circuit in its recent opinion in *In re Glenn*.[1] The court of appeals observed that these terms have found their way into common legal parlance even though they are not to be found in the Bankruptcy Code, and cautioned that "care must be taken lest the parlance take on a life of its own."[2]

In 1980, P.J. Taggares Co. made various loans to H&W Farms, Inc., a corporation owned by the debtors, Mr. and Mrs. Glenn. The debtors co-signed for the loans and gave Taggares a security interest in crops and proceeds. Taggares also received a third mortgage on farm property that was owned by the debtors' daughter.

In September 1981, the debtors issued a promissory note to Taggares in the amount of $785,789 which covered existing debt, contemplated future advances, and carried interest at 18 percent per annum. This note was secured by a mortgage on the debtors' residential property, which was otherwise unencumbered. The mortgage was given on September 17 and recorded on September 18, 1981. On December 15, 1981, the Glenns and H&W Farms, Inc., filed petitions under chapter 11.

The bankruptcy court found that the mortgage on the residential property, for the most part, constituted an avoidable preference under Section 547(b) of the Bankruptcy Code. However, the court found that Taggares advanced $33,950 pursuant to the note and mortgage after the mortgage was given but before the petitions were filed. Accordingly, Section 547(c) precluded avoidance of the mortgage to the extent of $33,950. Although the court did not specify the applicable preference exception, it appears that the

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[1] 796 F.2d 1144 (9th Cir. 1986).

[2] 796 F.2d at 1147. For a recent example of the use of the terms "oversecured" and "undersecured" creditor by the Court of Appeals for the Fifth Circuit, see *In re* Timbers of Inwood Forest, 793 F.2d 1380 (5th Cir. 1986).

sum of $33,950 constituted new value given after the transaction within the scope of Section 547(c)(4). The remainder of Taggares's claims, amounting to approximately $600,000, were held to be unsecured because the two senior mortgages exhausted Taggares's security interest in the farm. The record is unclear regarding the disposition of the crops and proceeds. The bankruptcy court also found that the residential property subject to the mortgage had a value of $92,000 when the case was commenced.

In sum, Taggares had an allowed secured claim of $33,950 secured by a mortgage on real property worth $92,000, and also had substantial unsecured claims so that the total amount owed to it exceeded $600,000.

Based on this record, on January 30, 1985, the bankruptcy court awarded Taggares postpetition interest of $18,902 with interest thereafter of $16.74 per day until paid. These amounts represented 18 percent interest on the allowed secured claim of $33,950. The award was affirmed by the district court. Both courts held that Section 506(b) enabled Taggares to receive postpetition interest on its secured claim to the extent that the value of the property securing the claim exceeded the amount of the allowed secured claim on the date on which the petition was filed, notwithstanding that Taggares held unsecured claims far in excess of the value of the property. The court of appeals reviewed the bankruptcy court's opinion independently: "Since the only issue on appeal involves the interpretation of 11 U.S.C. § 506, our review is *de novo* . . . ('Statutory interpretation is a question of law subject to *de novo* review.')."[3]

The Court Dismantles a Muddle

The court of appeals began its discussion of the legal issue with a word of caution. "This appeal demonstrates the danger of relying on technical idioms rather than the law. The law that governs this case is clear."[4] The court then quoted Section 506(b) of the Bankruptcy Code which provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.[5]

Applying the facts to Section 506(b), the court observed that Taggares holds an allowed secured claim in the amount of $33,950 evidenced by a note providing for 18 percent interest and

[3] 796 F.2d at 1146.
[4] 796 F.2d at 1146.
[5] 11 U.S.C. § 506(b).

that the property that secures the claim was worth $92,000. Therefore, since the value of the property was greater than the amount of the allowed secured claim, $33,950, Taggares was entitled to postpetition interest.

Debtors' Arguments

The Glenns, however, raised two arguments: First, Taggares was an "undersecured" creditor and, therefore, not entitled to postpetition interest on any part of its claim because its unsecured claim exceeded $600,000 while its allowed secured claim amounted to only $33,950. The court of appeals rejected the debtors' position.

> The terms "undersecured" and "oversecured" creditor have been used to describe various concepts. On eminent scholar uses "undersecured" to describe a creditor who holds a claim that is partially secured and partially unsecured. . . . Others use these terms to describe the concepts in section 506(b): an undersecured creditor is one who holds an allowed secured claim for an amount which exceeds the value of the property securing it; an oversecured creditor is one who holds an allowed secured claim in an amount less than the value of the property securing it. . . . These terms, which are not to be found in section 506, have found their way into common legal parlance. They properly may be used to save many words. However, care must be taken lest the parlance take on a life of its own.[6]

The court of appeals emphasized that the dominant theme of the Bankruptcy Reform Act of 1978 is "the turn away from the classification of creditors to the classification of claims."[7] The court focused on Section 506(a) which bifurcates a debt or debts into secured and unsecured components, the secured portion of the debt being called a secured claim. Since Section 506(b) refers only to secured claims, the "existence of an unsecured claim, whether held by the holder of a secured claim or by another, is irrelevant in determining whether postpetition interest should be awarded."[8] Accordingly, the court rejected the debtors' "attempt to muddle a clear statutory mandate by misuse of nonstatutory terminology."[9]

The second argument raised by the debtors was that Taggares's interest in the residential property was limited to the amount of the allowed secured claim (i.e., $33,950) and, therefore, Taggares had no interest in the mortgage from which postpetition interest could be allowed. However, this argument ignored Section 506(b) which allows postpetition interest at the contract rate. "The neces-

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[6] 796 F.2d at 1146–1147.
[7] *Id.* at 1147.
[8] *Id.*
[9] *Id.*

sary consequence of section 506 (b) is an award in excess of the principal amount of the allowed secured claim."[10]

Observation

The court's opinion in *In re Glenn* should serve as an important reminder that use of popular idioms may lead to oversimplified and inaccurate analysis of a legal problem. Use of the terms "oversecured" and "undersecured" may be misleading when the issue relates to the proper classification of claims or the bifurcation of claims into secured and unsecured components.

[10] *Id.*