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From the Bankruptcy Courts: Staying the Undersecured Creditor in Chapter 11: No Compensation for Delay

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STAYING THE UNDERSECURED CREDITOR IN CHAPTER 11: NO COMPENSATION FOR DELAY

In the realm of state law, the secured creditor who has perfected its lien on personal property in accordance with the provisions of Article 9 of the Uniform Commercial Code, or who has recorded a mortgage on real estate, rests comfortable in the knowledge that the debtor's failure to make the installment payments when due gives the creditor the right to foreclose and sell the collateral to satisfy the indebtedness. An important benefit that flows from having this right, which may be said to affect the value of this right, is the ability of the secured creditor to obtain the proceeds from the sale of the collateral for its immediate beneficial use and investment. If the sale proceeds are less than the balance of the debt, the secured creditor is undersecured and has the remedy of suing the debtor to collect the deficiency.

What happens, however, if the debtor defaults and, while the value of the collateral is less than the balance of the debt, the debtor enters the realm of bankruptcy by filing a chapter 11 petition? Will the undersecured creditor reap the benefit of its right to foreclose, sell the collateral, and immediately reinvest the proceeds? The Supreme Court supplied the answer to this question in the recent case of *United States Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*[1]

The Facts of the Case

Timbers, a limited partnership, owned a 188-unit apartment complex in Houston. United held a ten-year note executed by Timbers in June 1982 in the principal amount of $4 million, secured by a deed of trust on the apartment complex and an assignment of rents. No payment had been made on the note since 1984. United noticed a foreclosure on the property, but on March 4, 1985, Timbers filed a chapter 11 petition,

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[1] 108 S. Ct. 626 (1988).

which had the effect of automatically staying the foreclosure.[2] The parties agreed to an order allowing Timbers to pay United the net income produced by the apartments.

On March 18, 1985, United moved in the bankruptcy court for relief from the automatic stay under Section 362(d)(1) of the Bankruptcy Code alleging that Timbers failed to provide adequate protection of United's security interest. At an evidentiary hearing, United argued that in the absence of the stay under Section 362 it would have been able to foreclose, sell the property, and reinvest the proceeds at market rate. United argued that the deprivation of its ability to reinvest the foreclosure proceeds without compensation means that Timbers had not provided United with "adequate protection" of its interest in the present value of such proceeds. The real estate experts agreed that the property was likely to appreciate to a modest extent, but United was undersecured at the time of the hearing in that the value of the property was less than $4,366,389, the amount due on the debt at that time.

Despite the fact that the collateral was not depreciating during the period of the automatic stay, the bankruptcy court agreed with United that it was not adequately protected. The bankruptcy court held that United's right to "adequate protection" included the right to receive "opportunity costs," which were the funds it would earn if it were allowed to foreclose, sell the collateral, and reinvest the proceeds. The bankruptcy court ordered Timbers to pay United monthly payments of $50,456, which included $42,500 for "lost opportunity costs" based on the estimated proceeds from foreclosure of $4.25 million reinvested at a 12 percent interest rate, to commence six months after the filing of the bankruptcy petition to reflect the normal foreclosure delays. These payments had to be made as a condition to the continuation of the automatic stay against foreclosure.

The bankruptcy court was not without authority for its decision. The court relied on the Ninth Circuit's decision in *In re American Mariner Industries, Inc.*,[3] which held that an undersecured creditor is entitled to periodic interest payments during the pendency of the bankruptcy case to compensate for lost opportunity costs.

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[2] See 11 U.S.C. § 362(a)(4).

[3] 734 F.2d 426 (9th Cir. 1984); see also, e.g., Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); *In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985). For a discussion of adequate protection of property rights and the automatic stay, see B. Weintraub & A. Resnick, *Bankruptcy Law Manual* para. 1.09[6] (rev. ed. 1986).

Court of Appeals

The district court affirmed the decision of the bankruptcy court, but the court of appeals reversed.[4] The court of appeals recognized that commentators and courts often see the issue regarding the right of an undersecured creditor to lost opportunity costs as one of policy and economics. The court of appeals, however, rejected this approach to the problem:

> One side opines that the failure to award postpetition interest payments will restrict the availability of secured credit to the detriment of businesses that cannot obtain credit otherwise. The other concentrates on the deleterious effects that postpetition interest payments will have on the possibility of reorganizations. It seems that the debate has become not what the Bankruptcy Code requires, but what it should require. If we were Members of Congress, or if bankruptcy law were not controlled by a statute, we might find the economic debate of primary significance. However, as judges, we must be governed by congressional intent as set forth in the Bankruptcy Code.[5]

The court of appeals, holding that United was not entitled to payments for lost opportunity costs as a condition of the continuation of the stay, saw the issue as one of statutory construction: "Does 'adequate protection' under § 362(d)(1) contemplate that an undersecured creditor will receive postpetition interest periodically in cash or some other form to compensate it for 'lost opportunity' when its right to foreclose is temporarily suspended by the automatic stay?"[6] The court of appeals examined several provisions of the Bankruptcy Code (including the interest provisions found in Sections 502 and 506) and their predecessors in the former Bankruptcy Act and concluded that unencumbered assets of the estate should not be used to benefit one class of creditors at the expense of another class.

The importance of this issue is reflected in the fact that the court of appeals agreed to a rehearing en banc, at which the court again held in favor of Timbers,[7] and the Supreme Court then granted United's petition for certiorari.

Statutory Construction Reiterated

The Supreme Court, using the same approach as the court of appeals by focusing on statutory construction rather than on policy and economics, affirmed the court of appeals decision and held that an undersecured creditor is not entitled to compensation for the

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[4] 793 F.2d 1380 (5th Cir. 1986).
[5] *Id.* at 1384.
[6] *Id.*
[7] 808 F.2d 363 (5th Cir. 1987).

delay in foreclosure caused by the automatic stay as an element of "adequate protection."

The Court focused on Section 362(d)(1), which provides for relief from the automatic stay "for cause, including the lack of adequate protection of an *interest in property* of such party in interest." [Emphasis added.] Section 361 gives content to the phrase "adequate protection" by setting forth three methods by which adequate protection may be afforded: (1) cash or periodic cash payments to the extent that the stay results in a decrease in the value of the party's interest in the property, (2) providing an additional or replacement lien to the extent that the stay results in a decrease in the value of the party's interest in the property, and (3) granting such other relief as will result in the "indubitable equivalent" of the party's interest in the property.

Clearly, the phrase "interest in property" in Section 362(d)(1) "includes the right of a secured creditor to have the security applied in payment of the debt upon completion of the reorganization; and that the interest is not adequately protected if the security is depreciating during the term of the stay."[8] However, does the phrase "interest in property" also include the secured party's right to take *immediate* possession of the collateral and apply it in payment of the debt? Although the Court agrees that "viewed in the isolated context of § 362(d)(1),"[9] the phrase could reasonably be given the meaning that United asserts, the interpretation of that phrase must take into consideration other sections of the Code:

> 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.[10]

Based on other sections of the Code, the Supreme Court concluded that the "interest in property" protected under Section 362(d)(1) does not include a secured party's right to immediate foreclosure.

Determination of Secured Status

The Court focused on Section 506(a) dealing with the amount of a secured claim in bankruptcy. That section provides that a creditor has a secured claim "to the extent of the value of such creditor's interest in the estate's inter-

[8] 108 S. Ct. at 629.

[9] *Id.* at 630.

[10] *Id.*

est in such property" and has an unsecured claim as to the balance. The creditor's interest in property within the context of Section 506(a) means the value of the collateral and does not take into account the right to immediate possession upon default. "If the latter were included, the 'value of such creditor's interest' would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time."[11] The Court believes that the phrase "value of such entity's interest" in Sections 361(1) and 361(2), when applied to secured creditors, has the same meaning.

A more important factor than the terminology used in Section 506(a) was the language of Section 506(b), which has the effect of denying undersecured creditors postpetition interest on their claims. Section 506(b) also denies oversecured creditors postpetition interest to the extent that the interest, when added to the principal amount of the claim, will exceed the value of the collateral. Since this provision allows payment of postpetition interest only out of the "security cushion," the undersecured creditor falls within the general rule found in Section 502(b)(2) that disallows postpetition interest.[12]

> If the Code had meant to give the undersecured creditor, who is thus denied interest on his *claim*, interest on the value of his *collateral*, surely this is where that disposition would have been set forth, and not obscured within the "adequate protection" provision of § 362(d)(1). Instead of the intricate phraseology set forth above, § 506(b) would simply have said that the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser."[13]

The Court rejected United's argument that Section 506(b) is merely an alternative method for compensating oversecured creditors and that the section does not mean that undersecured creditors are not entitled to compensation. "Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of a conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors."[14]

The Court also found that United's interpretation of Section 362(d)(1) was "structurally incon-

[11] *Id.*

[12] See 11 U.S.C. § 502(b), which provides for the allowance of a claim "except to the extent that . . . (2) such claim is for unmatured interest."

[13] 108 S. Ct. at 631.

[14] *Id.*

sistent" with Section 552, which provides that a prepetition security interest does not reach property acquired postpetition, except for a perfected security interest in postpetition proceeds, rents, and profits. Under United's position, the undersecured creditor who does not have a perfected security interest in after-acquired rents or profits "in effect achieves the same result by demanding the 'use value' of his collateral under § 362."[15]

United's interpretation of Section 362(d)(1) also "makes nonsense" of Section 362(d)(2), which, as an independent ground for relief from the stay, provides that the court shall grant relief if (1) the debtor does not have equity in the property (i.e., the creditor is undersecured) *and* (2) the property is not necessary to an effective reorganization.

> By applying the "adequate protection of an interest in property" provision of § 362(d)(1) to the alleged "interest" in the earning power of collateral, petitioner creates the strange consequence that § 362 entitles the secured creditor to relief from the stay (1) if he is undersecured (and thus not eligible for interest under § 506(b)), *or* (2) if he is undersecured *and* his collateral "is not necessary to an effective reorganization." This renders § 362(d)(2) a practical nullity and a theoretical absurdity."[16]

Indubitable Equivalent

United also argued that denying it compensation for the delay in foreclosure was inconsistent with Section 361(3), which provides that adequate protection may be given by granting relief "as will result in the realization by such entity of the *indubitable equivalent* of such entity's interest in such property." [Emphasis added.] United pointed to the same phrase, "indubitable equivalent," found in Section 1129(b)(2)(A)(iii), which provides standards for so-called cram-down confirmation and connotes the right of a secured creditor to receive present value of its collateral, including the payment of interest if the claim is to be paid over time. United argued, in essence, that since "indubitable equivalent" in Section 1129 requires payment to a secured creditor based on present value, then "indubitable equivalent" in Section 361(3) requires that "present value" of the collateral be realized as an element of adequate protection for automatic stay purposes.

Although the Court agreed that under Section 1129(b) a secured creditor is entitled to receive under a plan the present value of its collateral, the Court disagreed with United regarding the source of the "present value" requirement:

> This entitlement arises, however, not from the phrase "indubitable

[15] *Id.* at 632.
[16] *Id.*

equivalent" in § 1129(b)(2)(A)(iii), but from the provision of § 1129(b)(2)(A)(i)(II) that guarantees the secured creditor 'deferred cash payments . . . of a value, *as of the effective date of the plan*, of at least the value of such [secured claimant's] interest in the estate's interest in such property." (Emphasis added) . . . In § 361(3), by contrast, the relief pending the stay need only be such "*as will result in the realization* . . . of the indubitable equivalent" of the collateral. (Emphasis added). It is obvious (since §§ 361 and 362(d)(1) do not entitle the secured creditor to immediate payment of the principal of his collateral) that this "realization" is to "result" not at once, but only upon completion of the reorganization. It is *then* that he must be assured "realization . . . of the indubitable equivalent" of his collateral.[17]

The Court also rejected United's position that its interpretation of Sections 361 and 362(d)(1) is supported by legislative history that states that secured creditors "should not be deprived of the benefit of their bargain."[18] The Court found such generalizations inadequate to overcome the plain meaning of Sections 506 and 362(d)(1). United's reliance on the phrase "indubitable equivalent" in *In re Murel Holding Corp.*,[19] where the phrase was first used, also was dismissed by the Court as irrelevant because that phrase was used in *Murel* to refer to the jeopardized principal of the loan rather than interest.

Conclusion

It is interesting to note that the final paragraph of the Supreme Court's opinion states that the Fifth Circuit correctly held that "the undersecured petitioner is not entitled to *interest* on its collateral during the stay to assure adequate protection under 11 U.S.C. § 362(d)(1)."[20] Many courts and commentators discuss this issue in terms of "lost opportunity costs" or similar phrases. Call it what you will, the right to receive postpetition interest during the pendency of the automatic stay is the issue.

The final comment of the Court was that United never sought relief from the stay under Section 362(d)(2). Since United was undersecured, the debtor had no equity in the collateral. Nonetheless, it would appear from the facts that the debtor would have been able to meet its burden to prove that the apartment complex, which was the debtor's sole asset, was necessary to an effective reorganization, assuming that

[17] *Id.* at 633 (emphasis added).

[18] H.R. Rep. No. 595, 95th Cong., 1st Sess. 339, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5839; S. Rep. No. 989, 95th Cong., 2d Sess. 53, *reprinted in* 1978 U.S. Code Cong. & Admin. News 6295.

[19] 75 F.2d 941 (2d Cir. 1935).

[20] 108 S. Ct. at 635 (emphasis added).

a successful reorganization was likely.[21]

There is an important lesson in the Court's opinion that may be directed toward those who have expressed the view that secured creditors are entitled in bankruptcy to the same substantive rights and benefits that they enjoy out of bankruptcy. "The reorganized debtor is supposed to stand on his own two feet. The debtor in process of reorganization, by contrast, is given many temporary protections against the normal operation of the law."[22]

[21] The Court elaborated on the meaning of the phrase "necessary to an effective reorganization" in § 362(d)(2). "What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect*. This means . . . that there must be 'a reasonable possibility of a successful reorganization within a reasonable time.' " 108 S. Ct. at 632.

[22] 108 S. Ct. at 634.

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