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From the Bankruptcy Courts

Alan N. Resnick*

Who Benefits From Postpetition Appreciation of Collateral? Bankruptcy Court Adopts a Flexible Approach for Timing Valuation of Secured Claims in a Bankruptcy Case

Lawyers for secured creditors are well aware of the difficulties often encountered in valuing collateral for the purpose of determining the allowed amount of a secured claim in a bankruptcy case. In addition to the usual problems in trying to place a dollar amount on the value of old equipment or aging inventory, the appropriate standards to be applied in a valuation dispute—for example, whether to use “going concern value” or “forced sale value,” or whether to base it on “wholesale value” rather than “retail value” or “replacement cost”—are not always clear.¹ Another factor that is often

key to the determination of valuation disputes is the time at which valuation is to be determined.

The Bankruptcy Code (Code) recognizes that valuation issues may arise in different contexts and at different stages during a bankruptcy case, and that courts are not restricted to one particular standard for all situations. Section 506(a) of the Code—which bifurcates an undersecured creditor’s right to payment into a secured claim up to the value of the collateral and an unsecured claim for the deficiency—provides that the value of collateral “shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.”² For example, a bankruptcy court may value collateral as of the date of the commencement of the case for the purpose of ruling on a motion for relief from the automatic

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¹ See, e.g., *In re Pullman Constr. Indus., Inc.*, 107 BR 909 (Bankr. ND Ill. 1989) (going-concern value, not forced-sale value, was appropriate standard for valuing collat-

eral for Chapter 11 plan confirmation purposes); *In re Malody*, 103 BR 745 (9th Cir. BAP 1989) (collateral consisting of vehicles should be valued at wholesale value, rather than the debtor’s replacement cost).

² 11 USC § 506(a). See also Rule 3012, Federal Rules of Bankruptcy Procedure, which permits a party in interest to file a motion asking the court to determine the value of a secured claim.

stay based on lack of adequate protection,³ and may later value the same property as of the date of the hearing on confirmation of a Chapter 11 plan for the purpose of determining whether the plan satisfies the cramdown requirements of Section 1129(b).⁴ Of course, the timing of the valuation determination could have a significant impact on the rights of a secured creditor when the collateral is fluctuating in value.

The Wood Case

In a recent decision, *In re Wood*,⁵ the Bankruptcy Court for the Middle District of Pennsylvania announced a test using eleven factors for determining the appropriate date for valuation purposes.⁶ In applying these factors to the particular facts of that case, the court held that the value of the collateral at the time of the commencement of the Chapter 11 case fixed the allowed amount of the secured claim for plan confirmation purposes, thus permitting the reorganizing debtor to reap the benefits of the collateral's significant appreciation during the case.

In *Wood*, the debtor homeowner filed a Chapter 11 petition in August 1993. According to an appraisal

taken in October of that year, the debtor's residential real estate was worth \$176,000. The first mortgagee's appraiser confirmed that the property was worth approximately \$176,000 as of December 1993. The real estate was encumbered by a first mortgage securing a debt in excess of \$234,000, and a second mortgage securing a debt of \$87,000. The debtor filed a Complaint to Determine Secured Status, asking the court to "strip down"⁷ the first mortgagee's secured claim to the value of the collateral as of the commencement of the case, that is, \$176,000, and to declare the second mortgagee's claim entirely unsecured.

At the hearing on the motion, it was shown that another valuation of the property was taken in May 1994, indicating that the property was worth \$196,400—an increase of more than \$20,000 within only a six-month period. The increase in value was due solely to the debtor's efforts in obtaining a zoning change from residential to "limited commercial." Predictably, the debtor argued that the date of the filing of the bankruptcy petition is the only relevant date for collateral valuation purposes, while the mortgagee, wanting the higher valuation to control, argued that valuation as of the date

³ See 11 USC §§ 361, 362(d)(1).

⁴ See 11 USC § 1129(b)(2)(A).

⁵ 190 BR 788 (Bankr. MD Pa. 1996).

⁶ The court acknowledged that, to a significant extent, these factors were drawn from an article by Patrick Fitzgerald, "Bankruptcy Code Section 506(a) and Undersecured Creditors: What Date for Valuation?" 34 UCLA L. Rev. 1953 (1987).

⁷ This case was commenced before, and was not affected by, § 1123(b)(5), added to the Code by the Bankruptcy Reform Act of 1994, which prohibits modification of the rights of a holder of a secured claim secured only by a mortgage on the debtor's principal residence. See 11 USC § 1123(b)(5).

of plan confirmation appropriately reflects the actual value of the premises as of the latest valuation.

Lack of Consensus on Date for Valuing Collateral

Before beginning its analysis, the bankruptcy court pointed out the lack of consensus on the valuation timing issue:

When researching the applicable date of valuation, I was not quite prepared for the sheer number of diverse opinions on the subject. A multitude of courts are quite firm that the applicable date of valuation of property of the estate is the date of filing the bankruptcy. A significant number of courts embrace the conclusion that the confirmation date is the focus point of valuation. Not to be confined to these choices, various courts have chosen the effective date of a plan as the valuation date. Some have even opted for the hearing date. We have found a court that used, as a reference, the filing date of the plan, and a court that chose the date that the proceeding to value was filed. When a sale is involved, the sale date has been critical to another court.⁸

The court selected Section 502(b) of the Code, which provides that in the face of an objection the court must determine the amount of a claim "as of the date of the filing of the petition," as its starting point for determining the timing issue. A portion of the claim may be secured and, as provided in Section 506(a), valu-

ation of the collateral is necessary to determine the allowed amount of the secured claim. But the language of Sections 502(b) and 506(a) only *suggests* that a claim is fixed as of the filing date: "this does not mean that the secured claim remains a constant."⁹ The court pointed out that the fluctuation of the allowed amount of the secured claim during the case is consistent with several sections of the Code. For example, Section 506(b) provides for increasing the allowed amount of a secured claim to add postpetition interest and fees to the extent that the value of the collateral exceeds the amount of the debt, and Section 552(b) extends certain prepetition security interests to postpetition proceeds and rents.

Searching legislative history for an answer, the court found ample support for the proposition that broad flexibility in valuation was intended, and that a judicial determination of value early in the case does not bind the court with respect to a later valuation for different purposes. As pointed out in the Congressional Record, "determinations for purposes of adequate protection are not binding for purposes of 'cram-down' on confirmation in a case under Chapter 11."¹⁰

Scanning the cases, the bankruptcy court found that there are some norms that are generally accepted in choosing valuation dates. "Almost universally," the courts

⁸ 190 BR at 790-791 (footnotes omitted). The court cited cases for each position. See notes 1-7 of the court's opinion.

⁹ 190 BR at 792.

¹⁰ 190 BR at 792 (quoting from 124 Cong. Rec. H11095 (Sept. 28, 1978)).

have used the date of filing as the appropriate one to value a secured creditor's interest for purposes of providing adequate protection,¹¹ and "typically" the date of filing is used when individual debtors attempt to avoid liens impairing exemptions under Section 522(f).¹² "Conversely, the vast majority of courts have considered the date of confirmation and/or the effective date of the plan as the relevant date to value the secured claim of that creditor for purposes of plan implementation."¹³

The bankruptcy court in *Wood* was critical of those courts that have utilized one date for valuation purposes, regardless of the particular circumstances of the case:

What intrigues me about the multitude of opinions that have been written on section 506(a) is the willingness of the courts to unqualifiedly accept any one date as necessarily *the* fixed point of valuation of a secured creditor's claim. If choosing the confirmation date for plan confirmation purposes is required, hasn't that court, in fact, removed the flexibility advised by section 506(a)? I can take judicial notice that, generally speaking, vehicles depreciate and real estate appreciates. I suspect that the equities of a given case have motivated the courts to select either the petition file date or the plan confirmation date as the applicable and controlling date of valuation. For example, as indicated earlier, those courts that have utilized the filing date for confirmation purposes were valuing depreciating vehicles. They, nev-

ertheless, have ostensibly locked themselves into using that same date in all superseding cases regardless of whether the secured property is appreciating or depreciating.¹⁴

The Eleven-Factor Test

The court concluded that the selection of the date to be used for adjudicating the kind of valuation issue involved in *Wood* should turn on a number of factors, rather than be restricted to any one date applicable in all cases. That is, valuing collateral for cramdown purposes at a confirmation hearing does not, in all cases, have to be based on its value at the time of the confirmation hearing, but may under certain circumstances be based on the value of the property at an earlier time. The eleven factors that the court identified as relevant to this determination include:

1. The impact of the debtor's efforts on the postpetition change in value.
2. The expectancies of the parties at the time they may have made the loan agreement (if any).
3. The desirability of uniformity. Will the application of different dates for valuation purposes reach an absurd result?
4. The convenience of administration.
5. The equitable concept that those who bear the risk should benefit from the rise in value.

¹¹ 190 BR at 792.

¹² 190 BR at 793. See 11 USC § 522(f).

¹³ 190 BR 792-793.

¹⁴ 190 BR at 794 (footnotes omitted).

6. A resulting windfall to any one party should be discouraged.
7. The bankruptcy policy set forth in section 552(b) which extends prepetition liens to postpetition proceeds in certain situations.
8. The bankruptcy policy set forth in 11 U.S.C. § 362(d), which encourages the tendering of adequate protection payments to a creditor holding depreciating collateral.
9. The off-stated policy of bankruptcy to secure the debtor a 'fresh start'. [citation omitted]
10. The result of utilizing a specific date of valuation on the bankruptcy itself including that impact upon senior and junior lien creditors.
11. Whether the party benefitting from a delay in valuation has been responsible for that delay.¹⁵

Applying these factors to the case before it, the court noted that:

- The increase in collateral value during the case was due solely to the debtor's efforts in having the property re-zoned from residential to commercial use.
- Although general appreciation of real estate could have been anticipated at the time of the original transaction, there was no expectation at that time that the property would appreciate due to zoning changes.
- Because the Code places the risk of depreciation of collateral on the debtor, this generally suggests that the debtor should be the party to benefit from increases in value.
- The secured creditor does not need any adequate protection because the collateral has not diminished in value during the bankruptcy.
- Rewarding the debtor's postpetition efforts by allowing it to retain the new value added to the collateral supports the debtor's fresh start.
- Because the plan provides for no distributions to unsecured creditors, the debtor would receive a \$20,000 windfall if the filing date is used as the applicable date of valuation.
- An analogy to Section 552(b)—which extends a pre-petition security interest to postpetition proceeds—strongly suggests that a creditor's lien should generally extend to appreciating collateral.
- Using one date for valuation as opposed to another is not likely to cause any absurdities or inconveniences of administration in this one-issue case involving a plan offering no payments to unsecured creditors.
- There is no indication that any delay in adjudication has benefited either side.

The Lesson of *Wood*

Based on these findings, the court held that the date of the filing of the

¹⁵ 190 BR at 794-795.

petition is the appropriate date for valuing the collateral in this case, thereby giving the debtor the benefit of the increase in collateral value. Summarizing these findings and emphasizing those on which it apparently placed the greatest weight, the court wrote: *

[T]his property has increased in value during the bankruptcy solely because of the Debtor's efforts and not due to any general appreciation of the property. This was an increase in value not anticipated by the parties at the time of the bargain. Allowing the Debtor to benefit from this increase certainly encourages the Debtor in her fresh start. The Bank can expect to receive the present value of their allowed secured claim as determined on the date of the filing over the life of the plan. There is no unfairness to this result. It is for these reasons that I conclude

that, on these facts, the applicable date for valuing the allowed secured claim is the date of filing."¹⁶

But the most significant lesson of the case is found in a warning at the end of the court's opinion, apparently intended for those inclined to search for bright-line tests and clear rules instead of appreciating the flexibility of fact-specific guidelines based on multiple factors: "Inasmuch as we hereby adopt a flexible approach to selecting the appropriate date of valuation, I reserve the right to choose a different valuation point in any future case based on those factors enunciated herein."¹⁷

¹⁶ 190 BR at 795.

¹⁷ 190 BR at 795.

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