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From the Bankruptcy Courts

Alan N. Resnick*

Supreme Court Adopts Replacement Cost Method of Valuing Collateral for Chapter 13 Cram Down Purposes

Since the Bankruptcy Code was enacted as part of the Bankruptcy Reform Act of 1978, courts have not agreed on the proper standard for valuing collateral for the purpose of determining the rights of an objecting secured creditor when the debtor proposes to keep collateral under a Chapter 13 plan. Although the conflict over the most appropriate standard for determining collateral value had been fought primarily on the bankruptcy court level, this battle has moved up to the appellate courts in recent years.

Conflicting appellate decisions—each focusing on a bankruptcy court's valuation of a secured creditor's interest in a motor vehicle retained by the debtor under a Chapter 13 plan—had resulted in a lack of uniformity with respect to valuation methods. For example, the Court of Appeals for the Fifth Circuit upheld a bankruptcy court's valuation of a truck based on its net foreclosure sale value, rather than its retail or replacement value. The Court of Appeals for the Eighth Circuit held that it was proper to base the value of collateral on its replacement value or retail price, while the Seventh Circuit adopted a split-the-difference approach based on the average between the wholesale value and the retail value.

The Rash Case

This division among the circuits led to the Supreme Court's recent decision in Associates Commercial Corp. v. Rash. In 1989, Mr. Rash, who needed a tractor truck for his freight-hauling business, purchased such a vehicle for $73,700. He made a down payment and gave the seller a security interest in the truck to secure his agreement to pay the balance in sixty monthly installments. The seller assigned the note and the

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1 In re Rash, 90 F3d 1036 (5th Cir. 1996) (en banc).
2 In re Trimble, 50 F3d 530 (8th Cir. 1995).
3 In re Hoskins, 102 F3d 311 (7th Cir. 1996).
security interest to Associates Commercial Corporation (ACC).

Three years after the purchase of the truck—when the balance due was $41,171—Rash and his wife filed a joint Chapter 13 petition in the Bankruptcy Court for the Eastern District of Texas, listed ACC as a secured creditor, and filed a plan that provided that Rash would retain the truck for use in his freight-hauling business. The plan proposed to pay ACC, over fifty-eight months, an amount equal to the value of the truck. The debtors alleged in the Chapter 13 petition that the value of the truck was $28,500. ACC objected to the plan, asked the bankruptcy court to lift the automatic stay to permit it to repossess the truck, and filed a proof of claim alleging that its claim was fully secured in the amount of $41,171. The Rashes filed an objection to the proof of claim.

Section 1325 of the Bankruptcy Code sets forth the requirements for confirmation of a Chapter 13 plan. With respect to a secured claim, Section 1325(a)(5) permits a court to confirm the plan if one of three alternative conditions are satisfied. Two of these alternative conditions—i.e., the secured creditor accepts the plan, or the debtor surrenders the collateral to the secured creditor—were not satisfied in the Rash case. The third alternative, often referred to as the "cram down" alternative, permits the debtor to retain the collateral over the secured creditor's objection, but only if the plan provides that the creditor retain its lien and that the debtor will pay the creditor, during the life of the plan, an amount that has a present value of not less than the "allowed amount" of the secured claim. If the creditor has an unsecured deficiency claim because the value of the collateral is less than the unpaid balance of the debt, the plan also must satisfy the requirements for treating an unsecured claim under Section 1325.

Bankruptcy Court Values Truck Based on Probable Net Foreclosure Sale Proceeds

Since Rash proposed to keep the truck over ACC's objection, the bankruptcy court had to determine the "allowed amount" of the secured claim. Section 506(a) of the Code provides, in part:

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value 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.

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5 11 USC § 1325.
6 See 11 USC § 1325(a)(5)(A).
7 See 11 USC § 1325(a)(5)(C).
8 See 11 USC § 1325(a)(5)(B).
9 See 11 USC §§ 506(a), 1325(a)(4), 1325(b).
on such disposition or use or on a plan affecting such creditor's interest. 10

The bankruptcy court in Rash held an evidentiary hearing to resolve the dispute over the truck's value. ACC urged the court to use as a valuation standard the so-called replacement value test, which focuses on the price that the debtor would have to pay to purchase a like vehicle, estimated by ACC's expert to be $41,000. The debtors challenged that approach and urged the court to base the value on the net amount that ACC would realize upon a foreclosure and sale of the truck, estimated by its expert to be $31,875. The bankruptcy court found that $31,875 was the amount that ACC would realize if it exercised its repossession and sale rights, set the allowed amount of the secured claim at that figure, and confirmed the plan. The result of the court's ruling was that ACC would receive, with respect to its secured claim, cash payments under the plan that would have a present value of $31,875. The district court affirmed.

ACC's appeal to the Fifth Circuit enjoyed initial success when a panel of the Court of Appeals reversed the bankruptcy court's valuation determination. 11 But the Fifth Circuit granted the debtor's request for a hearing en banc and then affirmed the decision of the district court, holding that ACC's allowed secured claim was limited to $31,875 based on the net amount likely to be realized in a foreclosure. 12

Fifth Circuit Focuses on State Law Remedies

The Fifth Circuit, in its en banc decision, recognized a conflict between using the replacement cost method of valuation to determine the allowed amount of the secured claim, as urged by ACC, and state law that defined the rights and remedies of a secured creditor. Under the law of Texas—which adopted Article 9 of the Uniform Commercial Code—a secured creditor has the right to foreclose and sell the collateral. 13 The Fifth Circuit commented that valuing collateral under a replacement cost standard would result in a value that is generally higher than the amount that a secured creditor would realize by exercising its foreclosure remedies under the Uniform Commercial Code. This result, which would "change the extent to which ACC is secured from what obtained under state law prior to the bankruptcy filing," 14 should be resisted by federal courts unless "clearly compelled" by the Bankruptcy Code. 15 The Fifth Circuit then concluded that the Bankruptcy Code, in particular Section 506(a), does not compel a replacement cost standard for collateral valuation.

10 11 USC § 506(a).
11 In re Rash, 31 F3d 325 (5th Cir. 1994).
12 In re Rash, 90 F3d 1036 (5th Cir. 1996) (en banc).
14 90 F3d at 1041.
15 90 F3d at 1042.
Focusing on the first sentence of Section 506(a), the Fifth Circuit reasoned that the collateral must be valued from the creditor’s perspective based on the rights it has under state law—which are limited to repossession and sale. For that reason, the Court of Appeals upheld the foreclosure value standard of valuation used by the bankruptcy court.

Supreme Court Adopts Replacement Value Standard

Because of the conflict among the circuits regarding the proper method of valuing collateral—i.e., whether to use the replacement value approach, the foreclosure value approach, or the split the difference approach—the Supreme Court granted certiorari in Rash. After analyzing Section 506(a), the Supreme Court reversed the Fifth Circuit and held that, in a cram down case, “the value of the property (and thus the amount of the secured claim under § 506(a)) is the price a willing buyer in the debtor’s trade, business, or situation would pay to obtain like property from a willing seller.”

But, the Court explained, “we do not suggest that a creditor is entitled to recover what it would cost the debtor to purchase the collateral brand new.” Rather, the bankruptcy court must determine the price that such a buyer would pay for “property of like age and condition.” By adopting this replacement value approach, the Supreme Court rejected the “typically lower foreclosure-value standard” approved by the Fifth Circuit.

Justice Ginsburg, writing for the Court, criticized the Fifth Circuit for relying on the first sentence of Section 506(a) to conclude that the foreclosure standard of valuation is required. The first sentence uses a certain phrase—“the creditor’s interest in the estate’s interest in such property”—which led the Fifth Circuit to hold that collateral value must be based on the limited foreclosure rights of the secured creditor under state law. But the Supreme Court concluded that this phrase “imparts no valuation standard.” Rather, the phrase “recognizes that a court may encounter, and in such instances must evaluate, limited or partial interests in collateral.”

Examining the first sentence of Section 506(a) in its entirety, the Court also noted that the sentence “tells a court what it must evaluate, but it does not say more; it is not enlightening on how to value the collateral.”

The Supreme Court then found that the second, not the first, sentence of Section 506(a) “does speak to the how question.” The second

16 117 S. Ct. at 1884.
17 117 S. Ct. at 1884, n. 2.
18 Id.
sentence provides that value "shall be determined in light of ... the proposed disposition or use of such property." The Court wrote that, because of that sentence, the proposed disposition or use of the collateral "is of paramount importance to the valuation question." After considering the options that a debtor has regarding the collateral, the Court commented that

Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor's choice to surrender the property or retain it. A replacement-value standard, on the other hand, distinguishes retention from surrender and renders meaningful the key words 'disposition or use.'

The Court recognized that, from both the debtor's and the creditor's perspectives, surrender and retention are not equivalent.

When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds. We recall here that ACC sought that very advantage. ... If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more 'adequate protection' ... do not fully offset these risks.

The Supreme Court did not sympathize with the Fifth Circuit's reluctance to disrespect applicable state law that defined the secured creditor's remedies as being limited to repossession and realization of net foreclosure value. The Supreme Court emphasized that the Bankruptcy Code, including Chapter 13, "has reshaped debtor and creditor rights in marked departure from state law." By allowing a Chapter 13 debtor to retain collateral over the objection of a secured creditor, the Code displaces state law rights to foreclosure upon a debtor's default. "It no more disrupts state law to make 'disposition or use' the guide for valuation than to authorize the rearrangement of rights the cram down power entails."

The Court also rejected the "ruleless approach allowing use of different valuation standards based on the facts and circumstances of individual cases" that was approved by the Court of Appeals for the Second Circuit in *In re Valenti*, as well as the "split-the-difference" approach sanctioned by the Seventh Circuit in *In re Hoskins.* "Whatever the attractiveness of a standard that picks the midpoint between foreclosure and replacement values, there is no warrant for it in the Code."
The Supreme Court’s Not-So-Simple Rule

But the Supreme Court did agree with the Seventh Circuit to the extent that it wrote in Hoskins that “a simple rule of valuation is needed” for purposes of predictability and uniformity.33

Ironically, the Supreme Court’s desire to have a simple rule was frustrated immediately after it set forth the following apparently clear statement of its holding in Rash: “In sum, under § 506(a), the value of property retained because the debtor has exercised the § 1325(a)(5)(B) ‘cram-down’ option is the cost the debtor would incur to obtain a like asset for the same ‘proposed . . . use.’”34 At the end of this sentence, the Court added the following footnote 6—which will likely become the most often quoted, as well as criticized, language of the entire opinion:

Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary:

A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. . . . Nor should the creditor gain from modifications to the property—e.g., the addition of accessories to a vehicle—to which a creditor’s lien would not extend under state law.35

By recognizing that “replacement value” might be the equivalent of the retail value, wholesale value, or some other value, depending on the type of debtor and nature of the collateral, the Supreme Court seems to have clouded the valuation issue as much as it has clarified it, thereby depriving bankruptcy courts of needed guidance about how to determine value. Does the bankruptcy court have to take into consideration whether the debtor is a sophisticated business executive who knows how to obtain similar property at a wholesale price, rather than an unsophisticated consumer who would normally pay the retail price from a dealer? Does that mean that a particular debtor may have to pay the retail price to retain collateral under a plan, while another debtor can pay a lower wholesale price to retain the equivalent collateral? If retail price is appropriate, how does a bankruptcy court deduct the value of warranties—including an implied warranty of merchantability under the Uniform Commercial Code?36 How does a court deduct an appro-

33 102 F3d at 314.
34 117 F3d at 1886.
35 117 S. Ct. at 1886, n. 6.
36 See UCC § 2-314.
appropriate amount for "inventory storage" or other "items the debtor does not receive when he retains his vehicle"?\textsuperscript{37}

It remains to be seen how bankruptcy courts will apply the Rash holding and the replacement value standard in view of footnote 6. We also will have to wait to see whether bankruptcy courts will apply Rash in other contexts that require valuation of collateral where the debtor retains the collateral over a secured creditor’s objection. In any event, the effect of the Rash holding will not likely be limited to Chapter 13 cases. Since the Court based its decision on the language of Section 506(a)—which applies in all types of bankruptcy cases\textsuperscript{38}—and the proposed use of the property, its reasoning also appears to be applicable to Chapter 11 and Chapter 12 cram downs where the debtor will retain collateral under a plan.\textsuperscript{39}

\textsuperscript{37} 117 S. Ct. at 1886, n. 6.

\textsuperscript{38} See 11 USC §§ 103(a), 901(a).

\textsuperscript{39} See 11 USC §§ 1129(b)(2)(A), 1225(a)(5).