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## Adequate Protection Under the Bankruptcy Code, Its Role in Business Reorganization

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### I. Introduction

A major problem under the Bankruptcy Act of 1898<sup>1</sup> was the question of debtor-in-possession's or trustee's<sup>2</sup> right after the commencement of a reorganization case to use property that collateralized a debt:<sup>3</sup> what form of protection would best satisfy competing interests<sup>4</sup> enabling and encouraging the debtor to reorganize and protecting the rights of secured creditors. The problem was of constitutional dimensions; the Supreme Court has held that, following the filing of a bankruptcy petition, secured creditors are entitled to protection of their rights in collateral.<sup>5</sup> The Act, which did not deal with the use by a debtor<sup>6</sup> of

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1. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (formerly at 11 U.S.C. §§ 1-1103 (1976)) [hereinafter referred to as the Act].

2. Absent a court order to the contrary, a debtor will remain in possession of and operate its business in a reorganization under Chapter 11 of the Bankruptcy Code of 1978, 11 U.S.C. §§ 1107-1108 (Supp. III 1979). Accordingly, as used herein, the term debtor will encompass debtors-in-possession as well as reorganization trustees.

3. King & Bauman, *Bankruptcy Law*, 1978 ANN. SURV. OF AM. L. 363, 369.

4. Shanor, *A New Deal For Secured Creditors in Bankruptcy*, 28 EMORY L.J. 587, 620 (1979).

5. *Wright v. Union Central Life Insurance Co.*, 311 U.S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935); Shanor, *supra* note 4. Constitutional issues involved in the use of collateral by a debtor during a reorganization arise from the

encumbered property provided the courts little, if any, guidance in striking an appropriate balance between these interests.<sup>7</sup>

The Bankruptcy Code of 1978,<sup>8</sup> which became effective on October 1, 1979, significantly affected this area through the medium of "adequate protection." The concept of adequate protection under the Code focuses on the collateral's value and the secured party's expectation of receiving that value; whereas in reclamation proceedings under the Act, the focus was on the right to receive the collateral itself.<sup>9</sup> Adequate protection tempers the protection and powers afforded the debtor by section 362 of the Code,<sup>10</sup> the automatic stay provision, which operates to stay all attempts, except through the bankruptcy proceedings, to enforce the debtor's monetary obligations, and by sections 363<sup>11</sup> and 364,<sup>12</sup> which, respectively, permit the debtor to use, sell or lease the debtor's property and obtain secured credit during the pendency of the bankruptcy case. If another's interest in property might be adversely affected, adequate protection is a required condition for "the continuation of a stay under section 362; the use, sale or lease of property under section 363, and the giving of security for a credit obligation under section 364."<sup>13</sup>

The Code does not define adequate protection. Section 361,<sup>14</sup> however, sets forth the following examples of adequate protection: periodic cash payments; additional or replacement liens; and such other means as will provide the secured creditor with the "indubitable equivalent" of its interest in the debtor's property.

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fifth amendment prohibitions against the taking of private property without due process of law. A detailed discussion of these issues is not within the scope of this article.

6. Kennedy, *Automatic Stays Under The New Bankruptcy Law*, 12 U. MICH. J. L. REP. 3, 43 n. 178 (1979).

7. *Use Of Secured Creditors' Collateral In Chapter X Reorganizations: A Proposed Modification Of The Commission's and Judges' Bills*, 1 J. CORP. L. 555, 557 (1975-76) [hereinafter cited as *A Proposed Modification*].

8. 11 U.S.C. §§ 101-151326 (Supp. III 1979) [hereinafter referred to as the Code]. Hereafter, all section numbers will refer to sections of the Bankruptcy Code unless otherwise indicated.

9. Shanor, *supra* note 4, at 621.

10. 11 U.S.C. § 362.

11. *Id.* § 363.

12. *Id.* § 364.

13. Kennedy, *supra* note 6, at 43 n. 178.

14. 11 U.S.C. § 361.

This article will examine the concept of adequate protection under the Code, especially in the context of Chapter 11 reorganizations.<sup>15</sup> Section I of this article provides an historical analysis of the concept of adequate protection. Section II discusses section 361 of the Code and its legislative history. Section III examines the function of the adequate protection concept in the context of business reorganizations by considering the situations in which adequate protection is required pursuant to sections 362, 363 and 364, and relevant cases. Finally, Section IV provides a brief discussion of some potential problems concerning adequate protection faced by debtors, secured creditors, and others.

## II. Historical Perspective

The Bankruptcy Act did not deal with the debtor's use after the filing of a petition in bankruptcy of encumbered property. The Act's provisions concerning stays, injunctions, sales, leases, and issuance of certificates of indebtedness included no requirement of adequate protection.<sup>16</sup> Adequate protection, however, was provided for objecting classes of creditors in Chapters X and XII<sup>17</sup> reorganizations after confirmation of a plan over such class's dissent. Section 216(7) of Chapter X and section 461(11) of Chapter XII of the Act each provided for the so-called "cramming down" of a plan by providing a dissenting class with "adequate protection for the realization by them of the value of their claims against the property dealt with by the plan."<sup>18</sup>

This adequate protection provided by the Act differed from the adequate protection during the reorganization contemplated by the Code. Under the Act, adequate protection was afforded at

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15. One of the Code's major departures from prior law under the Act is the consolidation, into one chapter, of all provisions governing business reorganizations. Chapter 11 of the Bankruptcy Code replaces and modernizes the following chapters of the Act: Chapter X (corporate reorganizations) §§ 101-276 of the Act, 52 Stat. 883; Chapter XI (arrangements) §§ 301-399 of the Act, 52 Stat. 905; and Chapter XII (real property arrangements by a noncorporate debtor) §§ 401-526 of the Act, 52 Stat. 916. Chapter 11 of the Code utilizes concepts contained in former Chapters X and XI, as well as some new concepts. King & Bauman, *supra* note 3, at 368.

16. Kennedy, *supra* note 6, at 43 n.178.

17. Former Chapter X, §§ 101-276 of the Act, 52 Stat. 883; and Chapter XII, §§ 401-526 of the Act, 52 Stat. 916. Hereafter, references to Chapters X, XI and XII will refer to Chapters X, XI and XII of the Bankruptcy Act, *see supra* note 15.

18. 2 COLLIER ON BANKR. ¶ 361.01 (1981) [hereinafter cited as 2 COLLIER].

the time of confirmation of a reorganization plan when a failure to provide adequate protection would leave the affected creditor without redress.<sup>19</sup> The Code provides adequate protection at an earlier stage, when the issue will not be susceptible to the detailed inquiry it would receive at the time of confirmation. On the other hand, an inadequacy in the protection afforded a creditor is more likely to be corrected if the protection is provided at an earlier stage than if it is provided at the time of confirmation. In dealing with adequate protection issues under the Code, the courts initially looked to cases under the Act dealing with stays, use, sale, and lease of property and the obtaining of credit rather than to cases under the Act dealing with adequate protection.<sup>20</sup>

In the pre-Code case *In re Yale Express Systems, Inc.*,<sup>21</sup> the United States Court of Appeals for the Second Circuit permitted liberal continued use of collateral. The court balanced the interests of the secured creditor against the interests of the debtor and the public in obtaining a successful reorganization. The debtor had defaulted on payments on a debt secured by a chattel mortgage on vehicles the debtor had purchased from the secured creditor. Subsequent to the default, the debtor filed a reorganization petition and the secured creditor commenced a reclamation proceeding for the vehicles. For reasons that were not clearly stated in its opinion, the district court denied the reclamation petition.<sup>22</sup> On appeal by the secured creditor, the Second Circuit remanded the case for further consideration of whether the equities favored the debtor's interim use of the collateral.<sup>23</sup> The Second Circuit noted that even if the district court on remand concluded that the debtor should retain the collateral, the court could provide other relief to the secured creditor, such as requiring the debtor to make rental payments.<sup>24</sup> On remand the district court did not compel the debtor to make rental payments because the court found that successful reorganization was a reasonable possibility and that the collateral

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19. *Id.*

20. *Id.*

21. *In re Yale Express Syss., Inc.* (Yale Express II), 384 F.2d 990 (2d Cir. 1967).

22. *In re Yale Express Syss., Inc.*, 250 F. Supp. 249 (S.D.N.Y. 1966).

23. *In re Yale Express Syss., Inc.*, (Yale Express I), 370 F.2d 433 (2d Cir. 1966).

24. *Id.* at 439.

was crucial to the reorganization.<sup>25</sup> The court of appeals accepted these findings and held that if the secured creditor were damaged by the debtor's use of collateral, the creditor would receive "equitable consideration," an administrative priority, in the reorganization plan.<sup>26</sup>

The *Yale Express* decision was justifiably criticized as making loss to the secured creditor a near certainty by permitting the debtor to use depreciating collateral for a marginally secured debt.<sup>27</sup> The secured creditor received no protection, and was left with the speculative hope that he would receive "equitable consideration" in the reorganization plan. *Yale Express* would be decided differently under the Code. An administrative priority as a method of providing adequate protection was rejected by the Code's drafters "because such protection is too uncertain to be meaningful."<sup>28</sup> Under the Code, in the absence of adequate protection, the secured creditor would be entitled to relief from the automatic stay.<sup>29</sup> The *Yale Express* cases, however, were the vanguard of a move to provide genuine creditor protection.<sup>30</sup> The discussions of the possibility of rental payments and of the competing equities favoring the debtor and those favoring the secured creditor were significant in the evolution of the concept of adequate protection.

In a factually similar case before the Second Circuit, *In re Bermec Corporation*,<sup>31</sup> the collateral involved was vehicles purchased and leased in the course of the debtor's business. The court permitted the debtor to continue leasing the vehicles and collecting the rents. Debtor's use was conditioned, however,

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25. The court rationalized that if rental payments were made other secured creditors could demand such payments resulting in depletion of debtor's operating collateral and frustration of the reorganization effort. These facts are reported in *In re Yale Express System, Inc. (Yale Express II)*, 384 F.2d at 991-92.

26. *Id.* at 992. For an excellent discussion of the *Yale Express* decisions, see *A Proposed Modification*, *supra* note 7, at 571-72.

27. Murphy, *Use of Collateral In Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CAL. L. REV. 1483, 1494 (1975). Murphy suggested that *Yale Express II* had little support in prior bankruptcy law and violated the secured creditor's fifth amendment rights. *Id.* at 1494 n. 71.

28. S. REP. NO. 989, 95th Cong., 2d Sess. 49, 54 (1978) [hereinafter cited as S. REP.], reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787.

29. 11 U.S.C. § 362(d)(1).

30. *A Proposed Modification*, *supra* note 7, at 572.

31. 445 F.2d 367 (2d Cir. 1971).

upon payment to the secured creditor of an amount equal to the economic depreciation of the collateral during the use period. As in *Yale Express*, the Second Circuit balanced the secured creditors' interests against the "congressional mandate to encourage attempts at corporate reorganizations."<sup>32</sup> The pre-reorganization depreciation payments ordered by the *Bermec* court to "approximately . . . preserve . . . [the secured creditors'] status quo"<sup>33</sup> are more consistent with the Code's concept of adequate protection than are the rental payments authorized in *Yale Express*.

In July 1973 the Commission on the Bankruptcy Laws of the United States submitted its report,<sup>34</sup> which included recommendations for changes in the bankruptcy laws,<sup>35</sup> and a proposed statute optimistically called the Bankruptcy Act of 1973.<sup>36</sup> Section 7-203 of the proposed Act, concerning the use of property leased or subject to a lien, included the following concept of adequate protection:

[A] secured party or lessor may file a complaint . . . to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party. The trustee or debtor shall have the burden of proving that the value of the secured creditor's interest in the property or the property leased as of the date of the petition is adequately protected.<sup>37</sup>

The commission, which did not attempt to codify the case law with respect to the adequacy of protection in any given situation, left the courts to develop the concept on a case by case basis.<sup>38</sup> The commission did suggest, however, conditions which courts might impose in appropriate circumstances, including: re-

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32. *Id.* at 369.

33. *Id.*

34. In 1970, as a result of hearings held in 1968, Congress created the Commission to study, analyze, evaluate and recommend changes in bankruptcy legislation, Pub. L. No. 91-354, 84 Stat. 468 (1970).

35. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973) [hereinafter cited as the REPORT OF THE COMMISSION].

36. *Id.* The Commission's proposed statute was accompanied by explanatory notes containing specific findings and representations. H. MILLER & M. COOK, A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT 6-7 (1979).

37. REPORT OF THE COMMISSION, *supra* note 35, at 236.

38. *Id.* at 237 n.3.

quiring other security of equivalent value; requiring additional security to the extent of the anticipated decrease in the collateral's value as a result of use when the debtor had marginal or no equity in the collateral; and giving a priority if it is clear that the proceeds from the liquidation of the estate's available property will be sufficient to pay the claim.<sup>39</sup> The impact of the commission's proposed codification of the adequate protection concept and of the *Yale Express* and *Bermec* cases was evident in the following pre-Code decisions.

*In re Blazon Flexible Flyer, Inc.*,<sup>40</sup> is illustrative of the principle that adequate protection is a fluid concept dependent on the circumstances evident during its application. In *Blazon*, the district court, in affirming an order of the bankruptcy court, held that a secured creditor was "adequately protected" by the following factors: a \$4,391,000.00 excess of the security over the debt; a requirement imposed by the bankruptcy court that the debtor transmit financial information to the secured creditor and the court; and the retention by the bankruptcy court of control over the case to permit revision of its orders on short notice if circumstances changed to the secured creditor's detriment.<sup>41</sup> The court thus fashioned adequate protection for the secured creditor without compelling the debtor to make payments or give a lien that could complicate the reorganization effort.

In *In re American Kitchen Foods, Inc.*,<sup>42</sup> the court protected secured creditors by replacement and additional liens. The debtor tendered and the court authorized additional collateral to indemnify the secured creditors against any diminution of their collateral resulting from the debtor's continued retention and use. Citing *Blazon*, among other cases, Bankruptcy Court Judge Cyr held that there was no unconstitutional impairment of the rights of secured creditors; the original collateral, combined with the additional collateral proffered, sufficiently secured the debt.<sup>43</sup>

While the *Yale Express*, *Bermec*, *Blazon Flexible Flyer* and

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39. *Id.* at 237 n.2.

40. 407 F. Supp. 861 (N.D. Ohio 1976).

41. *Id.* at 864-65.

42. 9 COLLIER BANKR. CAS. (MB) 537 (Bankr. D. Me. 1976).

43. *Id.* at 547.



*American Kitchen Foods* cases were not the only pre-Code cases to deal with the issue of a debtor's use of collateral during the course of a reorganization effort,<sup>44</sup> these cases had significant impact on the legislative process which led to the Code's enactment.

### III. Adequate Protection Under The Code

#### A. Introduction

The Code provides an important assurance for entities with interests in a debtor's property; as long as adequate protection is required, "although their remedies may be suspended or abrogated, and they may lose their rights in particular collateral, the value of their secured position at the time of the commencement of the case will be protected throughout the case."<sup>45</sup> As discussed below, adequate protection may be required for the continuation of the automatic stay,<sup>46</sup> for the debtor's use, sale or lease of estate property,<sup>47</sup> and for the granting of a senior lien on collateral in order to obtain credit.<sup>48</sup> Section 361 provides illustrations of what may constitute adequate protection:

When adequate protection is required under section 362, 363 or 364 of this title of an interest of an entity in property, such adequate protection may be provided by

(1) requiring the trustee to make periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

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44. The following pre-Code cases support the proposition that, if the secured creditor's status quo cannot be preserved or protected in the interim, the collateral may not be used: *In re Third Ave. Transit Corp.*, 198 F.2d 703 (2d Cir. 1952); *Reconstruction Finance Corp. v. Kaplan (In re Waltham Watch Co.)*, 185 F.2d 791 (1st Cir. 1950); *In re Gen. Stores Corp.*, 147 F. Supp. 350 (S.D.N.Y. 1957); cases cited in *A Proposed Modification*, *supra* note 7, at 573-76.

45. 2 COLLIER, *supra* note 18, at ¶ 361.01.

46. 11 U.S.C. § 362(d)(1).

47. *Id.* § 363(e).

48. *Id.* § 364(d)(1).

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.<sup>49</sup>

The drafting of section 361 indicates a primary concern with the most commonly litigated interests of secured creditors; however, lessors, owners, or co-owners of property of the debtor may also demand adequate protection.<sup>50</sup> Moreover, adequate protection extends to both legal and equitable interests such as "a right to redeem under a pledge or a right to recover property under a consignment."<sup>51</sup> Adequate protection will extend, however, only to the amount of a creditor's allowed secured claim.<sup>52</sup> Also, valueless junior unsecured deficiency claims will not be en-

49. *Id.* § 361.

50. *Id.* Further, a secured creditor with a right of setoff pursuant to section 553 is entitled to adequate protection. See *In re Princess Baking Corp.*, 5 Bankr. 587 (Bankr. S.D. Cal. 1980). In addition, a subordination agreement, although enforceable in bankruptcy pursuant to section 510(a), will not abrogate certain rights, which the Code guarantees to all secured creditors, such as adequate protection. See *In re Hart Ski Mfg. Co.*, 5 Bankr. 734 (Bankr. D. Minn. 1980).

51. H.R. REP. No. 595, 95th Cong., 1st Sess. 43-44 (1977)[hereinafter cited as H.R. REP.], reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963; S. REP., *supra* note 28.

One court has recently observed that:

[T]his classification is important because adequate protection depends upon the interest and property involved. Protection afforded a lessor, for example, may be different than that afforded a secured creditor. Treatment of a secured creditor who faces turnover may be different from treatments of a secured creditor who has not repossessed. Treatment of a senior lienholder may be different from treatment of a junior lienholder. Similarly, protection may vary if the property is real or personal, tangible or intangible, perdurable or perishable, or if its value is constant, depreciating, or subject to sudden or extreme fluctuations. Also relevant is the proposed use or idleness of the property.

*In re Alycan Interstate Corp.*, 12 Bankr. 803 (Bankr. D. Utah 1981).

52. 11 U.S.C. § 506(a) provides, in part, that:

[a]n allowed claim of a creditor secured by a lien . . . is a secured claim to the extent of the value of such creditor'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.

Any unsecured portion of a partially secured claim will not receive protection. 2 COLLIER, *supra* note 18, at ¶ 361.01. 11 U.S.C. § 1111(b)(2) permits creditors to elect to have their claims treated as secured claims to the full extent of the allowed claim, rather than to the extent of the collateral as under section 506(a). A creditor who has made an election under section 1111(b)(2) is entitled to adequate protection limited to the value of the collateral and not to the extent of the creditor's allowed secured claim. 124 CONG. REC. H11,092 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,409 (daily ed. Oct. 6, 1978).

titled to adequate protection<sup>53</sup> since only the value of an entity's interest is protected.

### B. *Section 361 Methods of Adequate Protection*

Section 361 is structured to illustrate "methods of adequate protection and to define the contours of the concept."<sup>54</sup> While adequate protection, when requested by the appropriate parties, is a matter of right, not discretion,<sup>55</sup> section 361 does not require that a court devise a method of adequate protection because to do so would place the court in an administrative role. Rather, section 361 provides the basis upon which a court can determine the adequacy of a debtor's proposed method of adequate protection in those circumstances in which a party affected by such proposal objects to it.<sup>56</sup>

Although adequate protection is derived from the fifth amendment's protection of property interests, Congress did not intend that the concept be strictly confined to the minimum protection required by the Constitution. Section 361 and adequate protection are also based on policy grounds; "secured creditors should not be deprived of the benefits of their bargains."<sup>57</sup> At the same time, the drafters recognized that giving secured creditors the absolute benefit of their bargains sometimes would be impossible, or would be seriously detrimental to the policies underlying the bankruptcy laws. In order to facilitate a debtor's rehabilitation, section 361 authorizes an alternate means of protecting secured creditors' interests. While a secured creditor might not be permitted to retain a lien on specific collateral, adequate protection attempts to ensure that a secured creditor will receive the value for which he bargained.<sup>58</sup>

Section 361 sets forth three non-exclusive, non-exhaustive methods of adequate protection: periodic cash payments, additional or replacement liens, and indubitable equivalence.<sup>59</sup>

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53. 2 COLLIER, *supra* note 18, at ¶ 361.01.

54. H.R. REP., *supra* note 51, at 338.

55. *Id.* at 343-44; S. REP., *supra* note 28, at 52-53.

56. H.R. REP., *supra* note 51, at 338; S. REP., *supra* note 28, at 49.

57. H. REP., *supra* note 51, at 339; S. REP., *supra* note 28, at 49, 53.

58. H.R. REP., *supra* note 51, at 339; S. REP., *supra* note 28, at 53.

59. 11 U.S.C. § 361.

### 1. Periodic Cash Payments

Section 361(1) proposes periodic cash payments as a method of providing adequate protection. Such payments are contemplated to the extent that the automatic stay, use, sale, lease or granting of a lien causes a decrease in the affected entity's interest in the property. Ordinarily, the secured party's interest will be protected against a decrease in value in the collateral.<sup>60</sup> The drafters noted that periodic cash payments, in the amount of the depreciation, would be appropriate if the collateral is depreciating at a relatively fixed rate, a method derived from the *Yale Express* case,<sup>61</sup> and from the *Bermec* case.<sup>62</sup>

### 2. Additional Or Replacement Liens

As a method of adequate protection, section 361(2) suggests additional or replacement liens to the extent of the decrease in value or actual consumption of the property involved. This method provides, through granting an interest in additional property, for the realization of the pre-bankruptcy value of the property if such property declines in value during the case.<sup>63</sup> As noted by the drafters, this device is consistent with the view that adequate protection is designed to protect the value of a secured creditor's collateral, not his rights in specific collateral.<sup>64</sup> In *In re American Kitchen Foods, Inc.*,<sup>65</sup> a pre-Code example of the type of situation in which this method would be appropriate, the secured creditors were given a secured claim against all of the debtors' assets which the court found exceeded the debt.

### 3. Indubitable Equivalent

Section 361(3) provides a method permitting such other re-

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60. 2 COLLIER, *supra* note 18, at ¶ 361.01.

61. H.R. REP., *supra* note 51, at 339. See *supra* notes 21-24 and accompanying text.

62. *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971). See *supra* notes 31-34 and accompanying text. In *Bermec*, the trustee offered to "pay the economic depreciation on the secured creditor's equipment to approximately preserve their *status quo*." See S. REP., *supra* note 28, at 54.

63. 11 U.S.C. § 361(2); H.R. REP., *supra* note 51, at 339-40; S. REP., *supra* note 28, at 54.

64. S. REP., *supra* note 28, at 54.

65. *In re American Kitchen Foods, Inc.*, 9 COLLIER BANKR. CAS. (MB) 537 (Bankr. D. Me. 1976). See *supra* text accompanying notes 42 & 43.

lief as will result in the affected entity receiving the "indubitable equivalent" of its interest in the collateral. The "indubitable equivalent" alternative was derived from the decision of the United States Court of Appeals for the Second Circuit in *In re Murel Holding Co.*,<sup>66</sup> a 1935 case involving adequate protection for a class of creditors dissenting from the confirmation of a reorganization plan.<sup>67</sup> There the Second Circuit stated:

It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.<sup>68</sup>

The "indubitable equivalence" method makes adequate protection a flexible concept adaptable to the various circumstances in which it is applied.<sup>69</sup> This method defines adequate protection conceptually and more clearly than the other methods of section 361, requiring such relief as will result in the realization of the value to be protected.<sup>70</sup>

Section 361(3) requires a mere "indubitable equivalence," rather than the "most indubitable equivalence" required by *Murel*.<sup>71</sup> This standard allows "ample room for case by case de-

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66. *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935). See also *In re American Mariner Indus., Inc.* 10 Bankr. 711 (Bankr. C.D. Cal. 1981).

67. Here the court did not allow a cramming down of a plan because no adequate protection was provided for dissenting mortgagees. The Second Circuit reversed the imposition of a stay of joint foreclosure of an apartment building because the two bankrupt corporate owners failed to prove that they could provide adequate protection for the mortgagee's interests. The court noted that adequate protection could be provided by four methods: 1) keeping the liens at status quo; 2) selling the property and attaching a lien to the proceeds; 3) paying the appraised value of the liens; or 4) any method devised through judicial discretion. None of these methods of protection had been provided by the debtor. *In re Murel Holding Corp.*, 75 F.2d at 942. This case may provide precedent for issues arising upon confirmation of a plan, rather than for adequate protection issues. See *In re American Mariner Indus., Inc.*, 10 Bankr. 711 (C.D. Cal. 1981).

68. *In re Murel Holding Corp.*, 75 F.2d at 942.

69. H.R. REP., *supra* note 51, at 340.

70. *Id.*

71. *In re Murel Holding Corp.*, 75 F.2d at 942.

velopment of adequate protection.”<sup>72</sup> Courts can adapt to new financing methods and fashion appropriate relief according to the circumstances of a given case,<sup>73</sup> such as allowing a third person’s guarantee outside the judicial process of compensation for any loss incurred in the case. Secured creditors can bid in their claims during the sale of the collateral and these claims will be offset against the price finally bid in.<sup>74</sup> Where a reserve fund is maintained under a security agreement, as in the typical bondholder case, “indubitable equivalence” would entail the protection of the bond-holders for the regular payments needed to service the debt as well as the reserve fund.<sup>75</sup>

Adequate protection can involve imposing upon the debtor duties or conditions which are quite different from the illustrations set forth in section 361.<sup>76</sup> For example, collateral comprised of inventory or receivables may be adequately protected either by an ongoing accounting to the creditors or by segregation of cash proceeds.<sup>77</sup> At times, adequate protection may be achieved indirectly by requiring the debtor to make payments to superior lienholders or to pay the taxes on, or operation expenses of, the collateral.<sup>78</sup> The form of adequate protection afforded in a given case may also depend upon the nature of the “entity” to be protected. For example, an institutional lender may be adequately protected by a debt service moratorium together with measures designed to preserve the collateral’s value. If the debt secured by the collateral, however, is a retired person’s principal asset, periodic payments may be the only way to adequately protect his interest.<sup>79</sup>

Section 361(3) expressly excludes the granting of compensa-

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72. H.R. REP., *supra* note 51, at 340.

73. *Id.*

74. *Id.*

75. 124 CONG. REC., H11,092 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,408-09 (daily ed. Oct. 6, 1978).

76. See *supra* text accompanying note 49.

77. 2 COLLIER, *supra* note 15, at ¶ 361.01.

78. *Id.*

79. *Id.* at ¶ 361.13. Bankruptcy courts now have the full powers of a court of equity, law or admiralty. 28 U.S.C. § 1481 (Supp. III 1979), as amended by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 241(a), 92 Stat. 2671. Further, the bankruptcy courts are empowered to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Code. 11 U.S.C. § 105.

tion under section 503(b)(1)<sup>80</sup> for administrative expenses as a method of providing the "indubitable equivalent" of a party's interest in property.<sup>81</sup> The House of Representatives drafts of the Code would have followed the suggestion of the *Yale Express* case and permitted the providing of adequate protection by giving a secured party an administrative priority to the extent of any decrease in the value of collateral.<sup>82</sup> This method was rejected because "[i]n every case there is the uncertainty that the estate will have sufficient property to pay administrative expenses in full."<sup>83</sup> Under section 507(b),<sup>84</sup> however, if protection is provided and later proves to have been inadequate, a secured creditor's claim receives first priority over all other allowable claims which are entitled to distribution under section 507(a)(1).<sup>85</sup> Such a priority is subordinate only to superpriorities granted under section 364(c)(1); it will be senior to other administrative expenses, including those attendant to any eventual liquidation under Chapter 7 of the Code.<sup>86</sup>

### C. Valuation

The valuation of the collateral is crucial to a determination of adequate protection because it is an entity's interest in property that must be protected. All of the adequate protection methods specified in section 361 are based upon the "value of

80. Code section 503(b)(1)(A) provides, in part, that:

[a]fter notice and a hearing, there shall be allowed, administrative expenses . . . [including] . . . the actual, necessary costs and expenses of preserving the estate . . . .

11 U.S.C. § 503(b)(1)(A).

81. *Id.* § 361(3).

82. 2 COLLIER, *supra*, note 15, at ¶ 361.01.

83. 124 CONG. REC. H11,092 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,408 (daily ed. Oct. 6, 1978).

84. 11 U.S.C. § 507(b).

85. *Id.* § 507(b) provides, in substance, that:

If the trustee, under section 362, 363 or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim under such subsection.

86. 2 COLLIER, *supra* note 18, at ¶ 361.01.

the protected entity's interest in the collateral involved."<sup>87</sup> Section 361, however, does not specify how or when value is to be determined. Congress recognized the continuous development of new ideas and of the law concerning valuation, and gave the courts the flexibility to adapt to the circumstances and modes of financing presented by each case.<sup>88</sup>

The commission had suggested liquidation value at the date of the filing of the petition as "a benchmark in determining adequate protection."<sup>89</sup> The drafters rejected this approach:

Neither is it expected that the courts will construe the term value to mean, in every case, forced liquidation value or full going concern value. There is a wide latitude between those two extremes. In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations based on the facts of the case. It will frequently be based on negotiation between the parties. Only if they cannot agree will the court become involved.<sup>90</sup>

The courts have also rejected the forced liquidation measure. For example, in *In re American Kitchen Foods, Inc.*,<sup>91</sup> where the collateral included inventory and accounts receivable which could be converted into cash in the orderly course of the debtor's continuing business, the bankruptcy court decided that the standard universally applicable in all cases and at every phase of each case should be "the most commercially reasonable disposition practicable."<sup>92</sup> In order to determine what is commercially reasonable in a given case, the court noted it is necessary to weigh factors such as the nature of the debtor's business, the prospects for rehabilitation, and the nature of the collateral.<sup>93</sup> This approach, based upon equitable, realistic, and practi-

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87. H.R. REP., *supra* note 51, at 339; S. REP., *supra* note 28, at 54.

88. H.R. REP., *supra* note 51, at 339; S. REP., *supra* note 28, at 54.

89. REPORT OF THE COMMISSION, *supra* note 35, at 237 n.3.

90. H.R. REP., *supra* note 51, at 339. It was further noted that the determination of value has no *res judicata* effect and is binding only for the purposes of a specific hearing where the finding is made. S. REP., *supra* note 25, at 54.

91. *In re American Kitchen Foods, Inc.*, 9 COLLIER BANKR. CAS. (MB) 537 (Bankr. D. Me. 1976).

92. *Id.* at 553.

93. *Id.* at 552; see 2 COLLIER, *supra* note 18, at ¶ 361.02.



cal considerations, should be useful as the courts wrestle with the valuation issues which arise under the Code.<sup>94</sup>

#### IV. The Role Of Adequate Protection In Business Reorganizations

##### A. Introduction

The drafters of the Code intended that following the filing of the petition in a Chapter 11 case the debtor or trustee, if appointed, would continue to operate the debtor's business.<sup>95</sup> Indeed, a successful reorganization will depend most often upon the continuation of the debtor's business. The Code includes provisions designed to facilitate continuation of the debtor's business under the otherwise unmanageable circumstances precipitated by the filing of the petition:<sup>96</sup> the automatic stay provisions of section 362;<sup>97</sup> the provisions of section 363 concerning

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94. The value assigned to the collateral by a secured creditor often may be an important tactical decision. For example, a creditor asserting a high collateral valuation in the early stages of a case risks a determination that he is not in need of adequate protection. Conversely, a low valuation might be unbelievable or can make it easier for the debtor to satisfy a creditor's claim in a reorganization plan. Moreover, the lower the value to be protected, the easier it will be to provide adequate protection; if the valuation is too low, it might be determined that the interest is a valueless junior lien unworthy of adequate protection. Valuation should not pass the risk of the debtor's continued operations to the creditor. On the other hand, premature anticipation of liquidation should not cause the termination of a case which, if continued, could result in the debtor's rehabilitation, or at least in a more substantial distribution to creditors. 2 COLLIER, *supra* note 18, at ¶ 361.02. A more detailed discussion of valuation is beyond the scope of this article.

95. Bisbee, *Business Reorganization Practice Under the Bankruptcy Reform Act of 1978*, 28 EMORY L.J. 709, 724 (1979). Code section 1107 places a debtor-in-possession in the shoes of a trustee in every way. 11 U.S.C. § 1107. H.R. REP., *supra* note 51, at 404; S. REP., *supra* note 28, at 116. Section 1108 provides that "[u]nless the court orders otherwise, the trustee may operate the debtor's business." 11 U.S.C. § 1108. Appointment of a trustee or examiner is provided for in section 1104, "for cause, including fraud, dishonesty, incompetence, or gross mismanagement . . . or if such appointment is in the interest of creditors." 11 U.S.C. § 1104.

96. Bisbee, *supra* note 94, at 724. As previously stated, the term debtor will encompass both debtors-in-possession and trustees. See *supra* note 2.

97. 11 U.S.C. § 362. Chapter 11 is not a self-contained unit. 11 U.S.C. § 103(a) makes the provisions of Chapter 1 (General Provisions, including definitions and rules of construction), Chapter 3 (Case Administration) and Chapter 5 (Creditors, the Debtor and the Estate) applicable to cases under Chapters 7, 11 and 13. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 AM. BANKR. L.J. 107, 108 (1979).

post-petition use, sale or lease of encumbered property;<sup>98</sup> and section 364, which facilitates the obtaining of credit.<sup>99</sup>

The debtor's ability to provide a secured creditor or other entity with adequate protection, however, may determine whether sections 362, 363, and 364 are available to the debtor. Under section 362(d) the automatic stay must be vacated if a party in interest requests, unless that party is afforded adequate protection. Similar protection is afforded by section 363, if collateral is being used, sold or leased, and section 364, if credit is being obtained by the giving of a lien which is equal or senior to an existing lien.<sup>100</sup> This section will examine the role of adequate protection in business reorganizations under Chapter 11 by discussing the conditions in which adequate protection is required under sections 362, 363, and 364, and by analyzing cases dealing with adequate protection in reorganizations.

### *B. Adequate Protection as a Condition for Continuation of the Automatic Stay*

The automatic stay under section 362 is one of the fundamental debtor protections supplied by the Code.<sup>101</sup> This section provides for a broad stay of litigation, lien enforcement, and other judicial and non-judicial actions which would affect or interfere with the debtor's property.<sup>102</sup> The stay, effective upon

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98. 11 U.S.C. § 363.

99. Bisbee, *supra* note 94, at 724.

100. 2 COLLIER, *supra* note 18, at ¶ 362.02.

101. H.R. REP., *supra* note 51, at 340.

102. 11 U.S.C. § 362; *see* 2 COLLIER, *supra* note 18, at ¶ 362.01. The stay is effective against:

- (1) a judicial, administrative, or other proceeding against the debtor, including the issuance or employment of process;
- (2) the enforcement of a judgment against the debtor or the property of the estate;
- (3) any act to obtain possession of property of or from the estate;
- (4) any act to create, perfect, or enforce a lien against property of the estate;
- (5) any act to create, perfect or enforce a lien against the debtor's property securing a pre-petition debt;
- (6) any act to collect, assess, or recover a pre-petition claim against the debtor;
- (7) setoff of any pre-petition debt owing to the debtor against any claim of the debtor; and
- (8) a proceeding by the debtor before the United States Tax Court.

*See* 11 U.S.C. § 362(a)(1)-(8); Kennedy, *supra* note 6, at 11, 12.

the filing of the petition,<sup>103</sup> applies to virtually "any formal or informal action against the debtor or property of the estate,"<sup>104</sup> except for the limitations set forth in section 362(b).<sup>105</sup> At the same time the stay protects creditors by facilitating the equal treatment of creditors and preventing "a race of diligence for the debtor's assets."<sup>106</sup>

Requests by secured creditors for relief from the automatic stay make up the lion's share of litigation involving adequate protection under the Code. A party in interest can request relief, under section 362(d)(1), such as termination, modification, annulment, or conditioning of the stay "for cause, including the lack of adequate protection of an interest in property of such party in interest."<sup>107</sup> Thirty days after the request, the automatic stay terminates with respect to the entity seeking relief from the stay. The court, after notice and hearing, however, may continue the stay. If the hearing on relief is preliminary, the court will continue the stay upon a showing of reasonable likelihood that the debtor will prevail at the final hearing. The final

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103. 11 U.S.C. § 362(a); 2 COLLIER, *supra* note 18, at ¶ 362.03.

104. 2 COLLIER, *supra* note 18, at ¶ 362.04. The stay gives the debtor "a breathing spell from his creditors. It stops all collection efforts, all harassment and all foreclosure actions. It permits the debtor to attempt a reorganization or repayment plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." H.R. REP., *supra* note 51, at 340; S. REP., *supra* note 28, at 54.

105. 11 U.S.C. § 362(b). Among the exceptions to the stay are criminal proceedings, the collection of alimony, maintenance or support, an action by a governmental unit to enforce its police or regulatory power, and the issuance to the debtor by a governmental unit of a notice of a tax deficiency. 11 U.S.C. §§ 362(b)(1),(2),(8).

106. H. REP., *supra* note 51, at 340; S. REP., *supra* note 28, at 49. In determining whether to lift the automatic stay, a court must balance and harmonize the "countervailing and competing interests" of the secured creditors, the unsecured creditors, and the debtor. *E.g.*, *In re First Century Trust Co.*, 12 Bankr. 204, 208 (Bankr. W.D. Tenn. 1981)(court refused to grant a second mortgagee relief from the stay and allow foreclosure where to do so would deprive priority and unsecured creditors of an opportunity to receive any portion of their debts, and the debtor of an opportunity to reorganize).

107. 11 U.S.C. § 362(d)(1). In addition to lack of adequate protection, "cause" may also include factors such as: a desire to permit the conclusion of an action in another tribunal or the lack of any connection or interference with the bankruptcy case, such as a divorce or child custody proceedings, or where the debtor is a fiduciary. H.R. REP., *supra* note 51, at 343-44; S. REP., *supra* note 28, at 52. See *In re Sulzer*, 2 Bankr. 630 (Bankr. S.D.N.Y. 1980). A debtor's baseless delaying tactics have been held to be sufficient cause for lifting the stay. See *In re GSVC Restaurant Corp.*, 10 Bankr. 300 (Bankr. S.D.N.Y. 1980). The debtor's delaying tactics, coupled with his failure to propose a method of adequate protection, prompted the court to grant the landlord relief from the automatic stay.

hearing must commence within thirty days after the preliminary hearing.<sup>108</sup> The only issues considered at a hearing on relief from the stay are the creditor's claim, the lack of adequacy of protection, and the existence of other reasons for relief from the stay.<sup>109</sup> The debtor will have the burden of proof on the issue of adequate protection and all other issues<sup>110</sup> except the issue of the debtor's interest in the property.<sup>111</sup> In certain circumstances, such as if the protection afforded such creditor becomes inadequate because of changed circumstances or if the debtor fails to afford the adequate protection offered,<sup>112</sup> a creditor who has been denied relief from the stay may successfully renew his request for such relief.

A creditor's request for relief from the stay may be denied if the debtor provides adequate protection in the form of periodic payments. In *In re A.L.S., Inc.*,<sup>113</sup> prior to the filing of the petition, the Chapter 11 debtor had subleased from the creditor premises in a shopping center. After the debtor defaulted on its rental payments the creditor terminated the lease. Following the

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108. 11 U.S.C. § 362(e).

109. H.R. REP., *supra* note 51, at 344; S. REP., *supra* note 28, at 55. Such a hearing is not the appropriate time to litigate other issues, such as the debtor's counterclaims against the creditor on largely unrelated matters. See *In re High Sky, Inc.*, 15 Bankr. 332 (Bankr. M.D. Pa. 1981); *In re Executive Leasing Corp.*, 3 Bankr. 261, 262 (Bankr. D.P.R. 1980). Even if a debtor's affirmative defenses and counterclaims are valid, a secured creditor seeking relief from the stay is entitled to adequate protection until there is a rendering of a final nonappealable judgment, which avoids or diminishes the pre-petition contract at issue. *In re High Sky, Inc.*, 15 Bankr. at 337 (citing *In re Born*, 10 Bankr. 43 (Bankr. S.D. Tex. 1981)).

110. 11 U.S.C. § 362(g). The statute refers to the "party opposing" relief from the stay. See generally 2 COLLIER, *supra* note 18, at ¶ 362.10.

111. The debtor's interest in the property is relevant because 11 U.S.C. § 362(d)(2) provides that, in addition to cause, including lack of adequate protection, relief from a stay of an act against property shall be granted if the debtor has no equity in such property and such property is not necessary to an effective reorganization. See, e.g., *In re Mikole Dev., Inc.*, 14 Bankr. 524, 526 (Bankr. E.D. Pa. 1981); *In re Clark Technical Assoc.*, 9 Bankr. 738 (Bankr. D. Conn. 1981). See also *In re Saint Peter's School*, 16 Bankr. 404 (Bankr. S.D.N.Y. 1982); *In re Riviera Inn of Wallingford, Inc.*, 7 Bankr. 725 (Bankr. D. Conn. 1980).

112. Relief from the stay is available whenever one of the alternate tests set forth in section 362(d) is met. 11 U.S.C. § 362(d). In denying relief from the stay, courts often invite the party seeking relief to renew its application should the debtor not provide the adequate protection ordered or agreed to, see, e.g., *In re A.L.S., Inc.*, 3 Bankr. 107 (Bankr. E.D. Pa. 1980), or if future circumstances warrant such renewal. See, e.g., *In re Spilsbury*, 5 Bankr. 578, 582 (Bankr. D. Nev. 1980).

113. 3 Bankr. 107 (Bankr. E.D. Pa. 1980).

filing of the petition, the creditor filed a complaint for relief from the stay to obtain permission to bring an action to obtain possession of the premises. The court denied the relief, in part, because it could provide adequate protection for the creditor by ordering the debtor to pay all rents and charges coming due thereafter under the lease. In addition, the debtor was required to deposit approximately three months rent with the creditor and to pay the creditor all amounts due under the lease.<sup>114</sup>

*In re Economy Trucking, Inc.*<sup>115</sup> involved a creditor seeking termination of the stay in order to continue foreclosure proceedings on vehicles in which the creditor had a security interest and of which the creditor had obtained possession through a writ of replevin. The court directed the creditor to return the vehicles to the debtor upon the debtor's demonstration of its ability to procure the necessary insurance<sup>116</sup> on the vehicles, and to lease the vehicles. In addition, the debtor was ordered to resume monthly installment payments and, within six months, to bring current all arrearages.<sup>117</sup>

A secured creditor's request for relief from the stay was denied in *In re Gamy & Levy Associates, Inc.*<sup>118</sup> in part because the Chapter 11 trustee offered adequate protection in the form of a replacement lien. The court held that the secured creditor was adequately protected by the trustee's assurances, that the creditor would have a lien on the proceeds of any sale of collat-

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114. *Id.* at 109. See also *In re Mulkey of Missouri, Inc.*, 5 Bankr. 15 (Bankr. W.D. Mo. 1980).

115. 1 COLLIER BANKR. CAS. 2d (MB) 997 (Bankr. D. Fla. 1980).

116. Requiring a debtor to obtain insurance is an example of the flexibility and adaptability of the concept of adequate protection. See *In re El Patio, Ltd.*, 6 Bankr. 518 (Bankr. C.D. Ca. 1980) (where value of real property is not expected to decrease, adequate protection is provided by debtor's prorated payment of accruing taxes and penalties, coupled with adequate assurance that the property is maintained and insured); see also *In re Ryals*, 3 Bankr. 522 (Bankr. E.D. Tenn. 1980) (insurance on an automobile is sufficient adequate protection in a Chapter 13 case).

117. *In re Economy Trucking, Inc.*, 1 COLLIER BANKR. CAS. 2d (MB) at 999. See also *In re Ryals*, 3 Bankr. 522 (Bankr. E.D. Tenn. 1980). Periodic payments will not always provide adequate protection. Relief from the stay has been granted in a case where payments offered by the debtor exceeded the monthly payments required on mortgages held by a secured creditor, but not where the guarantor of the mortgages was faced with foreclosures on other property to satisfy the lender's requirement of full payment. *In re Macare Enterprises, Inc.*, 4 Bankr. 520 (Bankr. N.D. Ohio 1980).

118. *Barnett Bank of Broward County v. Freehling (In re Gamy & Levy Assoc.)*, 2 COLLIER BANKR. CAS. 2d (MB) 21 (Bankr. S.D. Fla. 1980).

eral in which it had security and in which the debtor had equity, and that property in which the debtor had no equity would either be abandoned or sold with the creditor's consent, unless needed to operate the debtor's business, in which case the trustee would pay a reasonable charge for use.<sup>119</sup>

Relief from the stay will also be granted unless the debtor can provide a secured creditor seeking relief with the "indubitable equivalent" of such creditor's interest in the collateral. In *In re Anchorage Boat Sales, Inc.*,<sup>120</sup> as a result of the debtor's breach of a security agreement, a secured creditor cancelled the agreement, under which it had a security interest in the debtor's inventory and some additional property of the debtor. Following the debtor's filing of a petition for relief under Chapter 11, the creditor sought relief from the stay. The court granted relief, in part because the creditor was not adequately protected. The court compared the value of what the creditor would receive if the stay were continued and a plan confirmed with what the creditor would receive if the stay were lifted immediately.<sup>121</sup> The court reasoned that, upon confirmation of a plan, the creditor would be entitled to the present value equivalent<sup>122</sup> of its allowed secured claim, the value of the collateral on the plan's effective date. The creditor would be uncompensated, however, for the loss of the use of its money from the date of the proceeding for relief from the stay to the date of the confirmation of a plan, because the debtor had no equity cushion upon which interest payments under section 506 could be based.<sup>123</sup> The court con-

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119. *Id.* at 22-23; see also *In re Auto-Train Corp.* 6 Bankr. 510 (Bankr. D.D.C. 1980)(adequate protection is provided by cash payments to the extent funds are sufficient, and, if necessary, by assignment of unencumbered credit charges and liens on all unencumbered assets).

120. 4 Bankr. 635 (Bankr. E.D. N.Y. 1980).

121. *Id.* at 642. The court stated that the secured creditor would face an undue risk of harm if the stay were continued because under § 9-306 of the Uniform Commercial Code, U.C.C. § 9-306 (1972), the creditor could lose its security in cash proceeds which had been commingled. The court also noted that the debtor had no reasonable possibility of reorganization and had no equity in the collateral. *In re Anchorage Boat Sales, Inc.*, 4 Bankr. at 642.

122. *In re Anchorage Boat Sales, Inc.*, 4 Bankr. at 643. The court defined present value of the collateral as the amount the secured creditor would realize if he had in his hands today an amount equal to the collateral's value and was able to reinvest this amount in a way which would produce a return on such investment. *Id.*

123. Under 11 U.S.C. § 506(b) a secured creditor is entitled to interest only to the

cluded that because "payment ten years hence is not generally the equivalent of payment now," the creditor would not, absent relief from the stay, receive the "indubitable equivalent" of its interest.<sup>124</sup> A contrary result, however, has been reached in at least one other case. In *In re American Mariner Industries, Inc.*,<sup>125</sup> the court disagreed with *Anchorage Boat*, concluding that the right of an undersecured creditor to receive interest on the value of its collateral is not constitutionally protected by the fifth amendment, nor does section 361 require it as a policy matter.<sup>126</sup>

Prior to filing a Chapter 11 petition, the debtor in *In re Paradise Boat Leasing Corp.*<sup>127</sup> defaulted on a loan secured by the debtor's sole asset, a yacht. The court granted the secured creditor, a finance company, relief from the stay in order to enforce its lien on the yacht. The court stated that indubitable equivalence is the general test of adequate protection which required that the debtor's "payment . . . [to the secured creditor] must be at least as good as provided by his agreement."<sup>128</sup> On appeal by the debtor, the district court held that a misinterpre-

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extent that the collateral's value exceeds his allowed secured claim. In *In re Anchorage Boat Sales*, where there was a deficiency instead of an excess, the secured creditor would have had an unsecured claim for the deficiency, but would have no right to interest on the unsecured portion of the claim. 11 U.S.C. §§ 506(a),(b).

124. *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635 (citing *In re Murel Holding Corp.*, 75 F.2d 941, 943 (2d Cir. 1935)).

125. 10 Bankr. 711 (Bankr. C.D. Cal. 1981).

126. *American Mariner, id.*, criticized the *In re Anchorage Boat Sales* interpretation of *In re Murel* stating that:

Although *Muriel Holding* [sic] . . . is the source of the phrase "indubitable equivalent" as used in § 361(3), it should be remembered that the ruling in *Muriel Holding* [sic] involved adequate protection of a secured creditor being "crammed down" under § 77B of the Bankruptcy Act. Therefore, indubitable equivalent in the context of the *Muriel Holding* [sic] facts may be precedent for issues arising upon confirmation under § 1129(b)(2)(i)(II), but not to require interest to be paid to an undersecured creditor for being temporarily deprived of possession or use of its collateral.

*In re American Mariner Industries, Inc.*, 10 Bankr. at 712.

127. *In re Paradise Boat Leasing Corp.*, 2 Bankr. 482 (Bankr. D.V.I. 1979).

128. *Id.* at 483. Despite the debtor's substantial equity in the yacht, the bankruptcy court found that there was no adequate protection of the secured creditor's interest in the yacht because of the yacht's mobility and vulnerability to the perils of the sea. In addition, the court commented that the debtor's Chapter 11 petition appeared to be a mere attempt to forestall a particular secured creditor and that the debtor's business was conducted in a most unbusinesslike manner.

tation of section 361(3) by the bankruptcy court rendered suspect the termination of the stay.<sup>129</sup> Moreover, the district court noted that "as a court of equity the bankruptcy court is free to balance the hardships to the affected parties and fashion relief accordingly."<sup>130</sup> The case was remanded to the bankruptcy court for a determination whether less drastic relief could be fashioned, such as requiring the debtor to acquire sufficient insurance on the yacht.<sup>131</sup> The district court noted: "[t]he statute demands the 'mere indubitable equivalent rather than the *most* indubitable equivalence'. . . . Thus, 'where the creditor is in the business of extending credit a moratorium on debt service if accompanied by measures to preserve the collateral may suffice.'"<sup>132</sup>

Sometimes the debtor's equity in the collateral exceeds the secured creditor's claim. While this "equity cushion"<sup>133</sup> can itself constitute adequate protection,<sup>134</sup> the court will examine the equity cushion to ensure that it is large enough to truly protect the secured creditor's interest in the collateral.<sup>135</sup> In *In re San Cle-*

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129. *In re Paradise Boat Leasing Corp.*, 5 Bankr. 822, (Bankr. D.V.I. 1980).

130. *Id.* at 825 (citing 2 COLLIER, *supra* note 18, at ¶ 362.07).

131. *In re Paradise Boat Leasing Corp.*, 5 Bankr. at 825. The court noted that the bankruptcy court had raised little objection to the debtor's reorganization plan, except for the lack of adequate protection of the secured creditor's interest in the yacht. Accordingly, the district court believed that if this obstacle could be overcome, the plan would probably be acceptable. *Id.* at 824.

132. *Id.* at 825 (citing 2 COLLIER *supra*, note 18, at ¶ 361.01, ¶ 362.07 (emphasis in original)(citation omitted)).

133. 2 COLLIER *supra* note 18, at ¶ 361.01. An equity cushion has been defined as "the surplus of value remaining after the amount of indebtedness is subtracted from the fair market value of the collateral." *In re Commonwealth of Pennsylvania State Employees' Retirement Fund*, 14 Bankr. 542, 545 (Bankr. E.D. Pa. 1981)(citing *In re Pitts*, 2 Bankr. at 478)). In determining whether an equity cushion exists, all encumbrances are totalled, regardless of whether all lienholders have joined in the request for relief from the stay. *In re Mikole Developers, Inc.*, 14 Bankr. 524, 525 (Bankr. E.D. Pa. 1981)(citing *In re Dallastra*, 7 Bankr. 883 (Bankr. E.D. Pa. 1980)).

134. 2 COLLIER, *supra* note 18, at ¶ 361.01; see, e.g., *In re High Sky, Inc.*, 15 Bankr. 332 (M.D. Pa. 1981)(cushion held insufficient and relief from stay granted); *In re Pitts*, 2 Bankr. 476, 479 (Bankr. C.D. Cal. 1979)(court reluctantly continued the stay as to a second mortgagee based on a \$19,125.00 cushion on a chapter 13 debtor's residence).

135. While the protection of a creditor's cushion is not constitutionally required, the courts will not always permit the cushion to be eroded. 2 COLLIER, *supra* note 18, at ¶ 361.01. "In some instances the courts have acceded to the secured creditors' argument that the original bargain called for an equity cushion and that foreclosure is proper when the cushion is reduced to a minimal value, or disappears." *In re Hutton-Johnson Co., Inc.*, 6 Bankr. 855, 859 (Bankr. S.D.N.Y. 1980)(citing *In re Pitts*, 2 Bankr. 476, 478



*mente Estates*,<sup>136</sup> a bank sought relief from the stay to continue foreclosure proceedings against land upon which it held a deed of trust. The court found that the land's fair market value exceeded the encumbrances by \$2.1 million. The court held that this "equity cushion," over 65% more than the encumbrances, constituted adequate protection.<sup>137</sup> The court cited *In re Lake Tahoe Land Co.*<sup>138</sup> where the debt exceeded the value of the property.<sup>139</sup> In vacating the stay, the court stated that "adequate protection for a lender, as opposed to a seller, for land, even raw land partly developed by roads, sewer and water, is a leverage of 40-50% of the market value."<sup>140</sup> The court in *San Clemente* cautioned, however, that while the *Lake Tahoe* standard may "have the salutary effect of giving precise guidance to the standard to be used . . . it does seem to be inconsistent with the congressional intent that each case is to be judged on its own facts."<sup>141</sup>

If the equity cushion is small, or is being eroded by the debtor's inability to pay current interest and carrying charges,

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(Bankr. C.D. Cal. 1979)). See *In re Tucker*, 5 Bankr. 180 (Bankr. S.D.N.Y. 1980); *In re Lake Tahoe Land Co.*, 5 Bankr. 34 (Bankr. D. Nev. 1980). It does not follow, however, that adequate protection is "designed to put the secured creditor in the same position it was in when it initially negotiated the transaction." *In re Hutton-Johnson Co., Inc.*, 6 Bankr. at 860.

136. 5 Bankr. 605 (Bankr. S.D. Cal. 1980).

137. *Id.* at 610.

138. *In re Lake Tahoe Land Co.*, 5 Bankr. 34 (Bankr. D. Nev. 1980). If the secured creditor's claim exceeds the value of the collateral, there is no cushion and the debtor will have to provide adequate protection or be faced with the secured creditor's relief from the stay. See, e.g., *In re Hutton-Johnson Co., Inc.*, 6 Bankr. 855 (Bankr. S.D.N.Y. 1980); *In re Terra Mar Assoc.*, 3 Bankr. 462 (Bankr. D. Conn. 1980).

139. While "[i]n certain instances the property alone may provide a sufficient cushion for a secured creditor so as to justify a continuance of the status quo," *In re Thomas Parker Enterprises, Inc.*, 10 Bankr. 783, 789 (Bankr. D. Conn. 1981), absent an equity cushion, courts will grant relief from the stay unless the debtor affords the secured creditor some additional protection. *Id.* at 789-90; *In re Riviera Inn of Wallingford, Inc.*, 7 Bankr. 725, 729 (Bankr. D. Conn. 1980); *In re Hutton-Johnson Co., Inc.*, 6 Bankr. 855, 859 (Bankr. S.D.N.Y. 1980). See also *In re St. Peter's School*, 16 Bankr. 404 (Bankr. S.D.N.Y. 1982) where the total encumbrances on real property collateral exceeded its value, a first mortgagee bank was permitted to consummate a foreclosure sale. The court refused to continue the stay, which would have allowed the debtor to consider an offer to purchase the collateral. This purchase offer was held to be insufficient to satisfy the debtor's affirmative duty to "propose debtor's protections of the secured interest." *Id.* at 410-11.

140. *In re Lake Tahoe Land Co.*, 5 Bankr. at 37.

141. *In re San Clemente Estates*, 5 Bankr. at 610.

the court will often grant relief from the stay.<sup>142</sup> The existence of an equity cushion, however, is only one factor courts consider when deciding whether adequate protection has been afforded.<sup>143</sup> Courts may consider anticipated appreciation of the property in holding that a cushion is sufficient despite accruing interest and costs.<sup>144</sup> Where an equity cushion is not by itself sufficient, it may be combined with cash payments<sup>145</sup> or a lien on additional property to adequately protect a secured creditor's interest.<sup>146</sup> A court should consider the cumulative effect of the facts before it because "the adequacy of protection afforded by an equity cushion, stated either as a dollar amount or as a percentage of the estimated fair market value of the property, must ultimately be determined upon equitable considerations arising from the particular facts of each proceeding."<sup>147</sup> This approach is consistent

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142. See *In re Castle Ranch of Ramona, Inc.*, 3 Bankr. 45 (Bankr. S.D. Cal. 1980); see also *In re Alyucan Interstate Corp.*, 12 Bankr. 803, 810 (Bankr. D. Utah 1981).

143. See, e.g., *In re Pannell*, 12 Bankr. 51 (Bankr. E.D. Pa. 1981).

144. See, e.g., *In re Rogers Dev. Corp.*, 2 Bankr. 679 (Bankr. E.D. Va. 1980).

145. See, e.g., *In re McGowan*, 6 Bankr. 241 (Bankr. E.D. Pa. 1980); *In re Spilsbury*, 5 Bankr. 578 (Bankr. D. Nev. 1980); *In re Breuer*, 4 Bankr. 499 (Bankr. S.D.N.Y. 1980); *In re Walker*, 3 Bankr. 213 (Bankr. W.D. Va. 1980).

146. See, e.g., *In re Schockley Forest Indus. Inc.*, 5 Bankr. 160 (Bankr. N.D. Ga. 1980).

147. *In re High Sky, Inc.*, 15 Bankr. 332, 336 (Bankr. M.D. Pa. 1981)(citing *In re Tucker*, 5 Bankr. 180, 183 (Bankr. S.D.N.Y. 1980)). Because the amount of the cushion is dependent upon the value attributed to the property involved, valuation is an important issue in determining whether an equity cushion constitutes adequate protection in a given case. An in depth discussion of valuation is beyond the scope of this article. *In re High Sky, Inc.* is an excellent example of a court considering all relevant information concerning the debtor and the collateral. The court terminated the stay finding that the debtor had failed to sustain the burden that it had afforded the secured creditor adequate protection. The court based its holding on the following factors: an eroding equity cushion due to accumulating interest; absence of a sufficient equity cushion; no evidence that the property was appreciating significantly; debtor's failure to offer protection in addition to the property itself so as to satisfy the "indubitable equivalent" requirement; debtor's failure to propose a plan of reorganization in the five months following the filing of the petition; poor prospects for successful reorganization due to economic conditions; and debtor's apparent filing of its petition to forestall the pending foreclosure sale which had first been listed in 1976. *In re High Sky*, 15 Bankr. at 336.

One court, however, has rejected the equity cushion analysis on several grounds. First, the equity cushion is inconsistent with the purpose of adequate protection, which is to guard against lien impairments. Second, it concentrates on the preservation of equity, which is inconsistent with the illustrations of adequate protection set forth in section 361; these illustrations address compensation for a decrease in the value of the property due to the stay. Third, it is inconsistent with the statutory scheme of section 362(d)(2), which requires a showing that the property is unnecessary to an effective reor-

with the flexibility intended for the adequate protection concept, and particularly for the indubitable equivalence method of providing adequate protection.<sup>148</sup>

*C. Adequate Protection as a Condition for the Use, Sale, or Lease of Property*

The impact of the automatic stay might be affected by consideration of how the collateral may be used by the debtor or trustee during the stay. While use of collateral might be essential to the debtor's successful rehabilitation by allowing him to continue in his business, the collateral might be partially or completely consumed, thereby rendering irrelevant the status of the stay.<sup>149</sup> Section 363 permits the debtor within prescribed limits to use, sell, or lease property of the estate. In the ordinary course of business, a debtor may use, sell, or lease property without notice or hearing,<sup>150</sup> but may not use, sell, or lease cash collateral<sup>151</sup> unless the secured party consents<sup>152</sup> or the court so permits.<sup>153</sup> Outside the ordinary course of business, property of the estate may be used, sold, or leased only after notice and a hearing.<sup>154</sup> Moreover, the trustee's use, sale, or lease of property

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ganization, in addition to a lack of equity, rather than a specific equity cushion. Finally, the court felt that the equity cushion concept has no historical basis in the development of stay litigation. *In re Alycan Interstate Corp.*, 12 Bankr. 803, 809-12 (Bankr. D. Utah 1981).

148. Adequate protection was designed to mediate the polarities created by that "turbulent rivalry of interests in reorganization." *In re Alycan Interstate Corp.*, 12 Bankr. 803, 805 (Bankr. D. Utah 1981). This requires "not a formula, but a calculus, opentextured, pliant and versatile, adaptable to 'new ideas' which are 'continually being implemented in this field' and to 'varying circumstances and changing modes of financing.'" *Id.* (citing H.R. REP., *supra* note 51, reprinted in 1978 U.S. CODE CONG. & AD. NEWS AT 6295).

149. 2 COLLIER, *supra* note 18, at ¶ 363.01.

150. 11 U.S.C. § 363(c)(1).

151. 11 U.S.C. § 363(a) defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest."

152. *Id.* § 363(c)(2)(A).

153. *Id.* § 363(c)(2)(B).

154. *Id.* § 363(b). 11 U.S.C. § 102(1) defines "after notice and a hearing" as such notice and opportunity for a hearing as is appropriate in the particular circumstances. An act may be done without an actual hearing if a timely request for a hearing is not made or there is insufficient time for a hearing and the court authorizes the act.

may not be inconsistent with any relief granted from the stay.<sup>155</sup>

Section 363(e) provides that a secured party may at any time request that the court prohibit or condition the use, sale, or lease of collateral in order to provide the creditor with adequate protection. As under section 362(d), such adequate protection is mandated if requested by a secured party<sup>156</sup> and the debtor has the burden of proving that the protection he proposes is adequate.<sup>157</sup> The following cases illustrate the application of these principles.

In *In re Markim, Inc.*,<sup>158</sup> the debtor, a lessor-seller of construction equipment, entered into an agreement with secured creditors whereby the debtor granted them a blanket lien on its accounts receivable, its equity in rental equipment, and other property. Following the filing of a Chapter 11 petition, the debtor applied for permission to use cash collateral. The bankruptcy court granted this application over the objections of secured and unsecured creditors. The court held that the debtor had sustained its burden by establishing that the secured creditors' interests were adequately protected by the existence of sufficient equity in the debtor's property. The court noted, however, that even if the equity were insufficient, the secured creditors were adequately protected by the debtor's provisions to make monthly payments to the secured creditor, and the significant improvements in the efficiency of the debtor's operation.<sup>159</sup>

The debtor in *In re Xinde International, Inc.*<sup>160</sup> had sufficient equity in its equipment and fixtures to secure and maintain a 50% equity cushion relevant to a secured debt. The secured creditor opposed an application to use cash collateral and sought relief from the stay. The debtor was unable, however, to generate sufficient cash to purchase new materials needed to manufacture its product. Recognizing the need to balance creditor protection against the likelihood of a successful reorganization, the court stated:

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155. *Id.* § 363(d).

156. 2 COLLIER, *supra* note 18, at ¶ 363.06.

157. 11 U.S.C. § 363(e).

158. 15 Bankr. 56 (Bankr. E.D. Pa. 1981).

159. *Id.* at 59.

160. 13 Bankr. 212 (Bankr. D. Mass. 1981).

While it is true that use of cash collateral in an ongoing business to maintain its business activity may enhance the estate, and that the collateral would ordinarily be replenished as the business continues, a particular creditor can have realistic fears that replenishment of the cash collateral will not occur.<sup>161</sup>

Because of the debtor's apparent ability to replenish the collateral from current operations, and because of the existence of a substantial equity cushion, the court permitted debtor's use of cash collateral, without payments to the creditor for a ninety day period, during which time the debtor was directed to formulate a plan. An equity cushion in depreciating equipment does not provide adequate protection for long; therefore, if the debtor were unable to formulate and confirm a plan within the ninety days, the creditor would be permitted an immediate hearing to reconsider its request for periodic cash payments.<sup>162</sup>

The creditor in *In re Anderson-Walker Industries, Inc.*,<sup>163</sup> the Small Business Administration, held a security interest in the debtor's accounts receivable and other assets, and opposed the debtor's application for permission to use the accounts receivable. The court permitted the debtor to use the accounts receivable on the condition that the debtor continue making monthly payments on its SBA loan.<sup>164</sup> *In re Aurora Cord and Cable Co.*<sup>165</sup> involved an Internal Revenue Service lien on the

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161. *Id.* at 215.

162. *Id.* at 215-16. It has been held that, without an unconstitutional impairment of the security agreement, a bankruptcy court may require a creditor, who collected accounts receivable due the debtor under a security agreement, to pay the proceeds from pre-petition accounts receivable to the debtor, if such proceeds are necessary for the continuation of the debtor's business and if the debtor has other sufficient collateral to satisfy the secured indebtedness. *In re Able Sheet Metal, Inc.*, 15 Bankr. 878 (Bankr. E.D. Ark. 1981). The court in *Able* refused, however, to direct the secured creditor to pay accounts receivable proceeds to the debtor because the debtor failed to establish that there was other sufficient collateral to satisfy the creditor's claim. The court cited *In re American Kitchen Foods, Inc.*, 9 COLLIER BANKR. CAS. (MB) 537 (Bankr. N.D. Me. 1976), where the court released funds recovered by the debtor prior to the filing of the reorganization petition, but authorized additional collateral as protection against any diminution of the creditor's security interest. *In re Able Sheet Metal, Inc.*, 15 Bankr. at 883.

163. *In re Anderson-Walker Indus., Inc.*, 3 Bankr. 551 (Bankr. C.D. Cal. 1980).

164. *Id.* at 552. The court stated that it "borders on the frivolous for the SBA to argue that it is not adequately protected when the liquidation value of the collateral is 7.3 times the amount of the secured indebtedness." *Id.*

165. 2 Bankr. 342 (Bankr. N.D. Ill. 1980).

debtor's cash and receivables. The court fashioned an elaborate structure of adequate protection which included the requirement that the debtor open an escrow account with an immediate \$20,000.00 deposit and periodic deposits thereafter.<sup>166</sup> Prior to commencing a reorganization case, the debtor in *In re Inforex, Inc.*<sup>167</sup> financed through various banks purchases of equipment for lease in the course of its business. Under the terms of security agreements with the banks, lessees of debtor's equipment remitted payments to depository accounts maintained by the debtor. The court granted the debtor's application for permission to use the proceeds of its leases to maintain its business, finding that adequate protection was provided by two measures: the continued remittance to the depository accounts of rental payments; and the treatment of the debtor's obligation to the banks as a loan entitled to a first priority expense of administration status and secured by a security interest in substantially all of the debtor's assets.<sup>168</sup>

*In re Mansfield Tire & Rubber Co.*,<sup>169</sup> a Chapter 11 case filed on October 1, 1979, the Code's effective date, involved an application by the debtor for permission to use cash collateral. A security agreement granted the secured creditors' security interests in all of the debtor's accounts receivable and the proceeds of such accounts. Under this agreement, the debtor could use the proceeds so long as it maintained cash proceeds in a collateral account and current accounts receivable aggregating 140% of the unpaid balance owed to the secured creditors. The court accepted the debtor's proposal for adequate protection, by which the debtor agreed to turn over to the secured creditors all prepetition uncollected accounts receivable and any cash held in

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166. *Id.* at 347. In addition, the court ordered the debtor to not replace four recently terminated employees, reduce the salaries of two of the debtor's executives, and permit IRS agents to monitor the debtor's compliance with the court's order and to examine its books periodically. The court also granted the IRS liens on the debtor's accounts receivable, inventory, machinery, and equipment and, in the event the IRS became an unsecured creditor, raised its priority from sixth to second. The court further directed that half of any settlement of three claims pending against the government be deposited in the escrow account. Finally, the debtor was required to provide monthly financial statements. *Id.* at 347-48.

167. 10 Bankr. 497 (Bankr. D. Mass. 1979).

168. *Id.* at 499-500.

169. *In re Mansfield Tire & Rubber Co.*, No. 79-01238, slip op. (N.D. Ohio 1979).

the collateral accounts, and in substitution for cash proceeds used from pre-petition receivables collected prior to the hearing, to give the secured creditors a lien on specified real estate.<sup>170</sup>

In *In re Kenny Kar Leasing, Inc.*,<sup>171</sup> a bank, which financed purchases of vehicles by a Chapter 11 debtor in the car leasing business, sought an order prohibiting the debtor from using any cash collateral in which the bank had an interest. The debtor argued that the personal guarantee by the debtor's principal of the debtor's obligations to the bank was the equivalent of an additional or replacement lien. The court rejected this argument, stating that "[t]o compel a secured creditor to accept such risks on the basis of rights to pursue a guarantor, is to shift the hazards and the costs of the rehabilitation effort from the debtor to the secured creditor."<sup>172</sup> The court found this to be outside "the concept of adequate protection embodied in the Code."<sup>173</sup>

#### D. Adequate Protection as a Condition for Obtaining Credit

When income from the debtor's business is insufficient to cover operating expenses during a reorganization, the business cannot operate unless the debtor or trustee is able to obtain the necessary credit to finance the operations.<sup>174</sup> Thus, section 364 empowers the debtor or trustee to obtain credit under specified conditions. The debtor may obtain unsecured credit and incur unsecured debt in the ordinary course of business, under section 364(a), unless the court orders otherwise, and outside the ordinary course of business under section 364(b), after notice and a hearing.<sup>175</sup> In both cases the debts so incurred are allowable as administrative expenses under section 503(b)(1).<sup>176</sup> If the debtor is unable to obtain unsecured credit under section 503(b)(1), the

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170. *Id.* slip op. at 7-8; see also *In re Thompson*, 5 Bankr. 667 (Bankr. D. S. D. 1980)(security interest transferred to future money crops).

171. 5 Bankr. 304 (Bankr. C.D. Cal. 1980). But see H.R. REP., *supra* note 51, at 340, where it was suggested that adequate protection under section 361(3) (indubitable equivalence) may be provided by a third person's guarantee, outside the judicial process, of compensation for any loss incurred in the case.

172. *In re Kenny Kar Leasing, Inc.*, 5 Bankr. at 309.

173. *Id.*

174. Bisbee, *supra* note 94, at 734.

175. 11 U.S.C. § 364(b).

176. *Id.* § 364; see also Bisbee, *supra* note 94.

court, after notice and a hearing, may authorize the debtor or trustee to obtain credit or incur debt by providing the post-petition creditor with priority over all administrative expenses specified in sections 503(b) and 507(b), a lien on unencumbered property, or a junior lien on encumbered property.<sup>177</sup>

If the debtor is unable to obtain credit through any of the previously mentioned methods, section 364(d)(1) empowers the court, after notice and hearing, to authorize the debtor or trustee to obtain credit or incur debt secured by a senior or equal lien on encumbered property.<sup>178</sup> A condition precedent to the granting of this so-called "superpriority" is adequate protection of the prior lienor's interest.<sup>179</sup> The debtor or trustee has the burden of proof on the issue of adequate protection.<sup>180</sup>

The debtor in *In re Stratbucker*,<sup>181</sup> a farmer without the funds necessary to plant his spring crops, could obtain credit only if he could furnish post-petition creditors with a section 364(c) superpriority. The court granted the debtor's application finding that three objecting lien creditors were adequately protected because the value of the debtor's real estate exceeded the debt. The superpriority was limited, however, to the proceeds of crops grown with the funds advanced under written contracts bearing interest not in excess of 18%.<sup>182</sup> The court was influenced by the fact that the debtor's sole chance at rehabilitation was to continue his farming operation.

## V. Potential Difficulties In Applying The Concept Of Adequate Protection

As the courts and the bar gain more experience with adequate protection under the Code, some problems requiring resolution may arise. Debtors may often find it difficult to provide

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177. Bisbee, *supra* note 94, at 734-35. See 11 U.S.C. § 364(c). There is no statutory or constitutional requirement that adequate protection be afforded to the holders of unsecured claims whose recoveries may be impaired by credit obtained under section 364(c)(2) even if the lender is provided with a lien on property of the estate not otherwise encumbered. *In re Garland Corp.*, 6 Bankr. 456 (Bankr. 1st Cir. 1980).

178. Bisbee, *supra* note 94, at 735; 11 U.S.C. § 364(d)(1).

179. 11 U.S.C. § 364(d)(1).

180. *Id.* § 364(d)(2).

181. 4 Bankr. 251 (Bankr. D. Neb. 1980).

182. *Id.*



periodic cash payments,<sup>183</sup> or may not have sufficient unencumbered property to provide additional or replacement liens. Moreover, inflation and high interest rates are bound to make it difficult for debtors to afford secured creditors adequate protection. The volatility of interest rates might render inadequate what initially appears to be adequate protection. In addition, a debtor who provides one creditor with adequate protection may be faced with demands from other creditors for similar treatment.<sup>184</sup> If a debtor cannot afford a secured creditor adequate protection, however, the prospects for rehabilitation are poor. It would be inequitable to foist the uncertainties of such a debtor's future upon a secured creditor.

Another potential problem for litigants is some apparent uncertainty over the meaning of "indubitable equivalent."<sup>185</sup> Relying on the language in the legislative history of section 361, which states that a secured creditor is entitled to the benefit of his bargain,<sup>186</sup> some courts have interpreted "indubitable equivalence" to mean all to which the creditor would be entitled under the contract at issue.<sup>187</sup> The district court in *Paradise Boat Leasing* criticized this approach, noting that a mere indubitable equivalent, not the most indubitable equivalent, is required.<sup>188</sup> Although adequate protection is to be afforded according to the circumstances and equities of each case, more certainty may be needed in this area. This certainty may well be provided by future decisions.

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183. 2 COLLIER, *supra* note 18, at ¶ 361.01.

184. See *In re Yale Express System, Inc.* (Yale Express II), 384 F.2d at 992.

185. The indubitable equivalence requirement has been criticized in a case involving an application for relief from the automatic stay:

Indubitable equivalence is not a method; nor does it have substantive content. Indeed, something "indubitable" is more than "adequate;" "equivalent" is more than "protection;" hence, the illustration may eclipse the concept. At best, it is a semantic substitute for adequate protection and one with dubious, not indubitable, application to the question of relief from the stay.

*In re Alyucan Interstate Corp.*, 12 Bankr. 803, 809 (Bankr. D. Utah 1981).

186. H.R. REP., *supra* note 51, at 339; S. REP., *supra* note 28.

187. See, e.g., *In re Anchorage Boat Sales, Inc.*, 4 Bankr. 635 (Bankr. E.D.N.Y. 1980); *In re Paradise Boat Leasing Corp.*, 2 Bankr. 482 (Bankr. D.V.I. 1979), *rev'd*, 5 Bankr. 822 (D.V.I. 1980). It is noteworthy that in each of these cases the bankruptcy court was highly critical of the manner in which the debtor had operated. See also *supra* note 135 and cases cited therein.

188. *In re Paradise Boat Leasing Corp.*, 5 Bankr. at 825.

## VI. Conclusion

The concept of adequate protection as embodied in the Code represents:

[A] statutory effort to provide rules of fairness and equity to govern, adjust and balance the rights of secured creditors and debtors . . . [t]he adequate protection provisions are an effort to balance these conflicting interests; to grant the debtor the right to continue enjoyment and exploitation of property and assets upon which rehabilitation depends, not at the expense of secured creditors, but on terms which protect secured creditors in the *realization of the value* of their interests in such property and assets.<sup>189</sup>

This article has traced the development of adequate protection and has discussed the circumstances under which the Code and the cases interpreting the Code require adequate protection.

Sections 362, 363, and 364, which state when adequate protection is required, and section 361, which provides examples of adequate protection, have resolved many uncertainties concerning the use of collateral by a debtor in reorganization. The courts have used adequate protection as the flexible concept the drafters intended. This is evidenced by cases in which different forms of adequate protection have been combined to fit the circumstances.<sup>190</sup>

The concept of adequate protection goes to the very essence of business reorganizations under Chapter 11 of the Code. A debtor can avail itself of the protection of the automatic stay to use, sell, or lease property and to obtain credit. At the same time secured creditors are provided with the protection to which they are constitutionally entitled. Adequate protection may encourage a spirit of cooperation and negotiation between the debtor and its secured creditor, since it is to both parties' advantage to confirm a plan to revitalize the debtor's business, and to provide adequate protection in the interim. Thus, while the very flexibility of adequate protection may lead to uncertainty in its application, the concept is beneficial to the administration of business reorganizations under Chapter 11 of the Code.

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189. *In re Kenny Kar Leasing, Inc.*, 5 Bankr. 305, 308 (Bankr. C.D. Cal. 1980) (emphasis in original).

190. See, e.g., *In re Aurora Cord & Cable Co.*, 2 Bankr. 342 (Bankr. N.D. Ill. 1980).