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Adequate Protection for the Undersecured Creditor in a Chapter 11 Reorganization: Compensation for the Delay in Enforcing Foreclosure Rights

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ADEQUATE PROTECTION FOR THE UNDERSECURED CREDITOR IN A CHAPTER 11 REORGANIZATION: COMPENSATION FOR THE DELAY IN ENFORCING FORECLOSURE RIGHTS

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Consider the following scenario: Debtor, in default and threatened with foreclosure, files a petition under chapter 11 of the Bankruptcy Code (Code).[1] At the time of the filing of the petition, Debtor is indebted to Lender in the amount of $2,000,000. Although Debtor has pledged collateral as security for the repayment of the indebtedness, the collateral has a value of only $1,000,000. Thus, Debtor has no equity in the collateral and lender is substantially undersecured.

Ordinarily, Lender has the state law right to immediately repossess and sell the collateral.[2] After deducting the costs of the repossession and sale, Lender would reinvest the proceeds of the collateral sale. Presumably, Lender could then once again obtain an economic return on its investment.[3]

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1. Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326 (1982)).

2. *See* U.C.C. § 9-503 (1978). Under § 9-503 of the Uniform Commercial Code, Lender has "on default the right to take possession of the collateral." *Id. See also* Murdock v. Blake, 26 Utah 22, ___, 484 P.2d 164, 169 (1971) (on default, debtor loses right to possession and retains only contingent right to the surplus on the sale of the collateral, if any).

Although not an exclusive remedy, Lender may sell the collateral after default and use the proceeds from the sale towards the indebtedness. U.C.C. § 9-504.

3. Although Lender will forego the original contract rate of interest with Debtor, Lender will be

Debtor, by filing the bankruptcy petition, prevents Lender from exercising the right to repossess and sell the collateral.[4] Lender must now await the outcome of Debtor's Chapter 11 reorganization attempt.[5] Consequently, Lender must for some uncertain period of time forego the opportunity to repossess the collateral and reinvest the proceeds.

This Article will address the issue of whether Debtor must compensate Lender for this delay in exercising the right to repossess and sell the collateral during the pendency of the bankruptcy case. This issue will face the bankruptcy practitioner in every situation where no equity exists in the collateral[6] and the collateral is necessary for an effective reorganization.[7]

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able to earn the market rate of interest in effect at the time of the reinvestment of the collateral sale proceeds.

4. *See* 11 U.S.C. § 362 (a) (1982). Pursuant to § 362(a) of the Code, the filing of the petition operates as an automatic stay of all acts against the Debtor or the Debtor's property. *Id.* Section 362(a) provides as follows:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a) (3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a) (3)), operates as a stay, applicable to all entities, of—
>
> > (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
> > (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
> > (3) any act to obtain possession of property of the estate or of property from the estate;
> > (4) any act to create, perfect, or enforce any lien against property of the estate;
> > (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
> > (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
> > (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
> > (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Id.

For a discussion of the § 362 automatic stay, see Kennedy, *Automatic Stays under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 3 (1978).

5. There are only three possible outcomes of a Chapter 11 reorganization attempt: (1) a dismissal of the bankruptcy case, 11 U.S.C. § 1112; (2) a conversion of the case to a case proceeding under either Chapter 7 or Chapter 13, *id.;* or (3) the confirmation of a plan of reorganization, *id.* § 1129.

6. If the Lender is oversecured rather than undersecured, there seems to be little dispute among bankruptcy courts that the oversecured creditor is entitled to interest on its claim during the interim period from the filing of the petition to the confirmation of a plan. *See* Federal Land Bank v. Carson, 34 Bankr. 502 (Bankr. D. Kan. 1983) (adequate protection requires protection from continuing erosion of equity cushion by post petition accruing interest); Heritage Savings & Loan Assoc. v. Rogers Dev. Corp., 2 Bankr. 679 (Bankr. E.D. Va. 1980); Vlahos v. Pitts, 2 Bankr. 476 (Bankr C.D. Cal. 1979). *But see* O'Toole, *Adequate Protection and Postpetition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251 (1982) (oversecured creditor is not entitled to adequate protection of postpetition interest).

7. If there is no equity in the collateral and the collateral is not necessary for an effective

This Article will focus on the legislative history[8] and recent bankruptcy decisions regarding the concept of adequate protection under the Code.[9] In addition, this Article will address the issue of whether compensation for delay in exercising foreclosure rights is constitutionally required.[10]

I. THE ABILITY TO REPOSSESS AND REINVEST THE COLLATERAL SALE PROCEEDS IS A VALUABLE RIGHT OF THE SECURED CREDITOR

The right to repossess the collateral and use the proceeds of the collateral sale is the essence of secured lending.[11] Indeed, the existence of collateral is the only basic difference between a secured creditor and an unsecured creditor.[12] The right to repossess and sell the collateral also has a very real economic value to the secured creditor. First, it provides a method of repaying the indebtedness. Second, it assures, to the extent of the value of the collateral, an almost immediate repayment of the indebtedness and the ability to reinvest the repayment in the marketplace.

A delay in repossessing and selling the collateral has a very real cost. For example, assuming an annual market interest rate of 15% and a collateral value of $1,000,000, Lender will incur an opportunity cost of $130,435 if the right to repossess and sell the collateral is delayed for only one year.[13] Thus, the delay in repossessing and selling the collateral has an ascertainable and real cost to a secured creditor.

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reorganization, the secured creditor is entitled to relief from the automatic stay regardless of the existence of adequate protection. 11 U.S.C. § 362 (d) (2) (1982).

8. *See infra* notes 20-52 and accompanying text.

9. *See infra* notes 53-76 and accompanying text.

10. *See infra* notes 77-91 and accompanying text.

11. CitiCorp Homeowners, Inc. v. Western Surety Co., 131 Ariz. 334, ____, 641 P.2d 248, 250 (Ariz. Ct. App. 1982) (the most important remedy available to a secured creditor is the right to take possession of the collateral following the debtor's default).

12. *See* Winters Nat'l Bank & Trust Co. v. Saker, 66 Ohio App.2d 31, ____, 419 N.E.2d 890, 893-94 (1979) (the existence of collateral provides an additional remedy to the standard remedies of the unsecured creditor).

13. *See* PROFESSIONAL PUBLISHING CORP., REALTY BLUEBOOK A-262 to 264 (1980. The following table sets out the value to the secured creditor of collateral proceeds received in different years at different market interest rates:

		Cost of Delay of Foreclosure		
		Value of collateral proceeds if received at the end of		
Collateral Value	Market Interest Rate	Year 1	Year 2	Year 3
$1,000,000	10%	$909,091	$826,447	$751,316
1,000,000	15%	869,565	756,144	657,517
1,000,000	20%	833,333	694,445	578,704

Id.

II. THE AUTOMATIC STAY AND ADEQUATE PROTECTION

The commencement of the bankruptcy case results in an automatic stay of all acts by a secured creditor to enforce its liens.[14] The policy behind this extraordinary power of the automatic stay is twofold.

First, the Code drafters intended the automatic stay to give the debtor a "breathing spell" from his creditors.[15] Second, the automatic stay was intended to prevent one creditor from rushing to the courthouse resulting in harm to the other creditors of the debtor.[16] In other words, the Code attempts to treat all similarly situated creditors equally.

Although Congress recognized the need to enjoin lien enforcement, it tempered the automatic stay by imposing counterbalancing safeguards.[17] One of these safeguards is the right of a secured creditor to "adequate protection" of its interest during the pendency of the bankruptcy case.[18] Adequate protection is not,

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14. 11 U.S.C. § 362(a) (1982). For the text of § 362(a), see *supra* note 4.

15. H.R. REP. NO. 595, 95th Cong., 1st Sess. 340 [hereinafter cited as HOUSE REPORT], *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6296-97. *See also* Barclays Bank of New York v. Saypol, 31 Bankr. 796, 799 (Bankr. S.D. N.Y. 1982). The House Report provides as follows:

> It [the automatic 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 repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

HOUSE REPORT, *supra*.

16. HOUSE REPORT, *supra* note 15, at 341, 1978 U.S. CODE CONG. & AD. NEWS at 6298. *See also Saypol*, 31 Bankr. at 799.

17. *See* 11 U.S.C. § 362(d)(1), (e) (1982). The Bankruptcy Code provides two interrelated limits on the power of the automatic stay. First, a creditor is entitled to adequate protection. 11 U.S.C. § 362(d) (1). Second, the creditor is entitled to a prompt hearing on its request for relief from the automatic stay. *Id.* § 362(e). Under certain circumstances a creditor can obtain relief from the automatic stay *ex parte*. *Id.* § 362(f).

18. *See Id.* § 362(d)(1), (e). Basically, the secured creditor can use two approaches to obtain adequate protection of its interest. First, the secured creditor can seek relief from the automatic stay. *Id.* § 362(d)(1). Section 362(d)(1) provides as follows:

> (d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay —
>
> > (1) for cause, including the lack of adequate protection of an interest in property of such party in interest. . . .

Id.

Second, a secured creditor can demand adequate protection of its collateral, if its collateral is to be used, sold or leased. *Id.* § 363(e). Section 363(e) provides as follows:

> (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. In any hearing

however, specifically defined in the Code.[19] What is adequate and what must be protected requires an examination of the legislative history of the concept of adequate protection.

A. LEGISLATIVE HISTORY

Section 361 of the Code contains three nonexclusive[20] means of providing adequate protection to the creditor with an interest in the debtor's property.[21] First, the debtor in possession (or trustee) may make periodic cash payments to the creditor to the extent that the value of the creditor's interest in the property has decreased.[22] Second, the debtor in possessing may provide the creditor with an additional or replacement lien to the extent that the value of the creditor's interest in the property has decreased.[23] Third, the court may grant other relief that will permit the creditor to realize the "indubitable equivalent" of its interest in the property.[24]

Unfortunately, section 361 does not indicate what is to be protected but only how to provide adequate protection. The language used by Congress in section 361 is not, however, without significance in determining what is to be protected.

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under this section, the trustee has the burden of proof on the issue of adequate protection.

Id.

19. *See* HOUSE REPORT, *supra* note 15, at 338-39, 1978 U.S. CODE CONG. & AD. NEWS at 6295. Congress intended adequate protection to be a flexible concept, with the definition "left to a case-by-case interpretation." *Id.*

20. *See* 11 U.S.C. § 361 (1982). Although the list contained in § 361 is nonexclusive, § 361 does specifically preclude the use of an administrative priority for adequate protection. *See id.* § 361(3). Since administrative claims are only paid if unencumbered assets are available, Congress apparently concluded that an administrative priority was too speculative to constitute adequate protection. S. REP. NO. 989, 95th Cong., 2d Sess. 54 [hereinafter cited as SENATE REPORT], *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5840. *See also* Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. CHI. L. REV. 305, 313 (1983).

21. *See* 11 U.S.C. § 361 (1982).

22. *Id.* § 361(1). Section 361 provides as follows:

> 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
> (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.

Id. § 361.

23. *Id.* § 361(2).

24. *Id.* § 361(3).

Sections 361(1) and 361(2) provide for adequate protection to the extent that the automatic stay "results in a decrease in the *value* of such entity's interest in such property."[25] If Congress intended the term "value" to include not only the tangible value of collateral, but also the intangible value of other rights relating to collateral, such as the right to repossess and sell the collateral, then adequate protection must compensate a secured creditor for the delay in exercising foreclosure rights.

Both the House and Senate Reports indicate a concern for protecting the tangible value of the collateral from a decline due to physical depreciation.[26] Congress' concern for physical depreciation would not, however, preclude a desire to protect other aspects of a secured creditor's interest in collateral.[27]

The House Report indicates that the concept of adequate protection was intended to protect the secured creditor's bargain. The House Report states that section 361 ensures that the secured creditor will receive essentially what it bargained for:

> Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section [§361] recognizes the availability of alternate means of protecting a secured

25. 11 U.S.C. § 361(1), (2) (emphasis added).

26. HOUSE REPORT, *supra* note 9, at 338-40, 1978 U.S. CODE CONG. & AD. NEWS at 6295-96; SENATE REPORT *supra* note 14, at 54, 1978 U.S. CODE CONG. & AD. NEWS at 5840. The Senate Report contains the only explicit reference to the amount to be paid for purposes of adequate protection. The Senate Report provides as follows:

> This provision [§ 361(1)] is derived from *In re Bermec Corporation*, 445 F.2d 367 (2d Cir. 1971), though in that case it is not clear whether the payments offered were adequate to compensate the secured creditors for their loss. The use of periodic payments may be appropriate where, for example, the property in question is depreciating at a relatively fixed rate. The periodic payments would be to compensate for the depreciation and might, but need not necessarily, be in the same amount as payments due on the secured obligation.

Id.

In *Bermec* the Second Circuit could not find as clearly erroneous the lower court's finding that the secured creditor was adequately protected. *In re* Bermec Corp. 445 F.2d 367, 369 (2d Cir. 1971). The Second Circuit concluded that the trustee would be able to "pay the economic depreciation." *Id.* The court did not, however, describe what constitutes economic depreciation. Thus, the *Bermec* case sheds little light on what value Congress intended to protect.

27. *See* HOUSE REPORT, *supra* note 15, at 338, 1978 U.S. CODE CONG. & AD. NEWS at 6295. The House Report suggests that the courts should broadly interpret the rights entitled to protection:

> The interests of which the court may provide protection in the ways described in this section [§ 361] include equitable as well as legal interests. For example, a right to redeem under a pledge or a right to recover property under a consignment are both interests that are entitled to protection.

Id., 1978 U.S. CODE CONG. & AD. NEWS at 6295.

> creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.[28]

The right to repossess and sell collateral is an important part of the secured creditor's bargain.[29] Although the debtor is entitled to use and possess the collateral in his attempt to reorganize,[30] the House Report indicates that the secured creditor is entitled to protection of the value of the bargain with the debtor.[31] Thus, while the secured creditor cannot obtain its bargain in kind by repossessing and selling the collateral, the debtor must protect the bargain by providing alternative means of compensation for its declining value due to the delay in exercising its foreclosure rights.

Although sections 361(1) and 361(2) set forth specific examples of adequate protection methods, the last alternative method in section 361(3) was intended by Congress as a catch-all provision.[32] Section 361(3) provides that adequate protection may be sufficient if it "results in the realization. . . of the *indubitable equivalent* of such entity's interest in such property."[33]

The indubitable equivalent language was not initially part of section 361(3).[34] The House's original version of section 361(3) provided for "such other relief as will result in the realization by such entity of the value of such entity interest in property."[35] As a compromise between the House and Senate versions, the conferees inserted the term indubitable equivalent in section 361(3).[36]

The indubitable equivalent language appeared initially in the Senate's version of section 1129 of the Code, which deals with the requirements for the confirmation of a reorganization plan.[37] The Senate Report regarding section 1129 indicates that the term derives from Judge Learned Hand's opinion in *In re Murel Holding Corp.*[38]

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28. HOUSE REPORT, *supra* note 15, at 339, U.S. CODE CONG. & AD. NEWS at 6295.

29. *See supra* notes 11-12 and accompanying text.

30. 11 U.S.C. § 1108 (1982) (debtor in possession may continue to operate the business).

31. HOUSE REPORT, *supra* note 9, at 339, 1978 U.S. CODE CONG. & AD. NEWS at 6295.

32. W. COLLIER, COLLIER ON BANKRUPTCY ¶361.01[04] (L. King 15th ed. 1984).

33. 11 U.S.C. § 361(3) (1982) (emphasis added).

34. 124 CONG. REC. 32,395 (1978) (statement of Rep. Edwards). *See also* H.R. 8200, 95th Cong., 1st Sess. § 361 (1978); S. 2266, 95th Cong., 2d Sess. § 361 (1978).

35. H.R. 8200, § 361(4).

36. 124 CONG. REC. 32,395 (1978) (statement of Rep. Edwards); 124 CONG. REC. 33,495 (1978) (statement of Sen. DeConcini). The compromise also removed from the original House Bill the use of an administrative expense as a method of providing adequate protection. *Id.* at 33,994-95.

37. SENATE REPORT, *supra* note 20, at 127, 1978 U.S. CODE CONG. & AD. NEWS at 5913. The indubitable equivalent language is also contained in § 1129 as enacted. *See* 11 U.S.C. § 1129(b)(2)(a)(iii) 1982.

38. SENATE REPORT, *supra* note 20, at 127, 1978 U.S. CODE CONG. & AD. NEWS at 5913. The

In *Murel* a secured creditor appealed from an order denying relief from a stay of its right to foreclose.[39] The debtors' proposed plan of reorganization required the secured creditor to forego amortization payments on the indebtedness for a period of ten years with payment in full on the tenth year.[40] During the interim, the debtor in *Murel* proposed interest on the amount due at the rate of five and one-half percent annually.[41]

On appeal, the secured creditor argued that its interest was not adequately protected.[42] Judge Hand agreed and commented on the concept of adequate protection as follows:

> 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.[43]

Judge Hand's interpretation of the concept of adequate protection clearly places emphasis on the time value component of money. As aptly stated by Judge Hand, "payment ten years hence is not generally the equivalent of payment now."[44] By using the indubitable equivalent language in section 361, it seems apparent that Congress certainly envisioned compensation for delay in exercising foreclosure rights as a part of adequate protection.[45]

Congress also included the indubitable equivalent language in

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Senate Report state that "[t]he indubitable equivalent language is intended to follow the strict approach taken by Judge Learned Hand in *In re Murel Holding Corp.*, 75 F.2d 941 (2nd Cir. 1935)." *Id.*

39. *Metropolitan Life Ins. Co. v. Murel Holding Corp.*, 75 F.2d 941, 941 (2d Cir. 1935). Under § 77B of the old Act, the stay was not automatic; instead the debtor was required to seek an order staying any attempt by a creditor to enforce its liens. Act of June 7, 1934, ch. 424, 48 Stat. 911 (1934) (repealed 1978).

40. 75 F.2d at 942.

41. *Id.*

42. *See id.* Judge Hand concluded that if secured creditors do not consent to the proposed treatment in a plan, the plan "'must provide adequate protection for the realization by them . . . of the full value of their interest, claims or liens.'" *Id.*

43. *Id.*

44. *Id.*

45. *See* Crocker Nat'l Bank v. American Mariner Indus., Inc., 734 F.2d 426, 434 (9th Cir. 1984). Commenting on the overall significance of the use of the phrase "indubitable equivalent" in § 361, the Ninth Circuit Court of Appeals concluded that "it at least encourages if not requires a present value analysis under section 361." *Id.* For a more detailed discussion of *American Mariner* see *infra* notes 43-57 and accompanying text.

section 1129 of the Code.[46] Section 1129 sets out the requirements for a confirmable plan of reorganization.[47] A plan of reorganization may be confirmed over the objection of dissenting creditors if the plan complies with the cram-down provisions of section 1129.[48] A plan that provides for periodic cash payments that equal the present value of the secured creditor's claim would comply with the cram-down provisions of section 1129.[49]

As an alternative method to the deferred cash payments, a cram-down plan may provide "for the realization. . . of the indubitable equivalent" of the secured claims.[50] The use of indubitable equivalent as an alternative to deferred cash payments indicates, therefore, that Congress recognized that the indubitable equivalent language implied a present value connotation.[51]

The indubitable equivalent language in section 361 coupled with the intention to protect the secured creditor's bargain, leads to the conclusion that Congress intended to compensate the secured creditor for the delay in exercising its right to repossess and sell the collateral.

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46. *See* 11 U.S.C. § 1129(b)(2)(A)(iii) (1982).

47. *See Id.* § 1129(a).

48. *See Id.* § 1129(b). The cram-down phraseology comes from the ability of the bankruptcy court to confirm a plan of reorganization notwithstanding the failure to obtain the acceptance of all creditors. *See generally* COLLIER, *supra* note 32, ¶ 1129.01.

49. *See* 11 U.S.C. § 1129(b). Section 1129(b) provides as follows:

> (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
>
> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) with respect to a class of secured claims, the plan provides—
>
> (i) (I) that the holders of such claims retain the lien securing such claims, whether the property subject to such lien is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive an account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
>
> (ii) for the sale, subject to section 363 (k) of this title, of any property that is subject to the lien securing such claims, free and clear of such lien, with such lien to attach to the proceeds of such sale, and the treatment of such lien on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

Id.

50. *See Id.* § 1129(b)(2)(A)(iii).

51. *See* HOUSE REPORT, *supra* note 15, at 414, 1978 U.S. CODE CONG. & AD. NEWS at 6370

B. Case Law

Courts have split on the issue of whether adequate protection requires compensation for delay in exercising foreclosure rights.[52] The leading case supporting the proposition that adequate protection requires compensation for delay in exercising foreclosure rights is the Ninth Circuit's decision in *Crocker National Bank v. American Mariner Industries, Inc.*[53]

In *American Mariner,* an undersecured creditor appealed from bankruptcy court and bankruptcy appellate panel decisions denying its request for relief from the automatic stay.[54] The sole issue on appeal was whether the undersecured creditor was entitled to compensation under the concept of adequate protection for the delay in enforcing its lien rights.[55]

At the time the secured creditor, Crocker National, requested relief from the automatic stay, the indebtedness owed by its debtor, American Mariner, amounted to $365,000.[56] The collateral securing American Mariner's indebtedness had a liquidation value of $130,500.[57] As adequate protection Crocker National sought monthly cash payments equal to the reinvestment value of the collateral.[58]

("This [§ 1129 (b)] contemplates a present value analysis that will discount value to be received in the future. . . .").

52. For cases in which courts have concluded that adequate protection requires compensation for delay in exercising foreclosure rights under § 361, *see* Crocker Nat'l Bank v. American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984); Albion Prod. Credit Ass'n v. Langley, 30 Bankr. 595 (Bankr. N.D. Ind. 1983); Metropolitan Life Ins. Co. v. Monroe Park, 17 Bankr. 934 (Bankr. D. Del. 1982); United Va. Bank v. Virginia Foundry Co., 9 Bankr. 493 (Bankr. W.D. Va. 1981); Midlantic Nat'l Bank v. Anchorage Boat Sales, Inc., 4 Bankr. 635 (Bankr. E.D. N.Y. 1980). *See also* Comment, *supra* note 20.

For cases in which courts have come to an opposite conclusions, *see:* Lend Lease v. Briggs Transp. Co., 35 Bankr. 210 (Bankr. D. Minn. 1983); Norwest Bank Fargo v. Garnas, No. 83-05232, slip op. (Bankr. D.N.D. Dec. 28, 1983); Aegean Fare, Inc. v. Commonwealth of Mass., Dep't of Revenue, 34 Bankr. 965 (Bankr. D. Mass. 1983); First Fed. Sav. & Loan Ass'n of Lima v. Shriver, 33 Bankr. 176 (Bankr. N.D. Ohio 1983); Fort Worth Mortgage Corp. v. Cantrup, 32 Bankr. 1004 (Bankr. D. Colo. 1983); Barclays Bank of N.Y., N.A. v. Saypol, 31 Bankr. 796 (Bankr. S.D. N.Y. 1983); General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987 (Bankr. D. Utah 1982); *In re* Pine Lake Village Apt. Co., 19 Bankr. 819 (Bankr. S.D. N.Y. 1982); Bankers Life Ins. Co. of Neb. v. Alyucan, 12 Bankr. 803 (Bankr. D. Utah 1981).

53. 734 F.2d 426 (9th Cir. 1984).

54. Crocker Nat'l Bank v. American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984). The secured creditor, Crocker National, appealed from the bankruptcy court decision, 10 Bankr. 711 (Bankr. C.D. Cal. 1981), which was affirmed by the bankruptcy appellate panel for the Ninth Circuit, 27 Bankr. 1004 (Bankr. 9th Cir. 1983). 734 F.2d at 427.

55. *American Mariner,* 734 F.2d at 427.

56. Crocker Nat'l Bank v. American Mariner Indus., Inc., 27 Bankr. at 1005. On December 12, 1980, American Mariner filed its petition under chapter 11 of the Bankruptcy Code. Less than three months later, on February 23, 1981, Crocker National commenced a proceeding to obtain relief from the stay. *Id.*

57. *Id.*

58. *Id.* Crocker National sought monthly cash payments that would reflect a reinvestment at the prime interest rate, at that time 19%, plus two percentage points. This amounted to approximately $2300 per month. At some point, American Mariner offered payments of $1770 per month. *Id.*

The bankruptcy court denied Crocker National's request for a monthly cash payment equal to the reinvestment value on the theory that section 506(b),[59] by negative implication, precludes interest payments on undersecured claims.[60] Over a vigorous dissent,[61] the bankruptcy appellate panel subsequently affirmed the bankruptcy court.[62]

The bankruptcy appellant panel disagreed, however, with the bankruptcy court's conclusion that section 506(b), by negative implication, precludes interest payments to undersecured creditors.[63] Instead, the appellate panel concluded that merely as a matter of bankruptcy policy, it was inconceivable that Congress intended the debtor, while insolvent, to provide a market interest rate to an undersecured creditor as a condition for maintaining the automatic stay.[64]

After reviewing the legislative history of section 361, the Ninth Circuit reversed the bankruptcy court and appellate panel.[65] The court reasoned that Congress "well understood" the meaning of the term indubitable equivalent when it was incorporated into section 361.[66] The Ninth Circuit concluded that Congress intended

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59. 11 U.S.C. § 506(b) (1982). Section 506(b) provides as follows:

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

Id.

60. Crocker Nat'l Bank v. American Mariner Indus., Inc., 10 Bankr. at 712 (citing 11 U.S.C. § 506(b) (Supp. v. 1981)). Although the bankruptcy court concluded no interest was due as a part of adequate protection, it found that an offer of $1770 per month would be adequate protection for any depreciation in the value of the collateral. *Id.* at 714. The court noted, however, that "[i]f no progress is made within a reasonable time, the bank can reapply for relief of stay, or move to dismiss or for conversion to a Chapter 7." *Id.*

61. 27 Bankr. at 1014 (Hughes, J., dissenting). Judge Hughes concluded that undersecured creditors are entitled to compensation for the delay in repossessing their collateral. *Id.* at 1018. Hughes noted that adequate protection assures the economic equivalent of the bargain struck, *id.* at 1016-17, and that the creditor was entitled to the economic equivalent of the right to foreclose. *Id.* at 1018.

62. *Id.* the standard of review employed by the bankruptcy appellate panel was apparently whether the bankruptcy court abused its discretion in denying the request for relief from the automatic stay. *Id.*

63. *Id.* at 1009.

64. *See Id.* at 1010. The bankruptcy appellate panel stated as follows:

> All things considered, it is not possible, without engaging in strained construction, to conclude that it was the intention of Congress, where the debtor is insolvent and the collateral insufficient, that the automatic stay triggers interest, at market rate, on the value of the collateral; nor was it intended that the undersecured creditor be entitled to market rate interest from the date of bankruptcy forward, as a necessary condition for maintaining the stay.

Id.

65. *American Mariner,* 734 F.2d at 427.

66. *Id.* at 434. The Ninth Circuit concluded as follows: "After examining the origins of the

to compensate the secured creditor for the harm that results to its interest as a result of the automatic stay, including the cost occasioned by the delay in foreclosing its lien.[67]

In addition, the court noted that a different conclusion would only result in an unwarranted windfall to the debtor and the unsecured creditors at the expense of the undersecured creditor.[68] Thus, the Ninth Circuit concluded that the undersecured creditor "is entitled to compensation for the delay in enforcing its rights during the interim between the petition and confirmation of the plan."[69]

Perhaps the leading case supporting an opposite view is the case of *General Electric Mortgage Corp. v. South Village, Inc.*[70]

In *South Village* a shopping mall owner filed a petition under Chapter 11. General Electric Mortgage Corp., an undersecured creditor, sought relief from the automatic stay.[71] At issue before the *South Village* court was the identical issue facing the *American Mariner* court — whether the undersecured creditor is entitled to compensation as a part of adequate protection for the delay in foreclosure.[72]

In an exhaustive opinion, the *South Village* Court reviewed the legislative history and concluded that Congress did not intend to compensate an undersecured creditor for the delay in foreclosing its liens.[73] The court reasoned that the automatic stay was only an interim remedy that allows the debtor time to reorganize.[74]

The court suggested that the secured creditor has other remedies, such as submitting a creditor plan of reorganization or liquidation or moving for a dismissal of the case.[75] In light of these other remedies, the court in *South Village* determined that it would not require the debtor to pay interest for the delay.[76]

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phrase [indubitable equivalent] and its use elsewhere in the Bankruptcy Code, we conclude that it at least encourages if not requires a present value analysis under Section 361." *Id.* at 432.

67. *Id.* at 435.

68. *Id.*

69. *Id.*

70. 25 Bankr. 987 (Bankr. D. Utah 1982).

71. General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987, 988 (Bankr. D. Utah 1982). The evidence adduced at trial revealed that the secured creditor's debt equalled $4,369,000. The value of the collateral amounted to $4,340,000. Interest continued to accrue on the indebtedness at the rate of $1633 per day or $596,110 per year. The court found the collateral not sufficiently increasing in value to cover the increasing indebtedness. *Id.*

72. *See id.* The secured creditor demanded periodic cash payments equal to the market rate of interest. *Id.* at 989 n.1.

73. *Id.* at 991-96. The *South Village* court did not find the inclusion of the term "indubitable equivalent" to have much, if any, significance. *Id.* at 991 n.4. Although acknowledging the term derives from Judge Hand's opinion in *In re Murel Holding Co.*, 75 F.2d 941 (2d Cir. 1935), the court concluded that the result in *Murel* was "fact-specific, not a categorical imperative." *Id.* at 992 n.4.

74. *Id.* at 1000.

75. *Id.*

76. *Id.* at 1002. The court concluded that "[d]ebtors need not pay opportunity cost in light of these antidotes for delay found in the Code." *Id.*

III. CONSTITUTIONAL REQUIREMENTS

Although the courts have split on the issue of whether compensation for delay is required under the Bankruptcy Code, no court has held that the Constitution requires such compensation. Nonetheless, Congress' power to legislate bankruptcy law under article I, section 8 of the Constitution is limited by the fifth amendment.[77]

In *Louisville Joint Stock Land Bank v. Radford*,[78] the Supreme Court held unconstitutional the Frazier-Lemke Act, which allowed farmers in default to remain in possession of mortgaged property during a five year stay of foreclosure.[79] During the five year period of the stay, the farmer could purchase the property at its appraised value.[80] The purchase price could be paid by deferred payments over a period of six years with an annual rate of one percent interest.[81]

The Supreme Court found that the Frazier-Lemke Act stripped mortgagees of five traditional rights: (1) the right to retain its lien until the indebtedness is repaid; (2) the right to a judicial sale of mortgaged property; (3) the right to determine when such sale should be held; (4) the right to bid at a judicial sale, and (5) the right to control the property during default.[82] The Court concluded that the stripping of these rights constituted a taking without just compensation in violation of the fifth amendment.[83]

In *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke*[84] the Court upheld a modified version of the Frazier-Lemke Act.[85] The Court found that the modified version protected three of the five rights that it held impaired in *Radford:* (1) the right to retain its liens until the indebtedness is paid; (2) the right to a judicial sale, and (3) the right to bid at a judicial sale.[86] With the protection of

77. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935). "The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment." *Id.* Congress, unlike the states, is not prohibited from impairing the obligations of contracts. *Id.*

78. 295 U.S. 555 (1935).

79. Louisville Joint Stock Land Bank v. Radford, 295 U.S. at 575-76. *See* Frazier-Lemke Act, ch. 869, 48 Stat. 1289 (1934) (amended 1935, 1940).

80. *Id.* at 591.

81. *Id.*

82. *Id.* at 594-95.

83. *Id.* at 601-02.

84. 300 U.S. 440 (1937).

85. Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937). *See* Frazier-Lemke Act, ch. 792, 49 Stat. 942 (1935) (amended 1940) (expired by its own terms). Congress redrafted the Frazier-Lemke Act to cure the constitutional defects enumerated in *Radford.* 300 U.S. at 457.

86. 300 U.S. at 458-59. Under the modified version of the Frazier-Lemke Act, the debtor could retain possession of the property. The stay, however, remained in place for three years rather than five years and the liens remained in place during the stay. *Id.* at 460.

these rights, the Court concluded that the modified Frazier-Lemke Act did not represent an unreasonable modification of the creditor's rights.[87]

In a subsequent case, *Wright v. Union Central Life Insurance Co.*,[88] the Supreme Court concluded that the debtor's right to redeem mortgaged property at its appraised value was superior to the creditor's right to have a judicial sale and the right to bid at the sale.[89] Thus, *Union Central* in effect rendered meaningless the secured creditor's rights supposedly constitutionally protected in the modified version of the Frazier-Lemke Act.[90]

Radford and its progeny indicate that, even without compensation for delay in exercising foreclosure rights, the automatic stay provisions contained in the Code are more protective of creditors' rights than the Frazier-Lemke Act that the United States Supreme Court upheld in *Vinton* and *Union Central.*[91] Compensation for the delay in exercising foreclosure rights, therefore, would not likely be constitutionally required.

V. CONCLUSION

Although compensation for delay in exercising foreclosure rights would not likely be constitutionally required, adequate protection and section 361 were not intended by Congress to be confined to the constitutional requirements of the fifth amendment.[92] Congress intended section 361 to provide protection

87. *Id.* at 470.

88. 311 U.S. 273 (1940).

89. Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 279-80 (1940). In *Union Central* a conflict arose between the creditor who desired a judicial sale and the debtor who desired to redeem by paying an appraised value. *Id.* at 276. The Supreme Court held that the right to redeem outweighed the right to a judicial sale. *Id.* at 279.

90. The right to a judicial sale and the right to bid at a judicial sale, as expressed in *Vinton,* would have no value to the secured creditor if the debtor could redeem the collateral at its appraised value. The third right, the retention of a lien, important in *Vinton,* is also rendered meaningless since the lien could be discharged by the redemption. *See* Comment, *supra* note 20, at 310 n.24.

91. For instance, the Code places limitations on the use, sale, or lease of collateral. 11 U.S.C. § 363 (1982). A creditor is entitled to a hearing on the automatic stay within 30 days of the request for relief. *Id.* § 362(e). The secured creditor's liens remain in place throughout the bankruptcy proceedings unless avoided under the avoidance powers of the Code. *See id.* §§ 522, 544, 545, 547, 548, 549, 724.

92. HOUSE REPORT, *supra* note 15, at 339, 1978 U.S. CODE CONG. & AD. NEWS at 6295. The House Report provides as follows:

> The concept [adequate protection] is derived from the fifth amendment protection of property interests. *See Wright v. Union Central Life Ins. Co.,* 311 U.S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford,* 295 U.S. 555 (1935). It is not intended to be confined strictly to the constitutional protection required, however. The section [§ 361], and concept of adequate protection, is based as much on policy grounds as on constitutional grounds.

Id.

for the secured creditor's bargain.[93] In addition, Congress intended section 361 to further bankruptcy policy with a flexible equitable balancing approach to the various parties' interests.[94]

At the outset of the bankruptcy case, the debtor is entitled to a brief respite from the pressures of his creditors.[95] This enables the debtor to propose and file a plan of reorganization. The Code gives the debtor a 120-day exclusive time period for the filing of a plan of reorganization.[96] Because the time period is fairly brief, the debtor will probably not be required to compensate the secured creditor for the delay in exercising its foreclosure rights.[97]

After the 120-day time period has expired, the equities and bankruptcy policy favor granting the under secured creditors compensation for the delay as a part of adequate protection. First, it would place desirable pressure on the debtor to move toward the presentment and confirmation of a plan.[98] Had the debtor proposed a plan of reorganization during the 120-day time period, the plan would be required to either pay off the secured creditor's claim in full on the effective date of the plan or provide deferred cash payments with a present value equal to the secured claim.[99] Thus, the debtor actually has a disincentive to move towards the filing of a plan, unless the undersecured creditor can require, as a part of adequate protection, compensation for the delay in exercising its foreclosure rights.

Second, a prolonged use of the collateral by the debtor enables the debtor, in most instances, to produce income from the collateral. At the same time, however, the value to the secured creditor of the collateral sale proceeds diminishes in value.[100] This

93. *Id.* ("The purpose of the section [§ 361] is to insure that the secured creditor receives in value essentially what he bargained for").

94. *See id.* The House Report states as follows: "It is expected that the courts will apply the concept in light of [sic] facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. *Id. See also* Albion Prod. Credit Ass'n v. Langley, 30 Bankr. 595, 605 (Bankr. N.D. Ind. 1983).

95. 30 Bankr. at 605. The court in *Langley* commented on the purpose of the automatic stay as follows: "While the debtors are provided a respite from acts of creditors in order to get their affairs in order and plan an approach to reorganization, they should not be allowed to string this protection out over an unreasonable time period." *Id.*

96. 11 U.S.C. § 1121(b) (1982).

97. A balancing of the equities might not require compensation for such a short period of delay in exercising foreclosure rights. However, if the tangible value of the collateral is depreciating rather rapidly due to its use or tangible nature, adequate protection should be required during the initial 120-day time period as well.

98. 30 Bankr. at 605. The *Langley* court stated that "the purpose of the protection is to facilitate rehabilitation where possible. It is desirable that *some* pressure be maintained to move debtors along toward presentment of a plan, especially where the debtors have the continued use of another's collateral." *Id.* (emphasis in original). The bankruptcy court in *American Mariner* also suggested this approach by commenting that "[i]f no progress is made within a reasonable time, the bank can reapply for relief of stay, or move to dismiss or for conversion to a Chapter 7." 10 Bankr. at 714.

99. *See* 11 U.S.C. § 1129 (1982).

100. 30 Bankr. at 605-06. The *Langley* court commented, "The debtors should not be able to use

results in an unequitable shift of the benefits of the collateral from the secured creditor to the debtor and the unsecured creditors, at the expense of the under secured creditor.[101]

Third, compensation for delay in exercising foreclosure rights as a part of adequate protection would be more desirable than other remedies available to the secured creditor. For instance, the secured creditor has the option of moving for the dismissal of the bankruptcy case.[102] An approach allowing compensation for the delay in exercising foreclosure rights, however, is a more reasonable alternative than the all or nothing approach the bankruptcy case dismissal remedy would entail.[103]

In sum, bankruptcy policy and legislative history indicate that compensation for the delay in exercising foreclosure rights is a part of the adequate protection that must be provided to an undersecured creditor. During the initial 120-day time period set aside for the debtor to file a plan, the equities might not favor compensation for such a short delay. After that time period has expired, however, the Bankruptcy Court should require the debtor to compensate the secured creditor as a part of the concept of adequate protection for the delay in exercising its foreclosure rights.

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this creditor's collateral to earn new money while at the same time the ability of the collateral to satisfy the claim the creditor had on the date of filing is diminishing." *Id.*

101. 734 F.2d at 435. The court in *American Mariner* stated as follows: "To the extent that the debtor in bankruptcy can prevent the secured creditor from enforcing its rights against collateral while the debtor benefits from the creditor's money, the debtor and his unsecured creditors receive a windfall at the expense of the secured creditor." *Id.*

102. 11 U.S.C. § 1112(b) (1982). Section 1112(b) provides that the court may dismiss a case for cause, including inability to effectuate a plan or unreasonable delay by the debtor that is prejudicial to creditors. *Id.*

103. The all or nothing approach is suggested by the *South Village* court. General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987 (Bankr. D. Utah 1982). If the *South Village* approach is followed, courts will be required to determine whether a reorganization attempt should be discontinued in every instance in which a creditor is concerned about the erosion of its economic interests. Rather than making such a life or death decision, the bankruptcy court should require the debtor to pay compensation for the use of the collateral during the reorganization proceedings. If the debtor is unable or unwilling to pay for the use of the collateral, relief from the automatic stay is a less drastic remedy than the dismissal remedy proposed by *South Village*.