

LESSON 4

CASE ADMINISTRATION (Chapter 3 Bankruptcy Code)

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I. INTRODUCTION

Every secured lender can be harmed by a bankruptcy filing of its debtor if the lender has no access or control over the collateral securing its lien. The same holds true for a governmental entity holding a tax lien which attaches to existing collateral of the debtor. The Bankruptcy Code provides relief for secured lenders who may see the value of collateral diminish as the bankruptcy progresses, especially where liquid collateral, i.e., accounts receivable and inventory, are involved. This relief, called "adequate protection," comes in various forms. An award of periodic cash payments to the secured creditor is generally the preferable form of adequate protection. Other acceptable forms are the creation of post-petition replacement liens or surrender of all or a portion of the collateral to the creditor.

II. ADEQUATE PROTECTION - 11 U.S.C. § 361

Creditors who have a secured interest in any collateral of the debtor are entitled to adequate protection under the Code in order to prevent them from suffering a financial loss because of the bankruptcy. Although the term "adequate protection" is not defined in the Bankruptcy Code, the concept is simple--to preserve the value of the property or collateral securing a creditor's claim, thereby maintaining the *status quo*. Since adequate protection applies to claims of secured creditors, the Service is entitled to adequate protection only if its claim is secured by a tax lien (notice of which has been filed). Further, the Supreme Court has held that the Service's tax lien claim is not diminished as a result of the debtor's bankruptcy if the debtor provides "adequate protection" to the Service, particularly in the case of a turnover of property seized prior to the bankruptcy. See United States v. Whiting Pools, Inc. 462 U.S. 198 (1983).

The concept of "adequate protection" arises in the following situations in a bankruptcy case:

A. Motions to Lift the Stay

A creditor with a secured claim is entitled to receive adequate protection as compensation for the delay in enforcing its rights against the collateral caused by the automatic stay provided by 11 U.S.C. § 362. Because the filing of a bankruptcy case causes the secured creditor to lose the ability to liquidate the collateral and satisfy the debt, the debtor must afford the creditor "adequate protection" to preclude the creditor from filing a motion to lift the stay. Upon request of a secured creditor and after notice and hearing, the court shall grant relief from the stay for cause, including the lack of adequate protection of an interest in property of the secured creditor. 11 U.S.C. § 362(d)(1).

B. Use of Cash Collateral

Under section 363, a trustee (or debtor-in-possession) may not use cash collateral unless:

1. all parties that have an interest in the cash collateral consent; or
2. the court, after notice and hearing, authorizes the use of cash collateral.

A creditor who has a secured interest in the debtor's cash collateral may consent to the debtor's use of such if the creditor is granted adequate protection. The use of cash collateral orders to obtain adequate protection will be discussed later in this lesson.

C. Obtaining Secured Credit

Under section 364, adequate protection must be given in exchange for the granting of a senior lien on collateral to obtain credit.

Section 361 provides three nonexclusive examples of adequate protection:

1. single or periodic deferred cash payments;
2. additional or replacement liens; and
3. indubitable equivalent of the value of the creditor's interest in the collateral. See, In re Martin, 761 F.2d 472 (8th Cir. 1985) (Indubitable equivalent requires such relief as will result in the realization of the value of a secured creditor's interest.); In re Magnus, 50 B.R. 241 (Bankr. D.

N.D. 1985); In re Pac. Lifestyle Homes, Inc., 2009 Bankr. LEXIS 711 (Bankr. W.D. Wash. Mar. 16, 2009).

The principal factor in determining whether a secured creditor's interest is adequately protected is the existence of an adequate equity cushion. Most courts have held that a creditor's interest is adequately protected if the value of the secured assets exceeds the amount of its claim by a sufficient amount. What constitutes a "sufficient" equity cushion has been the subject of much litigation. See e.g., In re Mellor, 734 F.2d 1396 (9th Cir. 1984) where the court determined that a 20% equity cushion was adequate; In re Rogers Dev. Corp., 2 B.R. 679 (Bankr. E.D. Va. 1980) where the court held that a equity cushion of 15% to 20% of the value of the collateral was adequate protection as to a first mortgage holder; In re Haw. Pac. Indus., 17 B.R. 670 (Bankr. D. Hawaii 1982) where the court found that a 15% equity cushion in real estate was sufficient; cf. In re the Southerton Corp., 46 B.R. 391 (D. Ct. M.D. Pa. 1982) where the court held that a 17% equity cushion was not adequate protection; In re Colrud, 45 B.R. 169 (Bankr. D. Ala. 1984) holding that an equity cushion alone may not be sufficient to protect a secured creditor's interest.

In 1988, the Supreme Court resolved a split among the circuit courts of appeal regarding the issue as to whether an under-secured creditor is entitled to be compensated for the time value of money lost (i.e., post-petition interest) as a result of the delay in enforcing his rights against the collateral due to the filing of the bankruptcy. In United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988), the Court held that an under-secured creditor is not entitled to receive interest on his collateral during the period that the automatic stay is in force in order to insure adequate protection under section 362(d)(1).

An over-secured creditor may also seek interest on its claim, at least to the extent of the amount by which it is over-secured. Following the Supreme Court's decision in United States v. Ron Pair Enters., Inc., 489 U.S. 235 (1989), which held that the Government is entitled to receive post-petition interest on its secured claim if the claim is over-secured, over-secured creditors attempted to receive interim post-petition interest payments prior to confirmation of a plan in lieu of adequate protection payments. Most courts have denied such relief. The Eleventh Circuit has ruled that an over-secured creditor may not demand periodic payments for accruing post-petition interest as part of its "adequate protection" under Bankruptcy Code Section 362(d)(1). Orix Credit Alliance Inc. v. Delta Res. Inc. (In re Delta Res. Inc.), 54 F.3d 722 (11th Cir. 1995), cert. denied, 116 S.Ct. 488 (1996). The court explained that adequate protection encompasses the decline in the value of the collateral only, not the perpetuating ratio of the collateral to the debt. As a result of the Delta Res. decision and the court opinions which have reached the same conclusion, the interest on over-secured debt under the Ron Pair decision will be fixed and paid upon

confirmation of a Chapter 11 or Chapter 13 plan. This interest, which accrued post-petition, will be added to the pre-petition debt and paid over the period set forth in the plan.

III. USE, SALE, OR LEASE OF PROPERTY (CASH COLLATERAL ORDERS) – 11 U.S.C. § 363.

Under section 363, if the business of the debtor is authorized to be operated under section 721 (Chapter 7 case), section 1108 (Chapter 11 case), section 1203 or 1204 (Chapter 12 case), or section 1304 (Chapter 13 case), the trustee/debtor-in-possession may use, sell, or lease property of the estate in the ordinary course of business, except cash collateral, without court approval. However, under section 363(e), 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 any action as is necessary to provide adequate protection of such interest. Section 363(p) (formerly section 363(o)) provides that in any hearing under section 363, the trustee has the burden of proof on the issue of adequate protection and the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

If the trustee/debtor-in-possession proposes to use, sell, or lease property, other than cash collateral, not in the ordinary course of business, notice and a hearing are required. Bankruptcy Rule 6004 governs the procedural requirements for filing a motion for use, sale, or lease of property not in the ordinary course of business.

The Code has tighter restrictions on the use of cash collateral. Under section 363(c)(2), cash collateral may not be used, sold, or leased by the trustee/debtor-in-possession without the consent of the lien holder or the court's authorization after notice and a hearing. Under section 363(a), "cash collateral" is defined to mean cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired, in which the estate and an entity other than the estate have an interest. Cash collateral also includes the proceeds, products, offspring, rents or profits of property subject to a security interest subject to section 552(b), whether existing before or after the commencement of a bankruptcy case.

Cash collateral orders can be negotiated on behalf of the Service by the United States Attorney or by SBSE attorneys acting as Special Assistant United States Attorneys. These orders are designed to protect the value of the Service's lien interest in the cash collateral of the debtor so that the value of the lien interest is not diminished as a result of the debtor's continued business operations. A cash

collateral order is typically negotiated at the beginning of a Chapter 11 case and can continue in effect for any length of time although it usually expires upon the date of confirmation.

Cash collateral orders typically provide the Service with adequate protection in the form of replacement liens on post-petition accounts receivable, inventory and other property of the debtor, although monthly cash payments towards the lien claim is the preferred form of adequate protection. Requiring the debtor to maintain insurance covering the collateral secured by the federal tax lien is a typical term in appropriate situations (e.g., when the collateral is tangible) and a defined budget, restricting the debtor to spending limits in specific categories is not uncommon.

Bankruptcy Rule 4001(b) sets forth the procedural requirements for cash collateral motions, which can be filed either as a Motion for Authority to Use Cash Collateral or by submission of an Agreed Order for Use of Cash Collateral.

IV. OBTAINING CREDIT - 11 U.S.C. § 364

Under section 364(a), the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business if the trustee is authorized to operate the business of the debtor in a case under Chapter 7, 11, 12, or 13. The credit obtained is an allowable administrative expense under section 503(b)(1).

Section 364(b) provides that if unsecured credit is sought other than in the ordinary course of business, it must be authorized by the court after notice and hearing.

Under section 364(c), if credit is unobtainable by offering priority under section 503(b)(1), then the court may, after notice and hearing, authorize the trustee to obtain credit with priority over any and all administrative expenses, secured by a lien on property of the estate that is not otherwise subject to a lien, or secured by a junior lien on property of the estate that is subject to a lien.

Under section 364(d)(1), priority or parity with respect to other liens may be granted only if credit is otherwise unattainable and adequate protection is provided to the subordinated lienor or creditor given equal priority. The trustee has the burden to show that adequate protection exists.