# THE VALUATION OF SECURED CLAIMS IN BANKRUPTCY: A FRAMEWORK

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## I. INTRODUCTION: A BASIC BANKRUPTCY CONFLICT; §506(a)

One of the fundamental conflicts in bankruptcy involves the interests of secured creditors on one hand, and the interests of all other claimants to the estate— including the debtor, administrative claimants, and general unsecured creditors—on the other. Secured creditors would generally prefer to pursue their claims, outside of bankruptcy, against collateral that is property of a bankruptcy estate. If that is not possible, they want to maximize the payment they receive on their claims, and be paid maximum interest, before payment is made to any other party. The other parties, in turn, generally prefer that the secured creditors be stayed from pursuing nonbankruptcy remedies against property of the estate, so that the estate can use the property or try to negotiate a sale for more than the amount of the secured claim. The other parties also prefer that secured creditors be paid as little as possible on their claims, without interest. The resolution of these conflicts, of course, is determined within the framework of the Bankruptcy Code (Title 11, U.S.C.), but within that framework, the ultimate result usually depends on how the collateral securing a creditor's claim is valued, and so most of the litigated issues involving secured claims involve valuation. This outline provides a framework for considering questions of valuation of collateral in bankruptcy.

In this framework, one provision of the Code—§506(a)—is of paramount importance. Section 506(a) sets up a process of "bifurcating" secured claims. If a creditor has a claim against the debtor, secured by collateral that is property of the bankruptcy estate, and the value of the collateral is not sufficient to pay the entire claim, then the creditor is seen as having two claims in the bankruptcy case: first, a secured claim, to the extent of the value of the collateral (or, in the language of §506(a), "the extent of the value of such creditor's interest in the estate's interest in such property") and second, an unsecured claim, to the extent that there is a deficiency in the value of the collateral ("the extent that the value of such creditor's interest [in the estate property] . . . is less than the amount of such allowed claim."). Thus, §506(a) is directly relevant whenever a secured creditor is "undersecured," but it has an even broader impact, since courts use the principles of valuing interests of creditors developed under §506(a) for purposes of valuation generally.

## II. HOW THE QUESTIONS ARISE: DISPUTES RAISING ISSUES OF VALUATION.

### A. Whether secured creditors may pursue nonbankruptcy remedies against the collateral: relief from the automatic stay.

One of the major effects of the automatic stay imposed by §362(a) of the Code is to prevent secured creditors from taking any action, such as foreclosure or repossession, to satisfy their claims from collateral that is property of the estate. Section 362(d) allows relief from the stay in two specified situations, each of which, in different ways, is likely to involve questions of the value of collateral.

**1. Lack of Equity.** In situations where the collateral is not "necessary to an effective reorganization," §362(d)(2) allows relief from the automatic stay if the debtor does not "have an equity" in the collateral. Whether

the debtor has any equity in collateral depends on the value of the collateral compared to the amount of the claims that it secures. *Mendoza v. Temple-Inland Mortgage Corp. (In re Mendoza)*, 111 F.3d 1264, 1272 (5th Cir. 1997) ("'[I]n determining whether a secured creditor's interest is adequately protected, most courts engage in an analysis of the property's 'equity cushion'—the value of the property after deducting the claim of the creditor seeking relief from the automatic stay and all senior claims.'") (quoting *Nantucket Investors II v. California Fed. Bank. (In re Indian Palms Associates, Ltd.)*, 61 F.3d 197, 207 (3d Cir. 1995)); *Sutton v. Bank One (In re Sutton)*, 904 F.2d 327, 329 (5th Cir. 1990) ("'Equity' as used in §362(d) portends the difference between the value of the subject property and the encumbrances against it."); *In re Powell*, 223 B.R. 225, 235 (Bankr. N.D. Ala. 1998) ("Most courts hold that a debtor lacks equity when the balance of all debts secured by liens on the property exceed the fair market value of the property."); *In re Siciliano*, 167 B.R. 999, 1011 (Bankr. E.D. Pa. 1994) (relief from stay under §362(d)(2) requires a showing that the value of the collateral is less than the total indebtedness it secures).

**2. Lack of Adequate Protection.** The other basis for relief from the automatic stay, pursuant to §362(d)(1), is "for cause, including the lack of adequate protection." The interest of a secured creditor in collateral held by a bankruptcy estate "includes the right . . . to have [the collateral] applied in payment of the debt," and adequate protection requires that the value of the creditor's interest in the collateral be maintained. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc's, Ltd.*, 484 U.S. 365, 370, 108 S. Ct. 626, 630 (1988) (a creditor's interest "is not adequately protected if the security is depreciating during the term of the stay"). *Timbers* also holds, in effect, that the protected interest of a secured creditor is *limited* to the ultimate right of payment from the collateral, and does not include an additional right to immediate possession of that collateral; thus, adequate protection does not require the debtor to make interest payments to the secured creditor simply because the debtor retains the collateral. 484 U.S. at 380-81, 108 S. Ct. at 635. Rather, adequate protection is required only if there is an actual or threatened decline in the value of the creditor's interest. In such circumstances, some offsetting action must be taken (such as tendering cash payments or granting additional security), as specified by §361 of the Code; otherwise relief from the automatic stay is appropriate. 484 U.S. at 370, 108 S. Ct. at 630-32. In order to determine whether there is a need for adequate protection, and if so, the extent to which adequate protection is required, valuation of the collateral is required, both to determine the extent of the creditor's interest subject to protection and to determine the extent to which that interest has declined or will decline in value.

## B. Whether collateral can be used to enhance the estate.

If a secured creditor is not able to obtain access to its collateral through relief from the automatic stay, it will often be in the creditor's best interest to

minimize the extent to which the debtor can continue to use the property. In this way, the collateral (and the creditor's priority) are kept intact until such time as the creditor is able take action against the collateral.

1. **Eligibility for Chapter 13 relief.** If a bankruptcy case is filed under Chapter 13, one way to deny the use of collateral to the debtor is by terminating the bankruptcy case or forcing its conversion to Chapter 7. Section 109(e) of the Bankruptcy Code (Title 11, U.S.C.) limits the availability of Chapter 13 relief to debtors with less than specified amounts of secured and unsecured debt. Currently, under the 1998 Amendments to the Bankruptcy Reform Act of 1994, the limits are $269,250 in unsecured debt, and $807,750 in secured debt. Valuation of collateral may thus be critical in determining a debtor's eligibility for Chapter 13 relief. Section 506(a), as noted in the Introduction, provides that a claim is treated as secured only to the extent of the value of the collateral that supports it, with the balance of the claim being treated as unsecured. Thus, if a debtor filed a Chapter 13 case with schedules showing $500,000 in secured debt, but it was determined that the collateral supporting that debt was only worth $200,000, the remaining indebtedness, $300,000, would be an unsecured claim, putting the debtor over the eligibility limitation of §109(e). *See Miller v. United States*, 907 F.2d 80, 81-82 (8th Cir. 1990) (applying §506(a) to determine amount of unsecured debt under §109(e); *In re Day*, 747 F.2d 405, 406-07 (7th Cir. 1984) (same); *but see In re Pearson*, 773 F.2d 751, 756 (6th Cir. 1985) (court should generally accept valuation of claims on debtors' schedules); *Henrichsen v. Scovis (In re Scovis),* 249 F.3d 975, 982 (9th Cir. 2001) (agreeing the court should generally accept the debtor's schedules, checking only to see if the schedules were made in good faith).

2. **Use, sale, or lease of collateral/cash collateral/priming liens.** A more significant protection for the interests of secured creditors is set forth in the adequate protection provisions of §§363 and 364 of the Code. Section 363(e) allows a secured creditor, at any time, to obtain a court order prohibiting or conditioning the use, sale, or lease of any collateral, "as is necessary to provide adequate protection of [the creditor's] interest." *Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve, Inc.)*, 995 F.2d 948, 957 n.9 (10th Cir. 1993), *cert. denied sub nom. Rimmer v. Octagon Gas Systems, Inc.,* 510 U.S. 993, 114 S. Ct. 554 (1993). Moreover, if the collateral is in the form of cash or cash equivalents, §363(c)(2) prohibits any use of the collateral without the consent of the secured creditor or a court order conditioned on adequate protection. *Garvis Trien & Beck, P.C. v. Federal Home Loan Mortgage Corp. (In re Blackwood Associates, L.P.),* 153 F.3d 61, 67 (2d Cir. 1998); *In re Mocco*, 176 B.R. 335, 348 (Bankr. D. N.J. 1995). Finally, under §364(d)(1)(B), a secured creditor's lien on collateral may only be primed by a new loan made during a bankruptcy case if the court finds that the creditor's interest in the collateral is adequately protected. *In re Phoenix Steel Corp.*, 39 B.R. 218, 222 (D. Del. 1984). Thus, for the debtor to use collateral without the secured creditor's

consent, whether in the operation of its business, or as security for a new loan, a showing of adequate protection will likely be necessary, with the need to value the secured creditor's interest and the impact of the proposed use of the property on that interest.

### C. Whether the secured creditor's rights in the collateral may be avoided.

Section 522(f)(1) of the Code provides for the avoidance of any judicial lien that "impairs" exemptions to which the debtor would otherwise have been entitled. The most common circumstance in which this section comes into play is in avoiding judgment liens that impair a debtor's homestead exemption. The Bankruptcy Act of 1994 added §522(f)(2)(A), which defines "impair" in this context so as to preserve for debtors any postpetition increase in the value of their property. *In re Dolan*, 230 B.R. 642, 645 (Bankr. D. Conn. 1999) ("The 1994 Amendments provided a 'simple arithmetic test' designed to clarify Congress' intent to protect the debtor's 'fresh start' from being encumbered by judicial liens secured only by post-petition increases in the debtor's equity."). In effect, the new section avoids whatever portion of the lien is not supported by nonexempt equity. Thus, in a situation of a home worth $100,000, encumbered by a mortgage of $50,000, in a jurisdiction allowing a $15,000 homestead exemption, there would be $35,000 in nonexempt equity, and to the extent any judgment lien exceeded that amount it could be avoided. *See Holland v. Star Bank, N.A. (In re Holland),* 151 F.3d 547, 550 (6th Cir. 1998) (applying §522(f)(2)(A)); *East Cambridge Sav. Bank v. Silveira (In re Silveira)*, 141 F.3d 34, 36 (1st Cir. 1998) (same). Section 522(f)(1) thus avoids liens based, ultimately, on the value of the property: the higher the property value, the smaller the amount of lien avoidance. If the property value is in dispute, a valuation hearing is required.

### D. What the secured creditor is entitled to receive in satisfaction of its claim.

Every bankruptcy case that is fully administered reaches a point at which secured creditors' claims are satisfied. The satisfaction may be by payment (as with redemption or cramdown), or by surrender of the collateral to the creditor. Regardless of how the claims are satisfied, valuation questions under §506(a) may arise.

**1. Cramdown.** Chapters 11, 12, and 13 of the Bankruptcy Code each provide that a plan may modify secured claims. In Chapter 11, §-1123(a)(5)(E) allows a plan to provide for the "modification of any lien." Sections 1222(b)(2) and 1322(b)(2) allow Chapter 12 and 13 plans to "modify the rights of holders of secured claims." However, if the secured creditor does not agree to a "modified" treatment of its claim, and if the collateral is not to be surrendered to the secured creditor, the plan can only be confirmed if it meets minimum payment requirements. In Chapters 12 and 13, cramdown of a secured claim requires, pursuant to §§1225(a)(5)(B)(ii) and 1325(a)(5)(B)(ii), that the secured creditor receive, on account of its secured claim, a distribution of property with a value, as of the effective date of the plan, that is "not less than the

allowed amount of such claim." Section 1129(b)(2)(A)(i) states a similar requirement for Chapter 11 cramdown. In practice, these requirements have generally been understood to mean that a plan must pay the allowed amount of the secured claim together with a market rate of interest. *Bellamy v. Federal Home Loan Mortgage Corp. (In re Bellamy)*, 962 F.2d 176, 185-86 (2d Cir. 1992) (Chapter 13); *Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*, 961 F.2d 496, 500-01 (4th Cir. 1992), *cert. denied*, 506 U.S. 866, 113 S. Ct. 191 (1992) (Chapter 11). It is also understood that the "allowed amount" of the secured claim is what results from valuation under §-506(a). *Assoc's Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1041 (5th Cir. 1996) (en banc), *rev'd on other grounds*, 117 S. Ct. 1879 (1997) (Chapter 13); *680 Fifth Ave. Assoc's v. Mutual Benefit Life Ins. Co. (In re 680 Fifth Ave. Assoc's)*, 156 B.R. 726, 731 (Bankr. S.D.N.Y. 1993), *aff'd* 29 F.3d 95 (2d Cir. 1994) (Chapter 11). However, as discussed below (at III.D), there is no general agreement as to either the method for determining the amount of a secured claim in cramdown or the appropriate cramdown interest rate.

**2. Redemption.** Under §722, a Chapter 7 debtor may redeem certain personal property that has been exempted by "paying the holder of such lien the amount of the allowed secured claim." It is generally recognized that "allowed secured claim" in this context is, again, the claim resulting from bifurcation under §506(a). *See In re Ard*, 280 B.R. 910, 913 (Bankr. S.D. Ala. 2002); *In re White*, 231 B.R. 551, 555 (Bankr. D. Vt. 1999); *In re Lopez*, 224 B.R. 439, 443 (Bankr. C.D. Cal. 1998); *In re Williams*, 224 B.R. 873, 875 (Bankr. S.D. Ohio 1998).

**3. Surrender.** Sections 1225(a)(5)(C) and 1325(a)(5)(C) explicitly provide Chapter 12 and 13 debtors with the option of surrendering collateral to a secured creditor in satisfaction of the creditor's secured claim. In Chapter 11, a secured claim may be crammed down by giving the secured creditor the "indubitable equivalent" of its claim, pursuant to §-1129(b)(2)(A)(iii), and this provision has been interpreted to allow satisfaction of the claim by surrender of collateral. *In re May*, 174 B.R. 832, 836-40 (Bankr. S.D. Ga. 1994). If a debtor surrenders property to satisfy a secured claim, different valuation questions will arise, depending on whether the claim is oversecured or undersecured. If oversecured, the question is how much of the collateral needs to be surrendered to satisfy the creditor's entire claim. *Id*. If the claim is undersecured, the question is the extent of the creditor's remaining unsecured claim. *See Agricredit Corp. v. Harrison (In re Harrison)*, 987 F.2d 677, 680-82 (10th Cir. 1993) (discussing the need for allegedly undersecured creditor to assert right to unsecured claim after surrender of collateral). In either event, valuation of the collateral under §506(a) is required.

**E. Whether secured creditors are entitled to interest and costs.**

Section 506(b) of the Bankruptcy Code allows a secured creditor to augment its claim with interest and any reasonable fees and costs provided for under its agreement with the debtor, "[t]o the extent that [the] allowed secured claim is secured by property the value of which . . . is greater than the amount of the claim." Thus, the entitlement of a secured creditor to postpetition interest and costs is limited to the extent that it is oversecured, or, in other words, to the extent of its "equity cushion." *Orix Credit Alliance, Inc. v. Delta Resources, Inc. (In re Delta Resources, Inc.)*, 54 F.3d 722, 729 (11th Cir. 1995); *Community Bank v. Torcise (In re Torcise)*, 187 B.R. 18, 23 (S.D. Fla. 1995), *rev'd on other grounds*, 162 F.3d 1084 (11th Cir. 1998). To determine the extent of the equity cushion, the collateral must be valued. *See Nantucket Investor II v. California Federal Bank (In re Indian Palms Assocs., Ltd.)*, 61 F.3d 197, 201 (3d Cir. 1995) (discussing a valuation of collateral to determine the extent of the equity cushion for purposes of §506(b)).

**F. Whether a junior mortgagee is the holder of a secured claim under §-1322(b)(2).**

Section 1322(b)(2) of the Code, as noted above in II.D.1., generally allows Chapter 13 plans to "modify the rights of holders of secured claims," which involves, for nonconsenting creditors, cramdown pursuant to §1325(a)(5)(B)(ii). However, §1322(b)(2) includes an exception to the power to modify—it does not apply to any "claim secured only by a security interest in real property that is the debtor's principal residence." In *Nobelman v. American Sav. Bank*, 508 U.S. 324, 113 S. Ct. 2106 (1993), the Supreme Court held that a Chapter 13 plan may not cram down any secured claim that fits within this exception. Thus, it may be critical to determine whether a particular claim is secured by an interest in the debtor's residence. If so, the claim may have to be paid in full; if not, it may be subject to cramdown, and be stripped down to the value of the collateral that supports it. A number of circuit courts have held that if there is no collateral value to support a claim secured by a home mortgage, the claim should not be considered as "secured," and hence may be modified under §-1322(b)(2). *See Lane v. W. Interstate Bancorp* (*In re Lane*), 280 F.3d 663, 667-68 (6th Cir. 2002); *Pond v. Farm Specialist Realty* (*In re Pond*), 252 F.3d 122, 126 (2d Cir. 2001); *Tanner v. Firstplus Financial, Inc. (In re Tanner),* 217 F.3d 1357, 1360 (11th Cir. 2000); *Mc Donald v. Master Financial Inc. (In re McDonald)*, 205 F.3d 606, 611-12 (3d Cir. 2000) (collecting authorities); *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277, 288-89 (5th Cir. 2000) (collecting authorities); *see also Domestic Bank v. Mann (In re Mann)*, 249 B.R. 831, 836-37 (B.A.P. 1st Cir. 2000). Under these decisions, a valuation of the debtor's home, under §506(a), would be required to determine whether a creditor holds a secured claim for purposes of §1322(b)(2). This represents the majority position. However, a significant minority of decisions, relying on language in *Nobelman*, have held that a creditor secured by a home mortgage with no equity is still entitled to the protections of §1322(b)(2). See the authorities collected in *McDonald*, 205 B.R. at 611 n.3, and *Bartee,* 212 F.3d at 289 n.16.

## G. Whether a creditor has received a preferential transfer of the debtor's assets.

Section 547(b) of the Bankruptcy Code provides that a "trustee may avoid any transfer of an interest of the debtor in property . . . to or for" a creditor's benefit, "for or on account of an antecedent debt" that was made within "one year before the date of the [bankruptcy] filing . . . , if such creditor . . . was an insider" and the transfer enabled "such creditor to receive more than such creditor would receive" in a Chapter 7 liquidation. If a transfer is found to be preferential, §550 of the Bankruptcy Code allows the trustee to recover the transferred property, or its value, from the transferee. Transfers of the debtor's property to a fully secured creditor can never be preferential. *Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.),* 990 F.2d 551, 554 (10th Cir. 1993); Michael L. Cook et al., *Preference Litigation*, 767 PLI/COMM. 509, 538 (1998) (collecting authorities). Hence, a collateral's value can determine a creditor's liability under §§547(b) and 550.

## III. WHAT VALUE IS MEASURED: THE *RASH* INTERPRETATION OF §506(a); PROPOSALS FOR LEGISLATIVE CHANGE.

In all of the procedural contexts in which a dispute over the valuation of collateral may arise, there is one fundamental question: what "value" is at issue: (1) the value of the collateral to the creditor, which will generally be the amount of money that the creditor would obtain by reselling it, (2) the value of the collateral to the debtor, which will generally be the amount that the debtor would have to pay to replace it, or (3) some intermediate value. The difference between resale and replacement value may be significant. To take one common example, the cramdown of an auto loan in Chapter 13, the amount of the creditor's "allowed secured claim" can vary between the wholesale price at which the creditor could presumably resell the debtor's vehicle, and the retail price at which the debtor could purchase a replacement. In *In re Carlan*, 157 B.R. 324, 325 (Bankr. S.D. Tex. 1993), the court considered evidence of an automobile with a wholesale value of $6,050 and a retail value of $7,675, a difference of $1,625. This difference is almost 27% of the wholesale value, and 21% of the retail value. Perhaps the most striking variation between the resale and replacement approaches is reported in *Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530, 530 (8th Cir. 1995), where the parties stipulated that the wholesale value of the debtor's pickup truck was $4,000, but that the retail value was $6,500, an increase of 38% over wholesale.

The issue of disposition costs is a corollary to the question of whether resale or replacement should be the model for valuation of collateral. If what is being measured is the amount that a creditor would be able to obtain by reselling the collateral, the costs of that resale would be relevant, since they would reduce the resale proceeds. *Associates Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1063 n.5 (9th Cir. 1996) (en banc) (Smith, J., dissenting), *rev'd*, 117 S. Ct. 1879 (1997). On the other hand, if collateral value means the price that the debtor would have to pay to replace the collateral, disposition costs are irrelevant.

In *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997), the Supreme Court announced that the replacement cost to the debtor, rather than the resale price of the creditor should be the touchstone for valuation of collateral under §506(a). However, because of ambiguities in *Rash* itself, the issue has not been conclusively determined, and there have been proposals for legislative changes to the *Rash* decision.

**A. Pre-*Rash* Circuit court decisions.** Prior to the Supreme Court's decision in Rash, there were circuit court decisions supporting each of the three basic valuation approaches. In support of the idea that value should be measured by what it would cost the debtor to replace the collateral (generally retail price of consumer goods), there were several circuit opinions, including: *Winthrop Old Farm Nurseries, Inc. v. New Bedford Institution for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72 (1st Cir. 1995); *Coker v. Sovran Equity Mortgage Corp. (In re Coker)*, 973 F.2d 258 (4th Cir. 1992); *Huntington Nat'l Bank v. Pees (In re McClurkin)*, 31 F.3d 401 (6th Cir. 1994); *Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530 (8th Cir. 1995); and *Taffi v. United States (In re Taffi)*, 96 F.3d 1190 (9th Cir. 1996) (en banc). Opinions from two circuits supported resale valuation (generally wholesale price of consumer goods): *General Motors Acceptance Corp. v. Mitchell (In re Mitchell)*, 954 F.2d 557 (9th Cir.), *cert. denied*, 506 U.S. 908, 113 S. Ct. 303 (1992), which was

significantly limited by the *Taffi* decision, and *Associates Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036 (5th Cir. 1996) (en banc), *rev'd*, 117 S. Ct. 1879 (1997), which was reversed by the Supreme Court's decision. Two other circuit decisions required the use of an intermediate point between retail and wholesale values: *General Motors Acceptance Corp. v. Valenti (In re Valenti)*, 105 F.3d 55 (2d Cir. 1997); and *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996). This split in circuit authority provided the background for the Supreme Court's decision.

## B. The arguments presented to the Supreme Court in *Rash*.

The conflicting arguments on the resale/replacement dispute, as presented to the Supreme Court in *Rash*, were exhaustively set forth in the majority and dissenting opinions of the en banc Fifth Circuit *Rash* decision. See III.A., above. These arguments can be placed into four general categories.

**1. Statutory language.** Because §506(a) of the Bankruptcy Code is the central provision governing the valuation of secured claims, its terms are the focal point for the resale/replacement debate. §506(a) provides in pertinent part (emphasis added):

> [1] An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is *a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property*, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. [2] *Such value shall be determined in light of* the purpose of the valuation and of *the proposed disposition or use of such property*, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

The opinions that followed the resale approach to value focused primarily on the italicized portion of the first sentence of §506(a), holding that the value of a secured creditor's claim is "the value of such creditor's interest" in the debtor's property. The creditor's interest, in turn, is what the creditor could obtain from the property on resale. The Fifth Circuit en banc decision set forth this argument and collected decisions employing it. 90 F.3d at 1044. In this view, the second sentence of §506(a) directs the court to consider the "proposed disposition or use" of the collateral only to the extent that disposition or use is relevant, as when the court is required to determine adequate protection. *Id*. at 1048-50.

The opinions that advanced the replacement approach to value focused on the italicized portion of the second sentence of §506(a) and held that the court must always determine value based on the proposed disposition or use of the collateral. They then reasoned, either implicitly or explicitly, that the debtor's retention of the collateral indicates a value

to the debtor equal to what the debtor would be required to pay to buy a replacement. *See Rash*, 90 F.3d at 1066 (Smith, J., dissenting). In this view, the first sentence of §506(a) says nothing about the point of view from which collateral should be valued, since "the value of [the secured] creditor's interest" in estate property simply means the value of the collateral, without indicating the party whose interests are at issue. *Id.* at 1064.

In the Seventh Circuit's *Hoskins* decision, both the majority and concurring opinions concluded that the statutory language provided no clear directive on the standard of valuation. 102 F.3d at 314-15 (majority opinion), 317 (concurring opinion).

**2. Legislative history.** The legislative history of the Bankruptcy Code contains several comments that bear on the question of whether resale or replacement should be the model for valuation of collateral. The *Hoskins* majority suggested that they cancel one another out. 102 F.3d at 314.

**a. Section 506(a).** The Senate report on the Bankruptcy Code legislation discusses valuation under §506(a) as follows: "While courts will have to determine value on a case-by-case basis, the subsection makes it clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property." S. Rep. No. 989, at 68 (1978), *reprinted in* Appendix 3 *Collier on Bankruptcy* V-68 (15th ed. 1993). Supporters of the replacement approach saw this comment as indicating that the debtor's intention to retain collateral should have a critical impact on valuation. *See, e.g., Rash*, 90 F.3d at 1070 (Smith, J., dissenting). Supporters of the resale approach noted that the comment merely repeats the language of the statute. *See Rash*, 90 F.3d at 1056. Both approaches to valuation struggled with the "case-by-case" method suggested by the report, since this method seems inconsistent with any general valuation approach. *See Rash*, 90 F. 3d at 1059 (majority), 1070 (dissent).

**b. General discussion of Chapter 13.** The House report on the Bankruptcy Code legislation sets out a general discussion of the operation of the new Chapter 13, including what it calls an "important change . . . in the treatment of secured creditors." H.R. Rep. No. 595, at 124 (1978). The report goes on to describe how secured creditors in consumer cases often have liens on household goods with "little or no resale value" but "a high replacement cost," which situation "operates as pressure on the debtor to pay the secured creditor more than he would receive were he actually to repossess and sell the goods." *Id.* The current law is described as doing little to recognize the difference between "the true value of the goods and their value as leverage," and §506(a) of the Code is cited as changing this

situation by requiring the court to "value the secured creditor's interest." *Id.* The discussion concluded: "This is an important departure from a few misguided decisions under current law, under which a secured creditor with a $2000 [*sic*, the word "loan" is apparently omitted] secured by household goods worth only $200 is entitled in some cases to his full $2000 claim, in preference to all unsecured creditors." *Id.* The Fifth Circuit's en banc majority opinion saw this language as dictating resale rather than replacement cost as a measure of the secured creditor's claim. *Rash,* 90 F.3d at 1056. The dissent argued that replacement cost valuation is consistent with this discussion because it still reverses the cases granting secured status to the entire claim secured by household goods, allowing a secured claim only to the extent of the value of goods in the condition of the collateral at the time of the bankruptcy. *Id.* at 1070.

**c. Redemption.** Section 722 of the Bankruptcy Code allows a Chapter 7 debtor to redeem certain collateral by paying the secured creditor the amount of that creditor's allowed secured claim, as determined under §506(a). *See* II.D.2., above. The House report describes the operation of §722 in terms similar to those used to describe the change in the treatment of secured claims under Chapter 13. H.R. Rep. No. 595, at 127 (1977). The report describes current law as allowing creditors "to deprive a debtor of even the most insignificant household effects . . . even though the items have little if any realizable market value [because] the goods do have a high replacement cost." *Id.* The report goes on to describe the debtor's redemption right as "a right of first refusal on a foreclosure sale of the property involved." *Id.* The *Rash* majority points to this discussion as a rejection of replacement cost as a measure of value, with resale accepted as the norm. *Rash,* 90 F.3d at 1056-57. The dissent finds that redemption in Chapter 7 is irrelevant to the question of valuations of collateral in reorganization. *Id.* at 1070.

**3. Economic policy.**

**a. The principal dispute.** Advocates of both the resale and replacement approaches to value have acknowledged that replacement cost to the debtor produces a higher value for a secured claim than resale proceeds to the creditor. The economic policy debate between the two positions focuses on how this "bonus" over the resale value should be distributed. The dissent in the Fifth Circuit noted that reorganization involves risks of nonpayment and declining collateral value, so that some premium over resale value is appropriate, particularly since it is the debtor's retention of the collateral that allows the reorganization to go forward. *Rash,* 90 F.3d at 1066. Moreover, according to the dissent, a valuation based on the creditor's resale proceeds (the wholesale price) would allow the debtor to sell the

property later, at full (retail) replacement cost. *Id.* at 1073. The majority, on the other hand, saw resale (wholesale) value as reflecting the "true worth" of the collateral, while replacement (retail) cost is equivalent to that true worth plus the services of "inventory storage, reconditioning, marketing, and warranties of quality" that a retailer would add. *Id.* at 1051-52. The majority also noted that debtors would not likely be able to resell collateral at full replacement cost unless they also incurred the costs associated with retail sales. *Id.* at 1054.

**b. Value to the debtor not equivalent to repurchase cost.** Although not noted by the *Rash* majority, there is another difficulty with the economic analysis supporting the replacement approach to valuation: the value of collateral to the debtor who chooses to retain it may not be equivalent to its replacement (retail) cost. Debtors who act to maximize their economic interests will retain collateral even though its subjective worth to them is no more than the wholesale price that they would receive if they resold it. To illustrate this, suppose that a debtor needs an automobile that would cost $5,000 retail. Assume also that the debtor already has an automobile, with features the debtor does not need, having a retail value of $6,000 and a wholesale value of $4,500. Even though the debtor would not spend $6,000 to buy this car from a retailer, the debtor would retain it, rather than sell it for less than the $5,000 it would cost to buy a suitable replacement. The fact that a debtor chooses to retain collateral does not imply that the collateral has a value to the debtor equal to its retail price.

**c. Failure to preserve going concern value.** One of the main purposes of bankruptcy reorganization, as opposed to liquidation, is to preserve the going concern value of the debtor's assets. *Canadian Pacific Forest Products Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1442 (6th Cir. 1995). This purpose is contradicted by replacement valuation whenever the replacement cost is greater than the going concern value. To illustrate: suppose that a debtor operates a trucking concern, and owns 5 trucks, each of which could be repossessed and resold for $10,000, but which have a going concern value, being operated in the debtor's business, of $12,000. Suppose further that if the debtor had to replace the trucks, its cost would be $13,000, and that the debtor owes a secured creditor $13,000 on each truck, with no other creditors. The secured creditors would plainly be better off with reorganization than with liquidation, since they could realize the $12,000 going concern value on the trucks. However, the debtor could not cram down a reorganization on the creditors if replacement value is the rule, since the income of the business would not support payment of a $13,000 secured claim on each truck. The result would be a liquidation, in which the creditors each get $10,000.

4. **The relevance of state law.** Several of the decisions supporting resale valuation pointed to state law for additional support. The rationale was (1) that generally, federal law should be interpreted to leave state law property interests in place, unless there is a clear provision to the contrary, a principle enunciated by the Supreme Court in *Butner v. U.S.*, 440 U.S. 48, 56, 99 S. Ct. 914, 918 (1979), and (2) that, under state law, a creditor would only be entitled to repossess the collateral and obtain its value on resale, and so should not be given greater value than this in bankruptcy. *In re Hoskins*, 102 F.3d 311, 318 (7th Cir. 1996) (Easterbrook, J., concurring); *Rash*, 90 F.3d at 1041-42. The response of the replacement value proponents was that the Bankruptcy Code does clearly mandate a valuation under §506(a) at higher than resale value, and that state law says nothing about the value of collateral in a bankruptcy reorganization. *Rash*, 90 F.3d at 1068-69 (dissenting opinion).

## C. The Rash decision: the arguments, the holding, and the footnote.

At first glance, the Supreme Court's decision in *Rash* appears to be solidly supportive of the replacement approach in valuation. On each of the points of argument, the decision comes down on the replacement side, and it expressly adopts replacement valuation as a standard. However, footnote 6 of the Court's opinion interjects considerations that suggest valuation based on resale of collateral, and hence the opinion contains significant ambiguity.

1. **Statutory language.** The bulk of the Court's opinion is straightforward analysis of the language of §506(a), with the Court concluding that the second sentence of the subsection is controlling. 117 S. Ct. at 1185 ("As we comprehend §506(a), the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question."). Thus it follows that when the debtor proposes to retain collateral, it should be valued at a higher level than when the debtor proposes to give up the collateral. *Id.* ("From the creditor's perspective as well as the debtor's, surrender and retention are not equivalent acts."). Similarly, the Court rejects the opinions that propose some compromise between resale and replacement valuation, on the ground that these opinions have no support in the statutory language. *Id.* at 1886.

2. **Legislative history.** The Court dismisses the legislative history arguments in a footnote, concluding that it is sparse and ambiguous. *Id.* at 1886 n.4 ("We give no weight to the legislative history of §506(a), noting that it is unedifying, offering snippets that might support either standard of valuation.").

3. **Economic policy.** The Court addresses economic concerns briefly, subscribing to the proposition that reorganization presents creditors with risks to their collateral that must be offset by valuation at higher than resale level:

> If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more "adequate protection," 11 U.S.C. §-361, do not fully offset these risks. 117 S. Ct. at 1185.

4. **The relevance of state law.** The Court rejects the notion that respect for state law requires resale valuation, reasoning that reorganization itself disrupts state law (by allowing a debtor to retain collateral despite default in payment), and that there is no greater disruption in making replacement the basis for valuation. *Id.* at 1186.

5. **The holding.** After resolving all of the arguments as set forth above, the Court announced its holding as follows: "[U]nder §506(a), the value of property retained because the debtor has exercised the . . . 'cram down' option is the cost the debtor would incur to obtain a like asset for the same 'proposed . . . use.'" *Id.* This appears to be a clear adoption of the replacement approach to value.

6. **The ambiguity created by footnote 6.** As noted in the description of the positions taken by the courts of appeal on the valuation question, it had been generally understood that replacement value implied the price that a debtor would have to pay to obtain an actual replacement for the collateral in question. Thus, with automobiles, replacement cost was understood to imply the price charged by retailers of used cars in the debtor's area, since this would likely provide the only source for a replacement readily available to the debtor. The Eighth Circuit in *Trimble*, 50 F.3d at 530-31, and the Fifth Circuit in its original panel decision in *Rash*, 31 F.3d at 329, issued express holdings to the effect that the replacement value of a vehicle is its retail price. On the other hand, proponents of resale valuation argued that although retail might be the only basis on which a debtor could replace a particular item of collateral, retail value should not be used because it includes items of value not inherent in the collateral itself. Thus, the Fifth Circuit's en banc opinion in *Rash* pointed to items such as "inventory storage, reconditioning, marketing, and warranties of quality," that it believed were improperly added to resale value when replacement (retail) cost was employed. 90 F.3d at 1051. These arguments, one might have thought, would have been rejected by the Supreme Court in its choice of replacement valuation. Not so. In a footnote to the holding quoted above, the Court made the following statement:

> Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is

> its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. *Cf*. 90 F.3d, at 1051-52.

117 S. Ct. at 1186 n.6. Thus, the Court appears to modify the usual position of the replacement value proponents: what is being measured is not the actual price that a debtor would have to pay in an available market, but rather the value of the collateral itself, shorn of extra elements of value added by a retailer. The Court does not indicate how these items might be measured in a typical valuation situation.

## D. Applications of *Rash*.

Lower courts have reached conflicting results in applying the Supreme Court's *Rash* decision to cramdown situations, both with respect to valuation of the secured claims and the required cramdown interest rate.

### 1. Valuation of claims subject to cramdown.

**a.** ***Midpoint between retail and wholesale in the absence of evidence to the contrary.*** *First Merit N.A./Citizens Nat'l Bank v. Getz (In re Getz)*, 242 B.R. 916, 919-20 (B.A.P. 6th Cir. 2000) (affirming bankruptcy court's valuation using an average of NADA wholesale and retail prices); *In re Richards*, 243 B.R. 15, 19 (Bankr. N.D. Ohio 1999) (average of vehicle's retail and wholesale value in used car guide); *In re Lyles*, 226 B.R. 854 (Bankr. W.D. Tenn. 1998) (same); *In re Glueck*, 223 B.R. 514 (Bankr. S.D. Ohio 1998) (same); *In re Oglesby*, 221 B.R. 515 (Bankr. D. Colo. 1998) (average can be established by agreement between the parties or by the most current National Automobile Dealers Association ("NADA") guide book); *In re Younger*, 216 B.R. 649 (Bankr. W.D. Okla. 1998) (average established by NADA and other comparable guide books); *In re Franklin*, 213 B.R. 781 (Bankr. N.D. Fla. 1997) (same).

**b.** ***Retail value less five percent in the absence of evidence to the contrary.*** *In re Campbell*, 234 B.R. 101, 103 (Bankr. W.D. Mo. 1999) (Blue Book retail value less five percent used); *In re Renzelman*, 227 B.R. 740 (Bankr. W.D. Mo. 1998) (NADA retail value less five percent used).

**c.** ***Retail value in the absence of evidence to the contrary.*** *In re Ruiz*, 227 B.R. 264 (Bankr. W.D. Tex. 1998); *In re McCutchen*, 224 B.R. 373 (Bankr. E.D. Mich. 1998) (automobile; NADA guide or similar publication used when no other evidence presented); *In re Jones*, 219 B.R. 506 (Bankr. N.D. Ill. 1998) (NADA retail value on the date of plan confirmation); *In re*

*Jenkins*, 215 B.R. 689 (Bankr. N.D. Tex. 1997) (same); *In re Gates*, 214 B.R. 467, 471 n.6 (Bank. D. Md. 1997) (court recognized both "the NADA guide and the Kelly Blue Book as credible evidence of valuation"); *In re Russell*, 211 B.R. 12 (Bankr. E.D. N.C. 1997) (NADA retail value).

**d.** ***Value determined by market accessible to the debtor (no rule in the absence of particularized evidence).*** *In re McElroy*, 210 B.R. 833 (Bankr. D. Or. 1997).

**2. The appropriate interest rate for cram down.**

The courts have developed several different methods for determining the proper cramdown interest rate, each of which purports to be determining "market rate." *See In re Hardzog*, 901 F.2d 858, 859 (10th Cir. 1990), quoting 5 *Collier on Bankruptcy* §1225.03 at 1225-21 (1989) ("While the cases considering the issue are fairly uniform in agreeing that a market rate of interest is appropriate, the cases differ drastically in their interpretation of how a 'market' rate is to be determined.").

**a.** **Rate based on the creditor's cost of borrowing.** Several courts have agreed with debtors that present value under §-1325(a)(5)(B) is provided to a secured creditor by paying an interest rate equivalent to what the creditor would have to pay to borrow money—the "cost of funds" approach. The theory here is that, absent bankruptcy, the creditor would foreclose and obtain the value of the collateral. Borrowing an amount equal to the value of the collateral would put the creditor in this same position. All that is then required is that the debtor pay interest equivalent to that charged on the creditor's loan, and the creditor is made whole. Thus, *In re Hudock*, 124 B.R. 532, 534 (Bankr.N.D. Ill. 1991) found that interest on the value of an automobile retained by a Chapter 13 debtor should be paid at the prime rate, since this best approximates "the rate at which [the secured creditor] borrows the money it then uses to make loans to consumers." *Accord In re Jordan*, 130 B.R. 185, 190 (Bankr. D. N.J. 1991).

**b.** **Rate based on risk presented by the debtor's borrowing.** An opposing point of view (adopted by the majority of circuit court opinions) emphasizes that creditors may not be able to borrow the funds lost to them through inability to foreclose; this approach therefore requires that the creditor be paid the profit that would have been obtained had the creditor been able to make a new loan in the amount of the collateral value of the property retained by the debtor. This "rate of return" approach was applied in *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130-31 (4th Cir. 1993) (but limiting the rate to no more than that provided for by the contract between the debtor and creditor, holding that any excess would cause an inequitable

"windfall"); *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67-70 (3d Cir. 1993); *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990) (dealing with cram down in the context of Chapter 12); *Koopmans v. Farm Credit Serv. of Mid-America, ACA,* 102 F.3d 874, 875 (7th Cir. 1996) (following *Jones)*; *In re Till*, 301 F.3d 583, 591-92 (7th Cir. 2002) (applying *Koopmans* in Chapter 13); and *In re Smithwick*, 121 F.3d 211, 213-14 (5th Cir. 1997), *cert. denied, sub nom. Smithwick v. Green Tree Financial Servicing Corp*., 118 S. Ct. 1516 (1998). This approach has also been applied in several recent bankruptcy court decisions. *In re Richard*, 241 B.R. 403, 409-10 (Bankr. E.D. Tex. 1999) (following *Smithwick*, applying contract rate despite misgivings based on *Rash*); *In re Winston*, 236 B.R. 167, 172 (Bankr. E.D. Pa. 1999) (following *Jones*; using 20% contract rate); *In re Glueck*, 223 B.R. 514, 521-22 (Bankr. S.D. Ohio 1998).

**c. Rate based on generalized determination of risk.** Still a third approach calculates the appropriate interest rate for cram down by adding a "risk factor" interest rate to some standard measure of "risk-free" lending. *United States v. Doud,* 869 F.2d 1144 (8th Cir. 1989) (Chapter 12). The Second Circuit adopted this approach in *In re Valenti,* 105 F.3d 55, 63-64 (2d Cir. 1997) (interest rate should be that of a treasury instrument with a maturity equivalent to the duration of the payout under debtor's plan plus a risk premium of 1-3%). This approach has also been followed in a number of recent bankruptcy court decisions. *See, e.g., In re Scott*, 248 B.R. 786, 792-93 (Bankr. N.D. Ill. 2000) (invalidated by *Till*); *In re Gorham*, 247 B.R. 272, 274-80 (Bankr. W.D. Mo. 2000) (applying local rule providing for cramdown interest at the rate of a 30-year treasury bond plus 3%); *In re Richards*, 243 B.R. 15, 23 (Bankr. N.D. Ohio 1999) (employing "the conventional market rate for automobile loans in this region")' *In re Carson*, 227 B.R. 719 (Bankr. S.D. Ind. 1998) (applying the prime rate plus 1-1/2%); *In re Collins*, 167 B.R. 842 (Bankr. E.D. Tex. 1994) (treasury bond rate plus 2%); Moreover, at least one recent district court decision has adopted this approach. *American General Finance, Inc. v. Kleinknecht*, 230 B.R. 207 (M.D. Ga. 1999) (approving interest at the prime rate plus 3-1/2%).

## E. Proposals for legislative change.

### 1. The recommendation of the National Bankruptcy Review Commission.

The National Bankruptcy Review Commission was created by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, §-602 (1994), to make recommendations for legislative action respecting the Bankruptcy Code. On October 20, 1997, the Commission issued a

report that includes the following recommendations with respect to the valuation of collateral:

> A creditor's secured claim in personal property should be determined by the property's wholesale price.
>
> A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years*, §1.5.2 at 243 (Oct. 20, 1997). Although the recommendations are made in the context of a discussion of Chapter 13, the report makes it clear that they are intended to modify §506(a) in all of its applications. *Id.* at 248 ("This Proposal recommends that the same baseline standards be employed for all valuation purposes.")

The report asserts that wholesale value for personal property is both a bright-line standard, and that it represents a compromise between low valuation (such as might be obtained in a forced sale) and high valuation (retail). *Id.* at 250-51. At the same time, the report rejects a midpoint between wholesale and retail value for the economic reasons used by the proponents of resale valuation: "If the creditor is entitled to a higher replacement cost or retail, the creditor has a larger entitlement than if the debtor surrendered the property, without having to incur the expenses necessary to fetch a retail price." *Id.* at 253. "Wholesale price is a much better approximation of the collateral's actual value because retail price reflects an extra component of a retailer's value-adding attributes that are not relevant or appropriate in this context . . . " *Id.* at 255.

As to real property, the report similarly argues that fair market price less costs of sale (1) is a compromise position (between foreclosure value and fair market price without deducting sales costs) and (2) is "the best approximation of the property's market value." *Id.* at 256.

**2. Bankruptcy reform legislation.**

Since 1997, Congress has considered several proposals for significant changes to the Bankruptcy Code. As of the date of the most recent revision of this outline, the latest such proposal was H.R. 975, passed in the House but awaiting consideration by the Senate. Section 327 of H.R. 975 would amend §506(a) to provide that collateral in Chapter 7 and 13 cases is always valued at the cost to replace the property, without deducting the costs of sale or marketing, and that this replacement cost, for property "acquired for personal, family, or household purpose" is "the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined." The House Report accompanying the bill merely

paraphrases the language of this provision in its section-by-section analysis. H.R. Rep. No. 108-40, at 190.

## IV. HOW VALUE IS MEASURED: THE VALUATION "APPROACHES" AND TERMINOLOGY

Once an answer is found to the basic question of collateral valuation—whether it is determined by the creditor's resale receipts or the debtor's replacement cost—the next question is how to arrive at what those receipts or costs are likely to be. Whenever the debtor proposes to retain collateral, this valuation is purely hypothetical, since it seeks to determine the outcome of a transaction that has not taken place. *See In re Demakes Enterprises, Inc.*, 145 B.R. 362, 364 (Bankr. D. Mass. 1992) (citing authority for the proposition that valuation of collateral is "an estimated prediction of the price the property would bring" and hence is "little more than a 'shadow.'"). The Bankruptcy Code imposes no particular method of valuation. "In considering the evaluation of property by bankruptcy courts Congress did not dictate a particular appraisal method. Rather, valuation is determined case-by-case, taking into account the nature of the debtor's business, market conditions, the debtor's prospects for rehabilitation, and the type of collateral." *Sutton v. Bank One (In re Sutton)*, 904 F.2d 327, 330 (citing 2 *Collier on Bankruptcy* ¶ 361.02 (15th ed. 1990); H.R. Rep. No 595, at 339 (1978); *In re Conquest Offshore Int'l, Inc.*, 73 B.R. 171 (Bankr. S.D. Miss. 1986)). In practice, the type of collateral is the most important factor in determining the valuation method.

### A. Fungible assets: market reports and "fair market value."

The easiest collateral to value is fungible property that is actively purchased and sold. Perhaps the best example of such property is publicly traded corporate stock. One share of stock is exactly like another, assuring perfect fungibility, and the stock market is active, with many well-informed participants. Thus, prices in that market are a paradigm for "fair market value"— "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." *In re Fund Raiser Products Co.*, 163 B.R. 744, 750 (Bankr. E.D. Pa. 1994) (citing *United States v. Cartwright*, 411 U.S. 546, 551, 93 S. Ct. 1713, 1716 (1973)). The use of market reports as evidence is specifically authorized by Fed. R. Evid. 803(17). (However, even where there is an active market in fungible property securing a creditor's claim, the question remains whether resale proceeds or replacement cost should be the model for valuation. A creditor selling stock in the market will likely be required to pay commissions and to accept a lower "bid" price, reducing its resale proceeds, while a debtor, needing to replace the stock, would be required both to pay commissions and a higher "asking" price, increasing its replacement cost.)

In the reported decisions, the collateral most frequently valued according to market reports is used cars, trucks, and aircraft. Although such collateral is not perfectly fungible, one vehicle of a particular model and year is sufficiently similar to another, and the market for such items is sufficiently active, that market reports, in the form of "blue books," are frequently used by the courts as some evidence of value. *See, e.g., In re Renzelman,* 227 B.R. 740 (Bankr. W.D.

Mo. 1998); *In re Ruiz*, 227 B.R. 264 (Bankr. W.D. Tex. 1998); *In re Lyles*, 226 B.R. 854 (Bankr. W.D. Tenn. 1998); *In re McCutchen*, 224 B.R. 373 (Bankr. E.D. Mich. 1998); *In re Glueck*, 223 B.R. 514 (Bankr. S.D. Ohio 1998); *In re Oglesby*, 221 B.R. 515 (Bankr. D. Colo. 1998); *In re Jones*, 219 B.R. 506 (Bankr. N.D. Ill. 1998); *In re Younger*, 216 B.R. 649 (Bankr. W.D. Okla. 1998); *In re Jenkins*, 215 B.R. 689 (Bankr. N.D. Tex. 1997); *In re Gates*, 214 B.R. 467 (Bankr. D. Md. 1997); *In re Franklin*, 213 B.R. 781 (Bankr. N.D. Fla. 1997); *In re Russell*, 211 B.R. 12 (Bankr. E.D. N.C. 1997); *In re Roberts;* 210 B.R. 325 (Bankr. N.D. Iowa 1997); *In re Byington*, 197 B.R. 130, 138-39 (Bankr. D. Kan. 1996); William H. Zimmerman, Jr., *Introducing the Blue Book in Valuing Personal Property*, Norton Bankr. L. Adviser (Clark Boardman Callaghan, Rochester, N.Y.) Aug. 1996, at 13-15 (collecting authorities). These guides generally distinguish between retail and wholesale price, again leaving to the courts the question of which value is relevant. *See, e.g., Taffi v. United States (In re Taffi)*, 68 F.3d 306, 309 (9th Cir. 1995), *reh'g en banc*, 96 F.3d 1190 (9th Cir. 1996), *cert denied sub nom. Taffi v. U.S.*, 521 U.S. 1103, 117 S. Ct. 2478 (1997) ("[T]he terms 'wholesale' and 'retail' represent two different fair market values for an automobile.")

## B. Unique assets: appraisals.

Where the property securing a creditor's claim is not traded in an active market, some appraisal of its value is required. This situation occurs most frequently with claims secured by real estate, and there is a well-established, three-part methodology for approximating what a "fair market" price would be for a given property. *Custom Distribution Services, Inc. v. City of Perth Amboy Tax Assessor (In re Custom Distribution Services, Inc),* 216 B.R. 136, 142 (Bankr. D.N.J. 1997) (setting out recognized methodologies for real estate appraisal); *150 North St. Assoc's Ltd. Partnership v. City of Pittsfield (In re 150 North St. Assoc's Ltd. Partnership)*, 184 B.R. 1, 6 (Bankr. D. Mass. 1995) (same); *In re Apple Tree Partners, L.P.*, 131 B.R. 380, 401-02 (Bankr. W.D. Tenn. 1991) (same). This methodology is critically discussed in Leslie K. Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Investment Methods to Value Income-Producing Property*, 66 S. Cal. L. Rev. 2251 (1993).

1. **Sales comparison approach.** For any real estate, even vacant property, a value can be established by determining what prices have been paid for comparable property, with adjustments made to reflect differences between the comparables and the subject property. This is referred to as the "sales comparison approach" to value. This approach is obviously most useful when the comparable sales are both recent, and involve property very similar in location and quality to the subject. Beckhart, *supra* at 2268-69. In *In re Abruzzo*, 249 B.R. 78, 85-87 (Bankr. E.D. Penn. 2000), the court used competing appraisals by experts in real estate in determining the valuation of a property for purposes of lien avoidance.

2. **Cost approach.** For improved property, the sales comparison approach can be augmented with a "cost approach" that attempts to

measure value by determining what it would cost to purchase the land and construct the improvements on it (with adjustment for depreciation of the construction). The cost approach is "the most difficult for appraisers to use" and "less reliable" both because it requires construction expertise, and involves difficult issues of estimating depreciation. Beckhart, *supra* at 2272. Accordingly, the approach is routinely disregarded or mentioned only in passing. *150 North St.*, 184 B.R. at 6; *Barrow v. Certified Developers & Management Co. (In re Barrow)*, 95 B.R. 502, 504 (Bankr. N.D. Ohio 1989) ("The replacement cost of a structure rarely is correlative to the fair market value.").

**3. Income approach; "going concern value."** The final appraisal approach is applicable only to income-producing property. It sees the net income that the property produces as the interest on an investment. If an appropriate interest rate can be established, then the amount of the investment can be determined mathematically from the net income. The traditional method of accomplishing this task was to arrive at a "stabilized income" and then divide this amount by a capitalization rate. Beckhart, *supra* at 2273-78. A more sophisticated means of implementing this approach is the "discounted cash flow" method. Under this method, the appraiser estimates net income for each year of a several year holding period, and reduces the income for each of these years to present value, using an appropriate discount rate. A stabilized income is then capitalized to obtain a residual value at the end of the holding period, and this residual value is also reduced to present value. The sum of the present values for each year of the holding period and the residual value is the total value of the real estate. This method is recommended in the Beckhart article, *supra* at 2293-96, and was employed to value real estate in *203 N. LaSalle St. Ltd. Partnership*, 190 B.R. 567, 574 (Bankr. N.D. Ill. 1995), *aff'd sub nom. Bank of America, Ill. v. 203 North LaSalle St. Partnership*, 195 B.R. 692 (N.D. Ill. 1996) *aff'd sub nom. In re 203 N. LaSalle St. Partnership*, 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds sub nom. Bank of America Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. Partnership*, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). Whatever method is used, appraisers frequently give greatest weight to the income approach in valuations of income-producing property, and courts have accepted this reliance. *203 N. LaSalle*, 190 B.R. at 574; *Apple Tree Partners.*, 131 B.R. at 402.

Of course, it is possible to value *any* income-producing property by the income approach, and the technique is often used to value businesses, with the anticipated net earnings of a business serving as the basis for the valuation. *See, e.g., In re Cellular Information Systems, Inc.*, 171 B.R. 926, 930 (Bankr. S.D.N.Y. 1994) (discounted cash flow used to value debtor's business). When projected income is the basis for valuation of a business, rather than the market value of its individual assets, the value is referred to as "going concern." James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18, 19 (1987) (Going concern value is "based not upon asset values

as such but rather upon the ability of the entire mix to turn a profit" and is "calculated by applying a multiple to the projected profit.") (citing J. Bonright, *The Valuation of Property*, 237-38 (1937)); *Assoc's Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1053 n.23 (5th Cir. 1996) (en banc), *rev'd on other grounds,* 117 S. Ct. 1879 (1997). (Going concern value "is a concept peculiar to businesses."); *Thomas v. U.S. (In re Thomas)*, 246 B.R. 500, 505 (E.D. Penn. 2000) (affirming bankruptcy court's use of going concern value in valuing debtors' closely held stock in company when debtors anticipated continued operations of the company after plan confirmation).

### C. "Going concern" versus "forced sale" or "liquidation" valuation.

The House report accompanying the Bankruptcy Code legislation, in its discussion of §506(a), made the following statement:

> "Value" does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interest in the case.

H.R. Rep. No 595, at 356 (1977). In light of the meaning of "going concern value," discussed in the preceding section, this comment refers only to business valuations, and simply means that depending on the facts of the case, it may be appropriate to use an income approach to valuing the business ("going concern") or it may be appropriate to value the business by totalling the market prices of its assets ("forced sale" or "liquidation").

## V. WHEN VALUE IS MEASURED: AS OF WHAT TIME SHOULD VALUATION TAKE PLACE.

As noted at the beginning of this outline—at II., above—valuation of collateral is required in a number of different contexts. Because the value of collateral may vary during a bankruptcy case, the point in time as of which the collateral is valued can be quite important. However, the Bankruptcy Code itself presents no general rule as to the timing question, and in several of the contexts in which this question arises, the courts disagree about the time as of which collateral should be valued. *See Wood v. LA Bank (In re Wood)*, 190 B.R. 788, 790-93 (Bankr. M.D. Pa. 1996) (exhaustively cataloging the conflicting opinions). Whether it is the debtor or the creditor that argues for the earlier valuation time depends not only on the context of the valuation, but also on whether the collateral value is rising or falling.

### A. Relief from stay based on lack of equity: valuation as of time of stay hearing.

Section 362(d)(2), as noted at II.A.1., above, allows relief from the automatic stay in situations where the collateral in question is not necessary to an effective reorganization, and where the debtor "does not have an equity" in the property. There appears to be no substantial dispute in the reported decisions as to the

proper time for measuring the debtor's equity— the valuation should take place as of the time of the hearing on the motion for relief from stay. If, at that time, there is equity in the property, relief under §362(d) should be denied, even if at an earlier time the property may have had a lower value. Conversely, if there is no equity in the property at the time of the hearing, relief from stay would be appropriate even though, at an earlier time, the collateral was more valuable. *See Bloomington HH Investors, Ltd. Partnership v. Gibraltar Sav. Ass'n (In re Bloomington HH Investors, Ltd. Partnership)*, 114 B.R. 174, 176 (D. Minn. 1990), *aff'd,* 938 F.2d 188 (8th Cir. 1991) (affirming an order of relief from stay based on a finding of no equity at the time of the hearing, despite evidence indicating a substantially higher value one year earlier).

**B. Eligibility for Chapter 13 relief and lien avoidance under §522(f): valuation as of time of bankruptcy filing.**

The extent of the unsecured debt of a Chapter 13 debtor determines eligibility for Chapter 13 relief under Section 109(e) of the Code, and, as noted at II.B.1., above, the debtor's unsecured debt is increased by any unsecured claims that result from the bifurcation of secured claims under §506(a). The reported decisions are in substantial agreement that, because §109(e) determines eligibility "on the date of the filing of the petition," any valuation to determine the extent of secured claims should take place as of the filing date. *In re Cavaliere*, 194 B.R. 7, 13 (Bankr. D. Conn. 1996), *rev'd on other grounds, Cavaliere v. Supir*, 208 B.R. 784 (D. Conn. 1997); *In re Coates*, 180 B.R. 110, 118 (Bankr. D. S.C. 1995); *In re Potenza*, 75 B.R. 17, 18 (Bankr. D. Nev. 1987).

Similarly, for purposes of lien avoidance under §522(f), discussed at II.C., above, valuations have generally been conducted as of the filing date. *In re Abruzzo*, 249 B.R. 78, 85 (Bankr. E.D. Penn. 2000) (holding that the petition date is the appropriate valuation date for purposes of lien avoidance); *Stinson v. Williamson (In re Williamson),* 804 F.2d 1355, 1359 (5th Cir. 1986) (eligibility for homestead exemption must be determined as of original Chapter 11 filing, not the date of conversion to Chapter 7); *In re Chandler*, 77 B.R. 513, 515-15 (Bankr. E.D. Pa. 1987); *In re Grube,* 54 B.R. 655, 657 (D.N.J. 1985) (quoting *Rappaport v. Commercial Banking Corp. (In re Rappaport),* 19 B.R. 971, 973 (Bankr. E.D. Pa. 1982). This is consistent with the intent of new §522(f)(2)(A) to allow debtors the benefit of any postpetition increase in the value of their property. However, if a debtor is using §522(f) to avoid a lien on depreciating property, such as a judgment lien on a luxury automobile, valuation of the property as of the filing date is actually in the creditor's interest, since it fixes the amount of the unavoided lien as of that time, and causes any later decline in property value to come out of the value of the debtor's exemption.

**C. Preference avoidance under §547(b): valuation as of the time of the transfer.**

Under §§547(b) and 550 of the Bankruptcy Code, a creditor who has received a transfer of property from the debtor prepetition may be ordered to return either transferred property or its value to the estate if the transfer is found to be a preference. As explained at II.G, above, the value of a creditor's interest in

collateral held by the debtor can determine whether that creditor received a preference by being paid prepetition.

*Schwinn v. AFS Cycle & Co. (In re Schwinn Bicycle Co.)*, 182 B.R. 514, 523 (Bankr. N.D. Ill. 1995), holds that "collateral should be valued for purposes of a hypothetical liquidation under §547(b)(5) as of the date the bankruptcy petition was filed." However, as discussed in *Telesphere Liquidating Trust v. Galesi (In re Telesphere Communications, Inc.)*, 229 B.R. 173, 179 (Bankr. N.D. Ill. 1999), *Schwinn* relied on cases that involved only unsecured claims and had no need to examine the appropriate time for valuing collateral. In addition, the same court that decided *Schwinn* later abandoned the filing date as the appropriate date of valuation and concluded that a creditor that is "fully secured *prior to payment* . . . cannot be preferenced in having received [a] payment." *Schwinn Plan Comm. v. Transamerica Ins. Fin. Corp. (In re Schwinn Bicycle Co.)*, 200 B.R. 980, 991 (Bankr. N.D. Ill. 1995) (emphasis added). Likewise, the First Circuit has held that collateral must be valued at the time of the transfer and not at the time of the bankruptcy filing. *Travelers Ins. Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Serv., Inc.)*, 980 F.2d 792 (1st Cir. 1992).

Valuing the collateral on the date of the transfer appears the better approach, as secured creditors would be greatly harmed if they received payments on debts secured by collateral which depreciated between the time of payment and the bankruptcy filing. *Telesphere*, 229 B.R. at 180.

## D. Satisfaction of secured claims: valuation as of the time of claim satisfaction?

There are four ways in which a secured claim can be satisfied in bankruptcy without the consent of the creditor: (1) direct payment of the claim following a sale of the collateral under §363(f), free and clear of the creditor's lien; (2) redemption of the property, pursuant to §722, discussed at II.D.2., above; (3) cramdown of the claim, discussed at II.D.1; and (4) surrender of the collateral, discussed at II.D.3. These four situations all present the same result from the point of view of the creditor—establishing what rights the creditor will have in exchange for its claim—but the attitude of the courts has not been consistent in establishing the time as of which the claim should be valued in these situations. *In re Wood*, 190 B.R. at 790-93, sets out most of the conflicting authorities.

**1. Section 363(f) sales.** In situations of §363(f) sales, there is apparent agreement that the creditor should receive payment based on the actual sales price of the property. *Takisaki v. Alpine Group, Inc. (In re Alpine Group, Inc.)*, 151 B.R. 931, 935 (B.A.P. 9th Cir. 1993); *Schreiber v. IRS (In re Schreiber)*, 163 B.R. 327, 332 (Bankr. N.D. Ill. 1994); 3 *Collier on Bankruptcy*, ¶506.04, at 506-27 (15th ed. 1993) (actual consideration received by estate on sale of collateral should be dispositive as to value of secured claim as long as court has found the consideration fair); *But see Whalley v. Amer. Insurance Co. (In re Whalley)*, 202 B.R. 58, 62 (Bankr. W.D. Penn. 1996) (holding that the petition date and not the date of sale is the appropriate date for measuring creditor's secured claim).

**2. Redemption.** There are only a few reported decisions dealing with the time relevant for valuation of collateral in connection with redemption under §722, and they do not agree. One decision, *Kinser v. Otasco, Inc. (In re Kinser)*, 17 B.R. 468, 469 (Bankr. N.D. Ga. 1981), states without explanation that "[a]ny redemption . . . must be for fair market value as of the time of the filing of the Debtor's bankruptcy petition." Two other decisions, *Van Holt v. Commerce Bank (In re Van Holt)*, 28 B.R. 577, 578 (Bankr. W.D. Mo. 1983), and *Pierce v. Industrial Savings Co. (In re Pierce)*, 5 B.R. 346, 347 (Bankr. D. Neb. 1980), state that the time for valuation should ordinarily be the date of the redemption hearing. These decisions explain that such a valuation more closely approximates the value that the secured creditor might have received if the property had been repossessed and sold outside of bankruptcy.

**3. Cramdown.** In decisions arising from both Chapter 11 and Chapter 13 cases, there is a substantial debate as to whether, for purposes of cramdown, the valuation of a secured claim should be as of the time the case was filed or as of the time of the confirmation hearing. *In re Reddington/Sunarrow Ltd.*, 119 B.R. 809 (Bankr. D. N.M. 1990), is perhaps the leading Chapter 11 decision supporting valuation as of the petition date. It holds that additional collateral (in the form of rents) that came into existence after the filing of the petition could not increase the amount of a creditor's secured claim, since that was fixed at case filing. *Id.* at 813-14. *In re Flagler-At-First Associates, Ltd.*, 101 B.R. 372, 376 (Bankr. S.D. Fla. 1989), states this position emphatically: "[A]n allowed secured claim is determined 'as of the filing of the petition,' just like any other claim." Among Chapter 13 decisions, *Johnson v. General Motors Acceptance Corp. (In re Johnson)*, 165 B.R. 524, 528-29 (S.D. Ga. 1994), may be the leading case supporting cramdown valuation as of the filing date, on the ground that otherwise the creditor with a depreciating asset might have its property taken in violation of the Fifth Amendment.

The contrary view, that cramdown valuation should be made as of the time of confirmation, is also reflected in both Chapter 11 and Chapter 13 decisions. *In re Landing Associates, Ltd.*, 122 B.R. 288, 293 (Bankr. W.D. Tex. 1990), a Chapter 11 decision, holds that "the value of a secured claim for confirmation purposes is determined as of the confirmation date." *In re Kennedy*, 177 B.R. 967, 972-73 (Bankr. S.D. Ala. 1995), likewise holds that cramdown value should be determined as of the hearing on plan confirmation. *Wood v. LA Bank (In re Wood)*, 190 B.R. 788, 792-93 (Bankr. M.D. Pa. 1996), suggests that decisions establishing confirmation as the proper time for cramdown valuation are in the "vast majority."

**4. Surrender.** Although there are few cases discussing the timing of valuation in connection with surrender of collateral, at least one, *In re Erwin*, 25 B.R. 363, 365-66 (Bankr. D. Minn. 1982), holds that the

valuation should be as of the time of the surrender, in this case, at plan confirmation.

**5. Reasons for valuation at the time of claim satisfaction.** Because §-363(f) sales, redemption, cramdown, and surrender all affect secured creditors in the same way—establishing the rights they will have in exchange for their claims—it would seem that the time for valuing the creditor's claim should be the same in each situation. And indeed, the majority of the decisions arising in each of the situations suggests just such a consistent rule: the claim should be valued at the time of the sale, redemption, cramdown or surrender, when the new rights are established, rather than at some earlier point in the case. In addition to consistency, there are at least two other substantial reasons for measuring value at the time the claim is satisfied.

**a. Mandated valuation hearings.** Section 506(a), in providing for bifurcation of secured claims, states that "value shall be determined . . . in conjunction with any hearing on . . . disposition or use [of collateral] or on a plan affecting [a secured] creditor's interest." Thus, the statutory language itself mandates a separate valuation hearing in conjunction with *any* sale or redemption (since these are dispositions of collateral), and *any* confirmation of a plan involving cramdown, either by payment or surrender (since these affect a secured creditor's interest in collateral). If value were fixed at the beginning of the case, there would be no reason to require a valuation hearing in connection with every satisfaction of a secured claim.

**b. Superpriority for failure of adequate protection.** Section 507(b) of the Bankruptcy Code grants a priority, over all other administrative claims, to the administrative claim of a secured creditor who receives insufficient adequate protection. *Bonapfel v. Nalley Motor Trucks (In re Carpet Center Leasing Co.)*, 991 F.2d 682, 685 (11th Cir. 1993), *cert. denied,* 510 U.S. 1118, 114 S. Ct. 1069 (1994). This provision would be entirely superfluous if the secured claim of the creditor were fixed at the outset of the case. It is only because the secured creditor's claim may be worth less at the time of claim satisfaction than it was at an earlier time, when adequate protection was provided, that a superpriority administrative claim has any purpose. *See In re Kennedy*, 177 B.R. at 972 (adequate protection would be unnecessary if the creditor's claim were fixed at the time of filing). The existence of §507(b) relief also answers the concern expressed by the district court in *Johnson*, 165 B.R. at 528-29, that cramdown valuation as of the time of confirmation may be an unconstitutional taking. Indeed, the *Johnson* court itself recognizes that §507(b) may provide a "technically correct" approach to protecting the property rights of secured creditors, and complains only that it is "unnecessarily complicate[d]." 165 B.R. at 528-29.

## E. Entitlement to interest and costs: valuation as of time of claim satisfaction?

Section 506(b) of the Bankruptcy Code, as discussed at II.E., above, allows a secured creditor interest and contractually specified fees and costs, to the extent that its claim is secured by property "the value of which . . . is greater than the amount of such claim." Only a few published opinions discuss the relevant time to value a secured claim for purposes of §506(b), and their impact on the question is unclear. One decision, *In re Vermont Investment Ltd. Partnership*, 142 B.R. 571, 573 (Bankr. D. D.C. 1992), appears to assume that an undersecured claim is fixed for purposes of claim satisfaction at the beginning of the case, and then holds that any subsequent increase in the value of the collateral can be measured at any time for purposes of allowing (and paying) interest and costs under §506(b).

The most prominent recent case dealing with §506(b), *Orix Credit Alliance, Inc. v. Delta Resources, Inc. (In re Delta Resources)*, 54 F.3d 722 (11th Cir. 1995), *cert. denied*, 516 U.S. 980, 116 S. Ct. 488 (1995), takes a much more restrictive view of §506(b). In *Delta Resources*, the Eleventh Circuit dealt with the argument made by an oversecured creditor that it was entitled to periodic payments of interest as adequate protection, even if the value of its collateral was not declining, because otherwise its equity cushion would be eroded by accumulating interest and costs. *Id.* at 728. The court rejected this argument, holding that only the original value of the property was subject to adequate protection, not the equity cushion, which could properly be exhausted by accumulating interest and fees. *Id.* at 729, 730. The court also held that allowance of §506(b) interest and costs could only be made at the time the creditor's claim was satisfied, because, until that time, it would not be possible to determine how much of the value of the collateral would be used up in preservation and disposition of the collateral, pursuant to §506(c). *Id.* at 729-30. All of this is consistent with valuation of the collateral, for purposes of §-506(b), at the time of claim satisfaction (sale, redemption, confirmation, or surrender).

This conclusion is called into question, however, by an unexplained comment in the *Delta Resources* opinion: "[T]he oversecured creditor's allowed secured claim for postpetition interest is limited to the amount that a creditor was oversecured at the time of filing." 54 F.3d at 729. Taken literally, this dictum would require a separate valuation of the collateral, as of the time of case filing, to establish a ceiling on any §506(b) claim, and one subsequent decision has adopted this reading. *Community Bank v. Torcise (In re Torcise)*, 187 B.R. 18, 23(S.D. Fla. 1995), *rev'd on other grounds sub nom. Community Bank v. Torcise*, 162 F.3d 1084 (11th Cir. 1998) (506(b) valuation is made "on the basis of the claim . . . as it existed at the time of the petition date, because post-petition interest is limited to the amount by which the claim was oversecured at that time."). However, it may be that the *Delta Resources* dictum was only intended to emphasize the court's holding that adequate protection only applies to the original property value, so that the creditor is not *guaranteed* interest and costs at a level above the original equity cushion. If the value of collateral at the

time of claim satisfaction was greater than its value at the time the case was filed, there would appear to be no reason for not paying interest and costs up to the amount of the new equity cushion. This would make the allowance of a claim for interest and costs consistent with allowance of secured claims generally—fixing the amount of the claim at the time of claim satisfaction.

The Fifth Circuit agreed with the *Delta Resources* court in the context of "the ordinary 'underwater' asset case" but found that court's ruling "inappropriately narrow" "where the collateral is rising and the creditor's claim is decreasing." *Financial Security Assurance Inc. v. T-H New Orleans Ltd. Partnership (In re T-H New Orleans Ltd. Partnership)*, 116 F.3d 790, 797 n.7 (5th Cir. 1997). The Fifth Circuit rejected a single valuation approach and held that:

> where the collateral's value is increasing and/or the creditor's allowed claim has been or is being reduced by cash collateral payments, such that at some point in time prior to confirmation of the debtor's plan the creditor may become oversecured, valuation of the collateral and the creditor's claim should be flexible and not limited to a single point in time, such as the petition date or confirmation date.

*Id*. at 798. The *T-H* court found that its flexible approach recognized the non-limiting language of §506(b) as well as better balanced the rights of debtors and creditors. *Id*. at 798 To determine when interest should begin to accrue, a court need only find the "point in time where the creditor's claim becomes oversecured." *Id*. at 799.

## F. Entitlement to adequate protection: valuation as of time of bankruptcy filing?

**1. The nature of the dispute: determining the protected interest.** There is a substantial dispute in the reported decisions regarding the relevant time for valuing collateral for purposes of adequate protection. Before discussing the different positions taken by the courts on this question, it is important to recognize that adequate protection involves two different valuations. First, there must be a starting point —a determination of some claim value that is subject to adequate protection, which can be called the "protected interest." Second, there must be a determination of the extent to which the protected interest has declined or will decline in the absence of adequate protection. The second valuation is not in dispute. Once a protected interest has been established, it is clear that the creditor may seek adequate protection of its claim at any time—based on the current value of the claim— until the claim is satisfied. Then, if adequate protection has failed, the creditor may seek a superpriority administrative expense under §507(b), as discussed at V.C.4.b., above. Rather, the controversy in the cases is over the timing of the first valuation, that is, the time relevant for valuing the creditor's protected interest.

2. **Continuous valuation.** One group of decisions—involving both Chapter 11 and Chapter 13 cases—holds, in effect, that the protected interest of a secured creditor, for purposes of adequate protection, can be determined at any time during the pendency of the bankruptcy case, whenever requested by the creditor. This "continuous valuation" view is expressly stated by a number of Chapter 13 decisions, including *In re Cason*, 190 B.R. 917, 929-31 (Bankr. N.D. Ala. 1995), which cites with approval several of the other Chapter 13 cases adopting continuous valuation. Among Chapter 11 decisions, *In re Broomall Printing Corp.*, 131 B.R. 32, 35 (Bankr. D. Md. 1991), expressly adopts continuous valuation, and the approach is implied by a number of decisions cited and summarized in *In re Addison Properties Ltd. Partnership*, 185 B.R. 766, 776 (Bankr. N.D. Ill. 1995), including *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995).

3. **Valuation as of bankruptcy filing.** A second group of decisions holds that the interest subject to adequate protection is the value of a secured creditor's claim at the time of the bankruptcy filing. *Johnson v. General Motors Acceptance Corp. (In re Johnson)*, 165 B.R. 524, 528 (S.D. Ga. 1994) (Chapter 13); *Travelers Life & Annuity Co. v. Ritz-Carlton of D.C., Inc. (In re Ritz-Carlton, Inc.)*, 98 B.R. 170, 173 (S.D.N.Y. 1989) (Chapter 11) ("The general rule is that for adequate protection purposes a secured creditor's position as of the petition date is entitled to adequate protection against deterioration.").

4. **Reason for continuous valuation.** The rationale for allowing valuation of the protected interest of a secured creditor continuously, on the creditor's request, is principally to prevent unfair surprise. *See In re Best Products Co.*, 138 B.R. 155, 156-57 (Bankr. S.D.N.Y.), *aff'd,* 149 B.R. 346 (S.D.N.Y. 1992) (collecting authorities and citing *Ahlers v. Norwest Bank (In re Ahlers)*, 794 F.2d 388, 395 n.6 (8th Cir. 1986), *rev'd on other grounds, Norwest Bank v. Ahlers*, 485 U.S. 197, 108 S. Ct. 963 (1988) (" [T]he starting date should not be when the petition is filed, but rather when the secured creditor seeks either possession of the collateral or adequate protection. [T]his ruling will prevent a hardship to the debtor caused by an adequate protection motion filed well after the bankruptcy petition has been filed, which could require sizeable 'makeup' payments.").

5. **Reasons for valuation as of bankruptcy filing.** There are several reasons why the protected interest of a secured creditor for purposes of adequate protection should be valued as of the outset of the bankruptcy case. *Johnson v. General Motors Acceptance Corp. (In re Johnson)*, 165 B.R. 524, 528 (S.D. Ga. 1994) states the conceptual rationale for the rule: a bankruptcy filing imposes the automatic stay, which prevents the creditor from asserting its rights to the property, and so it is reasonable to protect the value of those rights as of that time. *Accord In re Landing Assoc's, Ltd.*, 122 B.R. 288, 292 (Bankr. W.D. Tex. 1990) ("[T]he function of adequate protection is to maintain the value of the creditor's interest in the property as of the filing date."). Practical

reasons for fixing the protected interest at the beginning of the case are given in *In re Addison Properties Ltd. Partnership*, 185 B.R. 766, 780-83 (Bankr. N.D. Ill. 1995). In any situation where the value of collateral increases, or generates income that is additional collateral, continuous valuation produces an incentive for the secured creditor to seek repeated valuations: with each increase in collateral value, a new level of protected interest would result; then, if the value subsequently decreased from the new high point, adequate protection would be required, even though the collateral might still be worth more than it was at the outset of the case. The result is a ratchet effect, with the secured creditor entitled to protection of the highest intermediate collateral value between the time of the bankruptcy filing and the time of claim satisfaction. In addition to giving the creditor far more protection than would exist in a nonbankruptcy context, this approach to adequate protection has a significant potential for expending administrative expenses and judicial resources in multiple valuation hearings.

**G. Dual valuation.**

The principles for the timing of valuation, suggested above in V.D. through V.F., create a system of dual valuation. The protected interest of a secured claim, for purposes of adequate protection, is valued as of the filing of the bankruptcy case. But the value of the secured claim for purposes of claim satisfaction is measured as of the time of the satisfaction, whether by sale, cramdown, redemption, or surrender. Section 506(b) interest and costs are measured as part of the claim at the time of satisfaction. The effect of dual valuation was discussed in *In re Addison Properties Ltd. Partnership*, 185 B.R. 766, 784 (Bankr. N.D. Ill. 1995), and this approach was applied in *In re Markos Gurnee Partnership, Diplomat North, Inc., and PCS Hotels*, Nos. 91 B 17242, 91 B 18792, 91 B 18793, slip op. (Bankr. N.D. Ill. Apr. 1, 1997), *aff'd sub nom. First Midwest Bank, N.A. v. Steege*, 1998 WL 295507 (N.D. Ill. May 21, 1998); *In re Duval Manor Associates*, 191 B.R. 622, 633-34 (Bankr. E.D. Pa. 1996).