SELECTED CHAPTER 11 ADEQUATE PROTECTION ISSUES

By Peter D. Russin, Esq. and Richard S. Lubliner, Esq.²

Introduction

Sections 362, 363, and 364 of the Bankruptcy Code require, in certain instances, that a court determine whether the interests of a secured creditor are adequately protected. While the concept of adequate protection is not defined in the Bankruptcy Code, it is generally accepted that it requires a debtor to propose some form of relief that will preserve the secured creditor’s interest in the collateral securing the debt, pending the outcome of the bankruptcy proceeding. In essence, adequate protection is a means to protect a secured creditor from being deprived of the benefit of its prepetition bargain. When adequate protection is required under the Bankruptcy Code, section 361 of the Bankruptcy Code states that it may be provided (i) by making periodic cash payments to the secured creditor; (ii) granting the secured creditor an additional or replacement lien in other property of the debtor; or (iii) granting the secured creditor such other means of relief so that the secured creditor will realize the indubitable equivalent of its interest in the property.

²The authors wish to acknowledge the valuable contributions of their co-panelist, Bankruptcy Judge Robert A. Mark, in the drafting and editing of this article.
The concept of adequate protection is derived from the fifth amendment protection of property interests. However, it is not limited strictly to constitutional considerations and seems to be based equally on policy and equitable grounds. This is evidenced by the fact that section 361 recognizes that there may be alternative means to giving the secured creditor the benefit of its bargain where giving a secured creditor the benefit of its bargain in kind may be impossible or detrimental to effectively administering the debtor’s estate. There are essentially four means of providing adequate protection. However, these four means are not considered to be exhaustive or exclusive. They all rely on the value of the protected entity’s interest in the property at issue. There is no precise formula as to how to ascertain what the value to be protected is, and this is left to be determined on a case by case basis.

The first method of adequate protection is periodic cash payments by the estate to the extent of a decrease in value of the secured creditor’s interest in the property. This means of providing adequate protection is usually utilized when the property at issue is depreciating in value at a relatively consistent rate. The periodic cash payments compensate the secured creditor for such depreciation.

The second method is providing the secured creditor with an additional or replacement lien on property other than the collateral to the extent of the decrease in value of the collateral. The purpose of this method is to provide the secured creditor with a means of realizing the value of the collateral, if it should decrease during the pendency of the bankruptcy case, by granting an interest in additional property from which the secured creditor may realize the value of its loss.


4 See In re Yale Express, Inc., 384 F.2d 990 (2d Cr. 1967).
The third method is granting the secured creditor an administrative expense claim to the extent of the loss it suffers as a result of the use of its collateral by the debtor. This involves a prediction as to whether the unencumbered assets that will remain if the case is converted from a reorganization to a liquidation will be sufficient to pay the secured creditor to the extent of its loss. Accordingly, it should only be used when there is relative certainty that administrative expenses will be paid in full in the event of a liquidation.

The fourth method gives the parties and courts flexibility by allowing such other relief as to ensure that the secured creditor will realize the value of its interest in the collateral. This flexible approach permits courts to adopt new methods of financing and formulate appropriate protection under the circumstances of each case, such as the provision of a third party guarantee.

This article will focus on the provision of adequate protection in three situations. First, we will examine what type of adequate protection, if any, prepetition lienholders must receive if they are to be primed by a new lender that is providing postpetition financing. Second, we will discuss whether traditional methods of adequate protection, particularly granting a first priority administrative expense claim pursuant to section 507(b), are appropriate if the postpetition financing provides few, if any, benefits to unsecured creditors. Finally, this article will analyze whether a debtor in a single asset real estate case can extend, for cause, the ninety day deadline within which it must file a plan or begin making interest payments if the secured creditor has a substantial equity cushion in the collateral.

**Adequate Protection in the Context of Priming Liens**
Section 364(d) of the Bankruptcy Code permits a court, after notice and a hearing, to authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate only if (A) the trustee (or debtor-in-possession) is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted. Proving the second element is often problematic since preservation of prepetition contractual liens is a primary consideration of the Bankruptcy Code. Accordingly, many courts are reluctant to grant priming liens and view such relief as an extraordinary last resort. In this regard, given the effect that a priming lien has on existing creditors, courts should be “particularly cautious” when determining whether the existing creditor that is being primed is adequately protected.

Despite the difficult burden, proposing priming liens to secure postpetition financing may become more common in real estate cases given the drastic depreciation in prices and the drying up of capital markets. Real estate developer debtors will be faced with the difficult problem of trying to complete their projects, often with a prepetition lender that is unwilling to extend postpetition financing. The debtor will have to seek other lenders in an effort to obtain postpetition financing and such lenders will likely demand a first lien. The issue becomes what adequate protection must be provided to prepetition lien holders who are to be primed. Cases considering the granting of priming liens typically focus on whether the lien holder to be primed would receive the benefit of its prepetition bargain if the priming lien is allowed and whether the


6In the Matter of Qualitech Steel Corp., 276 F.3d 245, 248 (7th Cir. 2001).

7See Mosello, 195 B.R. at 289 (internal citations omitted).
debtor has adequately demonstrated the likelihood of a successful reorganization. Three such
cases are discussed in more detail below.

Perhaps the seminal case on the granting of priming liens is *In re Timber Products, Inc.*

The debtors operated a lumber manufacturing business and needed cash to buy inventory. The
debtors filed a motion for authority to obtain credit secured by liens pursuant to section 364(d).
There were secured creditors holding liens on all of the debtors’ assets. The liens were granted
following a loan of $600,000 to one of the debtors and a non-debtor affiliate. The sole
shareholder of one of the debtors and his wife signed personal guarantees on the loan. The loan
proceeds proved insufficient and an additional $100,000 loan was extended. The debtors filed a
plan, the funding of which was dependant on the debtors obtaining new capital.

A postpetition lender agreed to lend the debtor up to $275,000 if it received a priming
lien. The existing lien holders objected arguing that their security interests in the debtors’
property would not be adequately protected if their liens were subordinated to the postpetition
lender. The bankruptcy court determined that the fair market value of the collateral was
$1,400,000 and that there was an equity cushion of approximately $635,000. Of the $275,000 to
be borrowed, $60,000 was to be used for start-up expenses and the remaining $215,000 would be
used to purchase inventory. Thus, the equity cushion would be reduced. Because the lien
holders were oversecured and interest was accruing, thereby eroding the equity cushion further,
the debtors offered payments under the plan as additional adequate protection. Therefore, the
bankruptcy court focused on whether the proposed borrowing would enable the debtors to
profitably reorganize. If, so, the court reasoned, the lien holders would be adequately protected.

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If not, their position would be in jeopardy.

The debtors presented evidence to support their postconfirmation projections. The existing lienholders presented evidence that the debtors could not operate profitably under the plan. In order to determine whether the existing lien holders were adequately protected, the court considered whether (i) the accrual of interest eroded the equity cushion; (ii) the property was increasing in value; (iii) debtors showed an inability to obtain postpetition refinancing; (iv) debtors had offered any other method of adequate protection; (v) current economic conditions suggested no realistic prospect for successful rehabilitation; and (vi) the debtors’ conduct of the litigation had been more than a deliberate tactic. Under the facts, the primary focus became feasibility of the debtors’ plan.

The court ultimately determined that the infusion of $275,000 in capital generated by the loan would be insufficient to cover the debtors’ expenses through the first several months of operation, when there would be little if any, accounts receivable generated and collected. The court also determined that the debtors’ revenue projections were overly optimistic, and that the projections did not account for contingencies which would negatively impact their projected margins. The court noted that when the issue is one of adequate protection for a secured creditor that is being primed, there must be some realistic assessment of future contingencies which would alter profitability. In this case, the debtors were unable to convince the court that the plan they proposed and the business under which they planned to operate would be successful and, therefore, the court determined, the existing lien holders could not be primed.

Subsequent cases have adopted the *Timbers* approach in determining whether to grant a postpetition lender a priming lien, placing particular emphasis on the prospects of a successful
reorganization, including *In re Stoney Creek Technologies, LLC*. In *Stoney Creek*, a new postpetition lender committed to fund $500,000 at the closing of the loan and an additional $1,000,000 thereafter at the lender’s discretion. All of the debtor’s assets secured debt of $3,100,000 held by a prepetition lien holder that would be primed if the postpetition financing was approved. The debtor contended that the prepetition lien holder was adequately protect as a result of an equity cushion.

The *Stoney Creek* court noted that the “Bankruptcy Code recognize[s] the primacy of prepetition contractual liens and seeks to preserve the financial interests created thereby.” In other words, the prepetition lender must be provided with the same level of protection it would have absent postpetition financing since it is entitled to retain the benefit of its prepetition bargain. Therefore, priming liens should only be granted as a “last resort.”

The *Stoney Creek* court rejected the debtor’s assertion that the existing lien holder was adequately protected by the existence of an equity cushion and noted that an equity cushion alone was not determinative as to whether adequate protection existed. Instead, the court applied the *Timbers* factors and placed the burden on establishing that the existing lien holder was adequately protected squarely on the debtor. The debtor offered no other method of adequate protection other than the equity cushion. The court determined that the debtor did not meet its burden of providing the existing lien holder with adequate protection, even assuming a large equity cushion, in large part because the debtor provided insufficient evidence that it could

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11 *Stoney Creek*, 364 B.R. at 890, citing *In re Qualitech Steel Corp.*, 276 F.3d at 248.
operate profitably. If it could not operate profitably, it would default on its obligations to the postpetition lender and the existing lien holder would be impaired because it would not be able to realize the value of its collateral. As in Timbers, the Stoney Creek court undertook a feasibility analysis and determined that any purported equity cushion was tenuous because of the debtor’s dim hopes for a successful reorganization where the postpetition lender was only obligated to fund $500,000, even with the security of a first position lien. The court was unwilling to gamble the existing lien holder’s prospects of receiving a meaningful distribution in the bankruptcy case on a speculative business model with narrow margins.

In Timbers and Stoney Creek, the decision turned on the feasibility of the debtors’ plan. In other cases, the focus is on whether the value added by the new financing will be sufficient to protect the prepetition lender, particularly if the prepetition equity cushion is small. This situation was addressed in the case of In re Strug-Division LLC. In Strug, there was approximately $18,000,000 due under two prepetition loans secured by the property of the debtor. Daily interest was accruing on the loans. The prepetition lien holder moved for relief from stay based on a lack of adequate protection, and the debtor asserted that it could successfully reorganize if it were allowed to borrow money by providing a priming lien to complete necessary renovations to its property. The court determined that the property had a value of approximately $19,000,000, provided that it was properly rehabilitated, which would cost between $1,300,000 and $2,000,000.

The bankruptcy court focused primarily on the existence and sufficiency of the alleged equity cushion. The court determined that if there was an equity cushion, it was small and

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eroding on a daily basis. Further, the court determined that it could not rely on the success of the debtor’s reorganization because the debtor had not convinced it that the proposed renovations would be successful in terms of increasing the value of the property. The only adequate protection being offered to the existing lien holder was the increase in value of the collateral as a result of the rehabilitation of the property. However, the court determined that the increase in value would not bring the total value to much more than the total debt plus the amount of any proposed postpetition priming loan. In this situation, the risk of being primed is inappropriately placed on the existing lien holder. The Court concluded that the Debtors could not borrow funds if a priming lien was required and therefore granted stay relief to the prepetition lender.

Priming lien issues can also arise even if the prepetition senior lender provides the postpetition financing if there are prepetition junior lienholders. Adequate protection of prepetition junior lienholders becomes the focus since the additional postpetition financing increases the debt secured by the senior lien. In these situations, the analysis may turn on whether the junior creditor was “in the money” on the petition date, that is, were the assets worth more than the senior debt. This situation occurred in one recent homebuilder case, In re Levitt and Sons, LLC13. The Levitt debtors are engaged in the business of designing, developing, building and selling homes. On the petition date, several of the debtors’ projects remained uncompleted and if they were unable to obtain substantial postpetition financing, the debtors announced their intention to abandon the projects to the prepetition lender. The debtors were unable to obtain financing absent granting a priming lien. One prepetition lender, which was undersecured, agreed to provide a postpetition financing revolving credit facility of $3,500,000

that could be increased to $10,000,000 in order to construct and sell partially built homes and perhaps start construction on other projects which would ultimately be sold. The postpetition loan was secured by a lien in all of the assets of the debtors which also secured the prepetition indebtedness of the prepetition loan. The lien being granted in connection with the postpetition loan would not prime any lien that was determined to be senior to the prepetition lien, but would be superior to all other liens. In addition to providing financing, the postpetition loan agreement provided a guarantee that the unsecured creditors would receive $3,000,000 or more from the sale of the debtor’s assets. Certain prepetition junior lienholders objected.

Relying on the fundamental principal that in order to be adequately protected, the prepetition creditor must be provided with the same level of protection it would have absent the postpetition financing, the Levitt court distinguished the case before it from Stoney Creek. In Stoney Creek, there was equity over and above the value of the prepetition debt and, therefore, the granting of a priming lien would have altered the realization of the collateral of the existing lien holder. By contrast, in Levitt, the prepetition senior lender was undersecured and the objecting junior lien holders were “out of the money” on the petition date. Since the junior lien holders would receive nothing in the absence of postpetition financing with a priming lien, they are not entitled to adequate protection. In short, where there is no value to the lien on the petition date, there is no interest to adequately protect. Therefore, the court approved the priming lien. The Levitt court also noted that the unsecured creditors were receiving a guaranteed $3,000,000 distribution although it does not appear that this fact entered into the court’s decision to grant the priming lien, but rather was more likely a factor in allowing the chapter 11 case to proceed.
In sum, courts will look to a multitude of factors, including those set forth in *Timbers*, to determine whether an existing lien holder is receiving the benefit of its prepetition bargain and may be primed. If the existing lien holder is “out of the money” because a senior lien holder is undersecured, the answer to this question is easy because the prepetition junior lien holder does not need to be provided with adequate protection. However, if there is an equity cushion and the existing lien holder’s distribution may be impaired by the granting of a priming lien, courts will closely scrutinize the granting of a priming lien. While the existence of an equity cushion is certainly a factor in determining whether an existing lien holder is adequately protected and may be primed, it is certainly not determinative of the issue. Courts will look to the size of the equity cushion and the rate at which it is eroding. Courts will also require a debtor to present evidence that the use of the proceeds obtained from a postpetition priming loan will increase the value of the existing lien holder’s collateral to an amount likely significantly more than just the value of the debt plus the postpetition loan. There must also be a tangible probability that the debtor will be successful in its reorganization. Absent such a showing, the risk that the postpetition priming loan will impair the value of the existing lien holder’s collateral is too great and a priming lien should not be granted. As one court aptly observed, “the authorization to prime an existing lien should not be read as authorization to increase substantially the risk of the existing lender in order to provide security for the new postpetition lender.”

Limiting Adequate Protection to Protect Unsecured Creditors

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Prepetition lenders typically demand an array of adequate protection provisions in exchange for postpetition financing. The debtors often have no alternative and are forced to agree to the lender’s demands. It then falls on the courts to reject loan provisions which will unduly prejudice the other creditors in the case.\textsuperscript{15}

In a recent case filed in the Southern District of Florida, the court had to determine whether to approve certain provisions of a postpetition financing agreement between the debtors and their undersecured prepetition lenders. \textit{In re All American Semiconductor, Inc.}, Case No. 07-12963-BKC-LMI. In that case, the prepetition lenders (“Banks”) to an electronic parts distribution business agreed to allow use of cash collateral under §363 and to provide additional financing under §364 subject to several conditions including entry of an order setting bid procedures and an auction sale on substantially all of Debtor’s assets. The Banks’ prepetition debt of $42 million was secured by a blanket lien on almost all of the Debtor’s assets. The lien did not attach to postpetition avoidance actions valued at $2 to 3 million and also did not encumber a potentially valuable prepetition litigation claim. The Banks wanted to keep the business operating since a sale of the assets as an ongoing business would exceed the liquidation value. Still, all parties agreed that even a sale as an ongoing business would yield far less than the Banks’ prepetition debt.

As adequate protection for the financing, the Banks insisted on a superpriority administrative expense claim to the extent the postpetition debt exceeded the value of the replacement liens. It was certain that the postpetition debt would far exceed the value of the

\textsuperscript{15}Several courts have issued guidelines for postpetition financing motions and orders. Examples of these local rules and guidelines are included in the supplemental materials provided in this program.
replacement liens since the debtors’ operations were significantly reduced and since, under the proposed terms, postpetition collections were to be applied first to reduce the prepetition debt. In fact, it was clear that if allowed, the Banks’ superpriority administrative expense claim would exceed the value of the unencumbered assets. The Creditors Committee objected to various aspects of the financing, including the superpriority administrative expense and the provision requiring the estate to waive any surcharge rights under §506. The Committee argued that financing the postpetition operations pending the sale would generate a higher price for the Banks’ collateral but do nothing for the unsecured creditors. The Committee argued that unsecured creditors would be worse off since assets which were unencumbered on the petition date would now be liquidated to pay the superpriority claim.

Before entering a final ruling, the court “advised” the parties on the record that the financing would not be approved as proposed. Even though the Banks agreed to exclude avoidance actions from their postpetition lien, all proceeds otherwise available from these unencumbered assets would likely be paid to the Banks on account of their superpriority administrative expense claim. Moreover, the court was clearly troubled by the provision waiving surcharge rights since a substantial portion of the expenses being funded by the financing would be incurred primarily to preserve the value of the Banks’ collateral. In short, the court was prepared to deny approval of any postpetition financing arrangement, the results of which would have required the case to be converted, as the debtor had no other source of funding.

Faced with the prospect of conversion and a shutdown of operations which would kill the prospects of a sale of the operating business, the Banks negotiated a compromise with the
Creditors Committee. Significantly, the Banks agreed that their superpriority administrative claim would **not** be payable from the proceeds of avoidance actions or the first $750,000 of proceeds from other assets unencumbered on the petition date. Other concessions included a carve-out for the Committee’s professional fees.\(^{16}\) Thus, just as priming liens cannot be approved if they will prejudice existing lienholders, postpetition financing provisions should not be approved where the “adequate protection” demanded by the lender will clearly impair the unsecured creditors.

**Does Adequate Protection Constitute Cause to Extend the Stay in a Single Asset Real Estate Case**

Pursuant to section 362(d)(3) of the Bankruptcy Code, with respect to a stay of an act against single asset real estate by a creditor whose claim is secured by an interest in such property, the court shall grant relief from the automatic stay unless, not later than 90 days after the entry for order for relief (or such later date as the court may determines for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later - (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or (B) the debtor has commenced monthly interest payments.

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\(^{16}\)The Court’s final Order was entered on May 21, 2007 (Docket Entry #256)
What constitutes sufficient “cause” for the court to extend the 90-day deadline? There are very few reported decisions defining what in fact constitutes “cause” in this context as well as a dearth of legislative history on the topic. Some cases note that section 362(d)(3) was implemented because Congress was concerned about the unfairness of a lengthy delay to mortgagees in chapter 11 cases involving single-asset real estate projects.\(^\text{17}\) However, such a delay would not appear to negatively impact a substantially oversecured creditor since an equity cushion would provide it with sufficient protection. Arguably, the primary purpose of the single asset real estate provisions is to prevent an undersecured creditor from being unduly delayed in foreclosing on its collateral as a result of a pending bankruptcy. Nonetheless, in denying a motion to extend the 90-day deadline, at least one court has espoused the view that a substantial equity cushion is inapplicable to section 362(d)(3) as section 362(d)(3) focuses “entirely on an in-hand realization of cash by the creditor, while the property remains in the debtor’s hands.”\(^\text{18}\)

In the case of *In re Heather Apartments Limited Partnership*, the debtor, having conceded it had filed a single asset real estate case, filed a motion for an extension of the 90-day deadline in section 362(d)(3), within which to file a plan or commence making interest payments. The debtor was indebted to the mortgagee in the approximate amount of $7,000,000. The debtor proposed to sells its asset for $8,500,000 to an unidentified entity. The debtor did not provide the court with specifics or a tangible proposal for the sale.

The *Heather Apartments* court noted since section 362(d)(3) did not provide an express definition of “cause,” cause would have to consist of something extraordinary that would tip the


equities of a case outside the balance that Congress envisioned. Section 362(d)(3), according to the court, provided “special deference” to the mortgagee in the form of an express entitlement to receive payments of contractual interest once 90 days have passed, with the only alternative available to the debtor being the filing of an arguably confirmable plan within the 90-day period.

The prospective sale in this case did not rise to the level of “cause” according to the court. The court did note that a prospective sale could act as a substitute for interest payments under section 362(d)(3), but the debtor would have the burden to show that a sale would close promptly. To meet such burden, the debtor would have to provide a binding purchase agreement, a binding lending commitment in favor of the prospective purchaser and substantial progress in moving toward a closing. Only then, according to the court, would a mortgagee be substantially protected under section 362(d)(3), justifying an extension of the 90-day period. The court determined that an equity cushion, no matter how substantial, does not constitute “cause” for the purposes of section 362(d)(3) because the purpose of section 362(d)(3) is the payment of cash after the 90-day period while the debtor possesses the collateral. Under this rationale, a debtor will have to file an arguably confirmable plan or commence contractual interest payments within 90 days (even if the mortgagee is substantially oversecured) unless it convinces a court it is very close to selling the collateral to a well-financed, well-documented buyer at a price that clearly exceeds the secured debt.

At least one other bankruptcy court has taken a different view on whether a substantial equity cushion provides a mortgagee with sufficient protection to justify an extension of the 90-
day period. In an unpublished decision in the chapter 11 case of In re Sundale Ltd.19, pending in the Southern District of Florida, the presence of a substantial equity cushion was a factor in determining whether “cause” existed to extend the 90-day deadline. Noting that there was no precise definition of “cause” under 362(d)(3), the court determined that it had discretion to determine what “cause” should mean. The court opined that a determination of what constitutes “cause” should be based upon a consideration of whether the creditor is being harmed, whether the creditor does have some protection, what the harm to the debtor may be if the extension is not granted, and what the benefit to the debtor may be if the extension is granted. In applying those factors, the court found that the creditor was oversecured and had a substantial equity cushion, and that the debtor would benefit from the granting of an extension. As such, the court found sufficient “cause” to justify an extension of the 90-day deadline.

The reasoning behind this ruling appears to be sound. The expedited time frame within which a debtor must file a plan or commence payments pursuant to section 362(d)(3) is meant to ensure that an undersecured creditor is not prejudiced by the automatic stay and the delay in realizing the value of its collateral. When the secured creditor is oversecured, there is no evidence of a rapid deterioration of the equity cushion, and the granting of an extension will benefit the debtor, such a benefit to the debtor should constitute “cause” and militate in favor of the granting of the extension. Such a determination is consistent with the apparent policy objectives behind single asset real estate cases.

One cautionary note is worth adding. Even if a debtor complies with the provisions of section 362(d)(3) and commences interest payments to the mortgagee or receives an extension of

19Case No. 07-21016-BKC-LMI
the 90-day period set forth in section 362(d)(3), it may find itself facing a motion for relief from stay under sections 362(d)(1), because the mortgagee is not adequately protected, or section 362(d)(2), if there is no equity in the property. For example, the debtor in a single asset real estate case may commence interest payments at the contractual rate pursuant to section 362(d)(3), but such payments may not adequately protect the mortgagee if the collateral is depreciating at a rate that is greater than the contractual interest rate. Some may consider that the contractual interest is presumptive evidence of adequate protection, but if the mortgagee can provide evidence of a rapid erosion of collateral that eclipses the payments it is receiving pursuant to section 362(d)(3), is it entitled to additional adequate protection or relief from stay? Our research has not uncovered any cases addressing this issue, but practitioners representing a single asset debtor should keep in mind that compliance with section 362(d)(3) may not eliminate the risk of stay relief being granted under other subsections of section 362(d).