CHAPTER 16

BANKRUPTCY

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**Background**

**Introduction**

When a debtor files for bankruptcy protection, the secured party’s ability to enforce its security interest becomes subject to the substantive and procedural limitations imposed by federal bankruptcy law. Although Article 9 is “state” law, most current decisions interpreting and applying Article 9 arise in the federal bankruptcy courts. Accordingly, a thorough understanding of the law of secured transactions requires a basic understanding of bankruptcy law.

A variety of policies and concerns motivate our system of federal bankruptcy law. One concern is that, outside of bankruptcy, a debtor’s financial distress can trigger a “race to the courthouse” by its creditors, with each creditor attempting to maximize its recovery before recovery efforts exhaust the debtor’s assets. Such a “race” has the potential to force the distressed but possibly solvent debtor into insolvency, when time, planning, and some “breathing space” might have enabled the debtor to recover a sound financial position. Thus, one of the primary objectives of bankruptcy law is to
provide a comprehensive system of debt collection that can help either avoid or mitigate the adverse consequences of the “race to the courthouse.”

In bankruptcy an insolvent debtor’s financial affairs are administered in a collective proceeding rather than through the ad hoc collection efforts of individual creditors. Within this collective proceeding, there is a strong emphasis upon the equitable (as distinct from equal) treatment of all creditors; bankruptcy law generally treats similarly situated creditors in a similar fashion, and discourages attempts by creditors to “opt out” of the collective process. Current bankruptcy law provides more, however, than just a collective debt collection system. Bankruptcy also provides insolvent debtors with the opportunity to obtain a “fresh start” or to “reorganize” their financial affairs. Individual debtors may choose to liquidate their pre-bankruptcy assets and thereby obtain an order discharging their pre-bankruptcy debts. In contrast, individual and business debtors may retain their assets and attempt to restructure and repay some or all of their pre-bankruptcy debts in a reorganization proceeding.

This variety of objectives is manifested in Title 11 of the United States Code, commonly known as the Bankruptcy Code. Enacted by Congress in 1978 and revised on several subsequent occasions (most recently by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or “BAPCPA”), the Code divides bankruptcy law into separate “Chapters.” Three of these Chapters (1, 3, and 5) contain general provisions that apply in all types of bankruptcy cases. The remaining Chapters govern the specific types of bankruptcy cases. Chapter 7 establishes the rules governing the liquidation of individual or business debtors. Chapter 11 governs the attempt by a business debtor to implement a plan for restructuring its pre-bankruptcy debts and rehabilitating its business. Chapter 12 establishes a procedure whereby farmers may restructure and repay pre-bankruptcy debts using post-bankruptcy earnings. Chapter 13 sets forth the rules that govern how an individual wage-earner may restructure its pre-bankruptcy debts and repay them using post-bankruptcy disposable income. This book does not discuss the procedure that governs proceedings under each Chapter of the Code; instead, this book generally will focus only upon those aspects of bankruptcy law that

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2This objective explains, for example, the Bankruptcy Code provision allowing the bankruptcy trustee to avoid (i.e., set aside or recover) certain transfers by the debtor prior to bankruptcy that had the effect of preferring certain creditors over other, similarly situated creditors (these transfers are called “preferences”). 11 U.S.C. § 547; see § 16.04[E] infra.


4Id. §§ 1101-1146. Although the majority of Chapter 11 cases involve debtors that are corporations, partnerships, or other business entities, the Supreme Court has held that individual debtors can use the provisions of Chapter 11. Toibb v. Radloff, 501 U.S. 157 (1991).


6Id. §§ 1301-1330.
have significant consequences for Article 9 secured transactions and the behavior of debtors and secured parties.\textsuperscript{7}

[B] The Bankruptcy Estate

The filing of a bankruptcy petition creates a bankruptcy estate.\textsuperscript{8} Subject to limited statutory exceptions, all of the interests in property (whether legal or equitable) owned by the debtor at the moment of the bankruptcy petition become part of the bankruptcy estate.\textsuperscript{9}

In a Chapter 7 case, the debtor essentially gives up all of its nonexempt property in exchange for a fresh start and a discharge of its debts. Thus, the Chapter 7 debtor generally does not retain possession and control of property of the estate. Instead, the bankruptcy trustee distributes the estate’s property in one of three ways: first, the trustee abandons any overencumbered property (\textit{i.e.}, property that secures a debt in excess of its value) or otherwise worthless property;\textsuperscript{10} second, the trustee abandons any exempt property (\textit{i.e.}, property that the debtor can retain free of creditor claims under applicable state or federal exemptions);\textsuperscript{11} third, the trustee liquidates the remaining property and distributes the proceeds to pay persons holding valid claims against the debtor and administrative expenses.\textsuperscript{12}

In contrast, in reorganization cases under Chapters 11, 12, and 13, property of the estate generally remains in control of the bankrupt debtor. In these Chapters, the bankrupt debtor typically retains its pre-bankruptcy assets and attempts to repay the claims of creditors using assets obtained and income generated after the bankruptcy petition. Thus, the reorganizing debtor remains in possession of property of the estate, and may continue to use that property in its reorganization efforts (subject to the supervision of the bankruptcy court).\textsuperscript{13}

As noted above, the bankruptcy estate includes all legal or equitable interests in property owned by the debtor at the time the debtor files a bankruptcy petition. If a secured party repossesses property from the debtor and completes an Article 9 disposition of the property before the debtor

\textsuperscript{7}For further discussion of the general procedures of bankruptcy, see generally Michael J. Herbert, \textit{Understanding Bankruptcy} (1995).

\textsuperscript{8}11 U.S.C. § 541(a).

\textsuperscript{9}Id. § 541(a)(1).

\textsuperscript{10}Id. § 554(a). When the trustee abandons property of the estate, title to that property is vested back into the debtor. Any creditor with a security interest in that property may then enforce that security interest, but only after first obtaining relief from the automatic stay as discussed in § 16.03[B] \textit{infra}.

\textsuperscript{11}11 U.S.C. § 554(a).

\textsuperscript{12}Id. § 726.

\textsuperscript{13}Id. §§ 1107(a), 1203(a), 1303.
files a bankruptcy petition, the property does not enter the bankruptcy estate — ownership will have passed to the foreclosure sale purchaser[^14] and Article 9 provides no right of post-sale redemption.[^15] If the secured party has repossessed property of the debtor prior to the bankruptcy petition but has not yet completed an Article 9 disposition, the debtor’s rights in the property have not yet been extinguished.[^16] In this situation, the proper view is that the repossessed property does become property of the bankruptcy estate, and that the secured party is obligated to turn the property over to the trustee/DIP.[^17]

### [C] The Bankruptcy Trustee

The central figure in bankruptcy cases is the trustee. The trustee is the official representative of the bankruptcy estate.[^18] In a Chapter 7 case, a trustee is always appointed. The Chapter 7 trustee collects and manages the property in the bankruptcy estate, investigates the bankrupt’s financial affairs, sets aside improper pre-bankruptcy transfers by the debtor, liquidates the property of the estate, and distributes the proceeds to those creditors entitled to payment under the Code’s

[^14]: U.C.C. § 9-617(a)(1).

[^15]: U.C.C. § 9-623(c). There is a limited possibility that the trustee/DIP may be able to set aside the pre-bankruptcy foreclosure sale as a fraudulent transfer, in which case the property would become part of the bankruptcy estate. This possibility is discussed in § 16.04[F][3] infra.

[^16]: U.C.C. § 9-617(a)(1).


The U.S. Court of Appeals for the Eleventh Circuit raised some question about this issue, at least as applied to repossessed vehicles, in its decisions in In re Kalter, 292 F.3d 1350 (11th Cir. 2002) (interpreting Florida law) and In re Lewis, 137 F.3d 1280 (11th Cir. 1998) (interpreting Alabama law). In each of those cases, the secured party had not yet disposed of the repossessed vehicle prior to the bankruptcy petition, but had applied for a title certificate to permit the secured party to demonstrate a clear title to a potential purchaser. In each case, the court treated the secured party’s conduct as having terminated the debtor’s title to the vehicle, and held that the debtor’s unexercised right of redemption was merely an intangible interest insufficient to make the vehicle part of the bankruptcy estate.

The Kalter and Lewis decisions (both of which arose under pre-revision Article 9) are poorly reasoned and patently incorrect. Furthermore, section 9-619(c) of revised Article 9 provides that “a transfer of the record or legal title to collateral to a secured party” in anticipation of an Article 9 sale is “not of itself a disposition of collateral” and thus would not extinguish the debtor’s equitable interest in the vehicle. U.C.C. § 9-619(c). Following the enactment of section 9-619(c), it is doubtful that any court would continue to follow the unfortunate decisions in Kalter and Lewis.

In reorganization cases, however, the role of the trustee differs. As in Chapter 7 cases, a trustee is always appointed in Chapter 12 and 13 cases, but that trustee does not collect and manage the property of the estate. Instead, the Chapter 12 or Chapter 13 trustee investigates the bankrupt debtor’s financial affairs, sets aside improper pre-bankruptcy transfers by the debtor, and collects all of the debtor’s post-bankruptcy disposable net income. The trustee then uses this income to pay the claims of creditors in accordance with the debtor’s court-approved plan of reorganization. Trustees are not appointed as a matter of course in Chapter 11 cases. In the typical Chapter 11 case, the Code authorizes the bankrupt debtor (called the “debtor-in-possession” or “DIP”) to carry out the powers of a Chapter 11 trustee.

In any bankruptcy case, the trustee (or the DIP) presents the primary potential threat to the Article 9 secured party and its ability to enforce its security interest. In all cases, the trustee/DIP examines the claims of creditors and can enforce any legal claims that the estate might have against creditors or other third parties. Pursuant to its avoiding powers, the trustee/DIP may invalidate certain pre-bankruptcy transfers, including unperfected security interests, fraudulent transfers, and security interests or other transfers that had the effect of preferring the Article 9 secured party over other pre-bankruptcy creditors.

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19 *Id.* § 704.

20 *Id.* §§ 1202(b); 1302(b).

21 A trustee may be appointed upon request of any party in interest for cause (including the debtor’s dishonesty, fraud, or incompetence), or if the court concludes that appointment of a trustee is otherwise necessary to protect the estate or the interests of creditors or other interest holders (such as stockholders of a bankrupt corporation). *Id.* § 1104(a).

22 *Id.* § 1107(a). The powers of the Chapter 11 trustee are listed in § 1106(a) and are similar to the powers provided to trustees in the other bankruptcy chapters.

23 *Id.* § 544(a). *See* § 16.04[B] *infra.*


§ 16.02 Contrasting Secured and Unsecured Claims

[A] What is a Claim?

Bankruptcy is a collective process in which the court resolves “claims” arising under nonbankruptcy law against financially distressed debtors. The Bankruptcy Code defines the term “claim” very broadly to incorporate any “right to payment, whether or not … reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”26 Likewise, the Code broadly defines “creditor” to include any individual or entity that holds “a claim against the debtor” that arose prior to filing of the bankruptcy petition.27 By defining the terms “claim” and “creditor” so broadly, the Code makes it possible for the bankruptcy process to address and resolve all of the debtor’s legal obligations arising out of its pre-bankruptcy activities.28

[B] The Allowance of Claims

To make distributions to creditors, bankruptcy must identify those creditors holding valid claims against the debtor. Not surprisingly, bankruptcy law does not honor all pre-bankruptcy claims; instead, policy concerns justify the disallowance of some claims. Sometimes the rationale for disallowing a claim rests upon nonbankruptcy law. For example, claims that are not enforceable under nonbankruptcy law — such as a “debt” evidenced by a forged promissory note — are not enforced in bankruptcy, lest such claimants receive better treatment in bankruptcy courts than they would outside of bankruptcy.29 In other cases, the rationale for disallowance is based on concerns of sound bankruptcy policy, such as the disallowance of claims for unmatured interest.30

27 Id. § 101(10).
30 Id. § 502(b)(2). For example, suppose that Creditor asserted an otherwise valid claim for $1,000 for goods shipped to Debtor on open account, and Creditor’s terms included an 18% interest charge on past due accounts. Section 502 would allow the claim in the amount of $1,000, plus any interest that had accrued up to the date of the bankruptcy petition, but section 502(b)(2) would disallow the claim to the extent of any interest that otherwise would have accrued under nonbankruptcy law after the petition date.

The Bankruptcy Code denies unmatured interest on unsecured claims as a matter of administrative convenience. Debtors typically do not have the assets to pay 100% of the principal balance of unsecured claims — much less any interest on those claims. By disallowing claims for unmatured interest, the Bankruptcy Code avoids the accrual of interest (and the inconvenience of recomputing claim balances) as the case proceeds. Vanston Bondholders’ Protective Comm. v. Green, 329 U.S. 156 (1946); In re Brooks, 323 F.3d 675 (8th Cir. 2003); In re Hanna, 872 F.2d 829 (8th Cir. 1989).

Notwithstanding section 502(b)(2), creditors holding oversecured claims (claims secured by property with a value exceeding the balance of the debt) can collect post-petition interest as part of their allowed

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Thus, Bankruptcy Code section 502 distinguishes between allowed claims and disallowed claims. Under section 502(a), claims are deemed “allowed” unless the trustee, the debtor, or some other party in interest raises a valid objection to the claim. Once a proper party raises an objection to the claim, the court must conduct a hearing and determine the amount of the creditor’s allowed claim.

[C] Secured Claims, Unsecured Claims, and Valuation

The Bankruptcy Code further separates claims into two primary categories — secured claims and unsecured claims. As a starting point, bankruptcy takes secured creditors as it finds them on the petition date — a security interest that is enforceable under nonbankruptcy law will also be respected in bankruptcy. A creditor with a valid lien (such as a mortgage or Article 9 security interest) upon certain of the debtor’s assets is treated as the holder of a secured claim against those assets and retains its pre-bankruptcy priority for any distribution from those assets. If Bank holds a valid Article 9 security interest in Chapter 7 Debtor’s inventory (worth $100,000) to secure a debt of $40,000, Bank will be repaid its $40,000 from the proceeds of the inventory before any administrative expenses or general creditors are paid. In contrast, the holders of unsecured claims — general creditors without any pre-bankruptcy lien against specific assets of the debtor — receive payment only on a pro rata basis to the extent that assets remain after payment of secured claims and the expenses of bankruptcy administration.

In some cases, however, a creditor will hold an undersecured claim — a claim that is secured by a lien upon assets of the debtor that have a value less than the total balance of the creditor’s allowed claim. For example, suppose Bank holds a valid Article 9 security interest in Chapter 7

31 11 U.S.C. § 502(a) (claims deemed allowed unless party in interest objects).

32 Id. § 502(b) (if objection is filed, court must determine amount of allowed claim after notice and hearing). Section 502(b) elaborates the circumstances upon which the court must disallow a creditor’s claim; its full reach is beyond the scope of this book.

33 This general statement is subject to two caveats regarding its scope. First, while the secured party’s lien itself is respected, the bankruptcy petition stays the secured party’s nonbankruptcy remedies to enforce that lien (such as foreclosure) during the pendency of bankruptcy, as discussed in § 16.03[A] infra. Second, in certain circumstances the Code gives the trustee or the debtor the power to avoid a creditor’s security interest, either in whole or in part, in order to advance one or more of the Code’s underlying policy objectives. Section 16.04 discusses these “avoiding powers.”


35 The trustee could, however, first deduct the “reasonable, necessary costs and expenses” of preserving and disposing of the inventory to the extent those costs and expenses provided a benefit to Bank. Id. § 506(c).

36 Id. §§ 726(a), 507(b).
Debtor’s inventory (worth $40,000) to secure a debt of $100,000. Outside of bankruptcy, the creditor would be deemed to hold one legal claim against the debtor in the amount of $100,000. The Bankruptcy Code, however, “bifurcates” the claim of an undersecured creditor such as Bank. Section 506(a)(1) treats Bank’s claim as if it were two separate claims — a secured claim equal to the value of the collateral, and an unsecured claim to the extent of the deficiency balance of Bank’s claim.\(^{37}\) In this example, Bank would thus have a secured claim of $40,000 and an unsecured claim of $60,000.\(^{38}\)

Few issues have generated more controversy in bankruptcy than the proper method for determining the value of a secured party’s collateral. An item of collateral might bring different prices if sold in different contexts. For example, a car sold at a foreclosure sale on the courthouse steps might bring a $10,000 sale price. The same car might bring a price of $11,000 if sold in a dealer auction, or a price of $13,000 if sold on a retail auto sales lot. Which price reflects the car’s “value” for purposes of bankruptcy valuation?

Section 506(a)(1) does not specify one particular measure of value for all collateral valuations. Instead, section 506(a)(1) provides a flexible, case-by-case standard, under which the court should determine the value of collateral “in light of the purpose of the valuation and of the proposed

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\(^{37}\)Section 506(a)(1) literally states that an allowed claim secured by a valid lien on certain property is secured to the extent of “the value of such creditor’s interest in the estate’s interest in such property.” *Id.* § 506(a)(1). In interpreting this section, the Supreme Court has equated the quoted language with “the value of the collateral.” United Savings Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988).

\(^{38}\)In this hypothetical, the most likely scenario is that the Chapter 7 trustee will abandon the property to Bank, which will conduct an Article 9 sale of the inventory and apply the proceeds to Bank’s debt. The unsecured portion of the Bank’s claim (the portion remaining after Bank sells the inventory) will be discharged in bankruptcy following any pro rata distribution to unsecured creditors.

In limited circumstances, Chapter 7 debtors may attempt to retain an overencumbered asset (such as a house or a valuable piece of art or jewelry). For example, suppose that a Chapter 7 debtor owns a home worth $60,000 that is subject to a mortgage held by Bank securing a debt of $70,000. Debtor wishes to retain possession of her home because she fears that after bankruptcy she will be unable to obtain credit to purchase another home. Thus, Debtor continues making her monthly mortgage payments to avoid losing her home (although she is not paying any of her other debts). Under section 506(a)(1), Bank would have a secured claim for $60,000 and an unsecured claim of $10,000; further, Debtor’s liability for the unsecured claim will be discharged. Bank’s mortgage lien, however, will survive bankruptcy unaffected. Thus, if Debtor wants to avoid foreclosure of the lien following bankruptcy, Debtor will have to repay the entire mortgage balance, not just the $60,000 secured portion of Bank’s claim. Dewsnup v. Timm, 502 U.S. 410 (1992).

In Chapter 11 cases only, the Code gives the undersecured creditor an option: it can (i) allow its claim to be bifurcated under section 506(a)(1) or (ii) elect to have its entire claim treated as secured under section 1111(b), even though section 506(a)(1) would otherwise bifurcate its claim. 11 U.S.C. § 1111(b). In the example given in the text, if Bank exercises its section 1111(b) election, Bank would have a secured claim for $100,000 and no unsecured claim at all. As a result of this election, Bank would have no right to receive any pro rata distributions to unsecured creditors.
This standard suggests that the court’s determination of the collateral’s “market value” is a function of both the debtor’s proposed use of the collateral and the procedural context of the bankruptcy case. For example, if a secured party is seeking relief from the automatic stay to be permitted to foreclose on the collateral, section 506(a)(1) suggests that the court should value the collateral using the price the collateral would bring in a commercially reasonable foreclosure sale. By contrast, if a Chapter 11 debtor proposes to retain the collateral under its plan, a court evaluating the debtor’s plan should value the collateral based on its “replacement value”—i.e., the price that it would cost the debtor to purchase similar collateral in a market transaction.

As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Congress added a new section 506(a)(2), which mandates valuation based on “replacement value” as to individual Chapter 7 and Chapter 13 debtors. Section 506(a)(2) provides as follows:

If the debtor is an individual in a case under chapter 7 or 13, [the value of] personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean 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.

§ 16.03 The Automatic Stay

[A] Nature and Scope

Outside of bankruptcy, creditors can resort to their ordinary collection remedies upon the debtor’s default. The filing of a bankruptcy petition, however, automatically triggers the stay authorized by section 362(a), which enjoins creditors from exercising their ordinary remedies to

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39Id. § 506(a).


41See infra § 16.03[B] (valuation in context of motions for relief from automatic stay).


4311 U.S.C. § 506(a)(2). For further discussion of the impact of section 506(a)(2) in the Chapter 7 context, see infra § 16.08 (valuation in context of Chapter 7 debtor’s redemption of collateral).
enforce or collect debts that arose prior to the bankruptcy petition. Under section 362(a), the filing of a bankruptcy petition means that a creditor legally may not engage in any of the following customary collection activities: filing suit to collect a pre-bankruptcy debt; prosecuting a previously filed suit to collect a pre-bankruptcy debt; enforcing a judgment obtained prior to bankruptcy; attaching, levying upon, or repossessing property of the bankruptcy estate; obtaining, perfecting, or enforcing a lien or security interest in property of the debtor or the bankruptcy estate; or taking any other action “to collect, assess, or recover” a pre-bankruptcy debt (including setting off a mutual debt owed to the debtor). Section 362(a) defines the scope of the stay in such broad and sweeping terms that dunning letters, phone calls to the debtor, and even polite requests for payment must stop once the debtor files its bankruptcy petition. Once the debtor files a bankruptcy petition, creditors “may continue to breathe, eat and sleep and are free to dream about the debtor,” but cannot do anything else with regard to the debtor unless that action falls within the limited and exclusive set of exceptions specified in section 362(b).

What happens when a creditor violates the automatic stay? Generally speaking, the debtor is unaffected; creditor actions taken in violation of the automatic stay are void. A creditor cannot

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44 11 U.S.C. § 362(a). The stay is self-executing; it arises automatically upon the filing of the bankruptcy petition, without any action by the debtor or the bankruptcy court.

45 Id. § 362(a)(1).

46 Id.

47 Id. § 362(a)(2).

48 Id. § 362(a)(3).

49 Id. § 362(a)(4), (5).

50 Id. § 362(a)(6), (7). The Supreme Court has held, however, that while a bank may not effect a setoff of the debtor’s bank account without obtaining relief from the stay, a bank can place an “administrative freeze” on a debtor’s bank account — thereby preventing any disbursements from the account — without violating the stay. Citizens Bank of Md. v. Strumpf, 516 U.S. 16 (1995).


52 Section 362(b) allows the commencement or continuation of certain actions to establish or enforce the debtor’s noncommercial obligations. See 11 U.S.C. §§ 362(b)(1) (criminal proceedings against debtor); 362(b)(2) (actions to establish paternity or orders for alimony, maintenance or support); 362(b)(4) (actions by governmental units to enforce police or regulatory power); 362(b)(9) (governmental tax audits and issuance of tax deficiency notices). Section 362(b)(10) permits a landlord of nonresidential land to repossess the land from the debtor if the lease has expired. Finally, section 362(b)(3) permits a secured party to perfect a lien against property of the estate (such as by filing an Article 9 financing statement) after the petition date — notwithstanding the stay prohibitions in section 362(a)(4)-(5) — in two limited circumstances that will be discussed in conjunction with the trustee’s avoiding powers in § 16.04[B] and § 16.04[E] infra.

53 Easley v. Pettibone Michigan Corp., 990 F.2d 905 (6th Cir. 1993) (post-petition filing of lawsuit against debtor); In re Schwartz, 954 F.2d 569 (9th Cir. 1992) (post-petition IRS tax assessment); In re Ward, 837
argue that its actions should be given effect because it lacked notice or knowledge of the debtor’s bankruptcy filing; actions that violate the stay are void even if the creditor honestly was unaware of the bankruptcy filing. Furthermore, creditors that knowingly violate the stay face potentially serious financial consequences. Under section 362(h), an individual that suffers injury as a result of a willful violation of the stay can recover actual damages (including costs and attorneys’ fees). In addition, section 362(h) authorizes the award of punitive damages for willful stay violations that involve egregious or outrageous conduct. Unless the bankruptcy court terminates or modifies the effectiveness of the stay, it remains in effect until the bankruptcy case is closed or dismissed, or until the debtor receives its discharge, whichever first occurs. Further, the stay remains in effect to

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54 11 U.S.C. § 362(h). On its face, section 362(h) limits the availability of damages to an “individual” injured by a willful stay violation. The majority of circuit courts has interpreted this provision literally and has refused to award damages or fees to corporate debtors. In re Spookyworld, Inc., 346 F.3d 1 (1st Cir. 2003); In re Just Brakes Corp. Sys., Inc., 108 F.3d 881 (8th Cir. 1997); Jove Engineering, Inc. v. I.R.S., 92 F.3d 1539 (11th Cir. 1996); In re Goodman, 991 F.2d 613 (9th Cir. 1993); In re Chateaugay Corp., 920 F.2d 183 (2d Cir. 1990). A few courts, however, have held that section 362(h)’s reference to “individual” debtors was likely a drafting error by Congress and have awarded damages or fees to corporate debtors. In re Atlantic Business and Community Corp., 901 F.2d 325 (3d Cir. 1990); Budget Serv. Co. v. Better Homes of Va., Inc., 804 F.2d 289 (4th Cir. 1986).

Courts have also disagreed as to whether the trustee can recover damages and fees under section 362(h). Compare In re Pace, 67 F.3d 187 (9th Cir. 1995) (no; trustee not an “individual”) with In re Garofalo’s Finer Foods, Inc., 186 B.R. 414 (N.D. Ill. 1995) (yes; trustee is an “individual”). Even if the trustee cannot recover damages and fees under section 362(h), however, the court retains discretion to award the trustee costs and attorneys’ fees under its power to sanction contempt as articulated in 11 U.S.C. § 105(a). In re Pace, 67 F.3d 187 (9th Cir. 1995); In re Lickman 297 B.R. 162 (Bankr. M.D. Fla. 2003).

55 See, e.g., In re Wagner, 74 B.R. 898 (Bankr. E.D. Pa. 1987) (secured party burst into debtor’s home, extinguished lights, held finger to debtor’s head and threatened to “blow [debtor’s] brains out” unless debtor repaid debt). Such egregious examples are easy, but some bankruptcy courts have also awarded punitive damages for creditor activity that posed no such physical threats. See, e.g., In re Shade, 261 B.R. 213 (Bankr. C.D. Ill. 2001) (secured party representative accosted debtor in courthouse following initial meeting of creditors and repeatedly demanded payment of secured party’s claim, reducing debtor to tears; court awarded $9,000 in punitive damages); In re Cepero, 226 B.R. 595 (Bankr. S.D. Ohio 1998) (secured party disposed of repossessed automobile after receiving repeated phone calls advising that debtor had filed bankruptcy petition and requesting return of the automobile; court awarded $12,000 in punitive damages); In re Miller, 200 B.R. 415 (Bankr. M.D. Fla. 1996) (creditor continued sending dunning letters and phone calls to couple following Chapter 7 petition in effort to collect $770 claim; court awarded $10,000 in punitive damages).

enjoin actions against any asset that is property of the bankruptcy estate for as long as that asset remains a part of the bankruptcy estate.\textsuperscript{57}

By halting all external collection efforts, the stay essentially forces creditors to resolve their claims against the debtor through the collective bankruptcy process, under the supervision of the bankruptcy court. The injunctive nature of the stay thus helps to promote the key objectives of the bankruptcy process: to provide the debtor with a “breathing spell” during which the debtor can arrange a plan for its reorganization or its orderly liquidation without undue pressure or harassment from creditors,\textsuperscript{58} and to preserve the assets of the bankruptcy estate for equitable distribution to similarly situated creditors.\textsuperscript{59}

[B] Relief from Stay

In adopting a broad, self-executing stay, Congress recognized that there would be situations in which a creditor’s interest in carrying out an otherwise stayed action (e.g., repossession and foreclosure of collateral) would outweigh the interests of the estate or the debtor in having the stay remain in effect. Congress thus provided a mechanism to allow the court, at the request of an affected creditor, to grant relief from the automatic stay to permit that creditor to act in a manner otherwise forbidden by section 362(a).\textsuperscript{60} The Bankruptcy Code sets forth two standards for relief from the stay that are relevant to Article 9 secured parties: section 361(d)(1), which entitles a creditor to relief for “cause,” and section 362(d)(2), which entitles a creditor to relief if the debtor has no equity in the collateral and the collateral is not necessary for the debtor’s effective reorganization.\textsuperscript{61}

\textsuperscript{57}Id. § 362(c)(1). During the case, property of the estate remains in the estate unless it is liquidated, abandoned under section 554, or the debtor can and does claim the property as exempt under section 522. In reorganization cases, confirmation of a plan of reorganization vests title to property of the estate in the reorganized debtor. Id. §§ 1141(b) (Chapter 11); 1227(b) (Chapter 12); 1327(b) (Chapter 13).


\textsuperscript{60}Section 362(d) specifies four types of relief that the bankruptcy court might order. First, the court could terminate the stay, permitting a creditor to begin or resume its collection efforts, but without validating any prior actions taken in violation of the stay. Second, the court could annul the stay, thereby validating any prior actions taken in violation of the stay. Third, the court could modify the stay, permitting a creditor to take a particular action but otherwise leaving the stay in place with respect to other actions (e.g., allowing the creditor to reduce an unliquidated claim to judgment in state court, but not allowing any execution upon that judgment). Fourth, the court could condition the continued effectiveness of the stay upon some action by the trustee or the debtor (e.g., allowing the stay to remain in effect upon the condition that the debtor file its reorganization plan within 30 days).

\textsuperscript{61}11 U.S.C. § 362(d). Section 362(d) also provides two other grounds for relief from stay applicable to real estate mortgagees. Section 362(d)(3) permits relief from the stay to certain real estate mortgagees in cases involving “single asset real estate.” Section 362(d)(4) permits relief from stay to real estate mortgagees

Section 362(d)(1) provides that the court shall grant a creditor relief from the stay if that creditor demonstrates “cause, including the lack of adequate protection of an interest in property” held by that creditor. 62

[a] Lack of adequate protection

The most frequently litigated ground in lifting the automatic stay for “cause” involves an allegation by a creditor that its interest in the debtor’s property is not being “adequately protected.” Because an unsecured creditor has no interest in any specific assets of the debtor, relief for lack of adequate protection is limited to creditors with valid and enforceable interests in specific assets of the debtor under nonbankruptcy law (such as Article 9 secured parties).

[i] Preserving the value of the secured party’s encumbrance

Outside of bankruptcy, a secured party could repossess its collateral from the debtor after default, liquidate the collateral in compliance with applicable law, recover the collateral’s value as of the date of the sale, and apply that amount to the underlying debt. By preventing the creditor from repossessing and selling the collateral — and by allowing the trustee or DIP to retain and use the collateral 63 — the stay imposes upon the secured party a risk that its collateral may depreciate during the pendency of the bankruptcy case. This depreciation could result from ordinary fluctuations in the value of the collateral, 64 from use of the collateral that physically exhausts the collateral’s economic value, 65 or from damage to or destruction of the collateral in an uninsured casualty. This risk of depreciation during bankruptcy poses a serious threat to the secured party. For example, assume that Bank holds a valid lien upon Debtor’s car to secure a $5,000 debt. Debtor files a Chapter 11 petition, and on the petition date, the car’s value is $5,000. During the Debtor’s bankruptcy, however, the debtor’s continued operation of the car will cause it to depreciate (for the sake of this example, assume that this depreciation can be measured at $150 per month). This depreciation would be of no consequence if Debtor could repay Bank the full $5,000 balance of the debt — but as Debtor is insolvent, full repayment is unlikely. Indeed, Debtor theoretically could

in cases in which the debtor’s petition is part of a scheme to hinder, delay, or defraud creditors that involves either transfer of the mortgaged property without the mortgagee’s consent or repetitive bankruptcy petitions.

62 Id. § 362(d)(1).

63 Under section 363(d), the trustee generally may use property of the estate in the ordinary course of business, without notice or hearing. The debtor in possession in a Chapter 11 case, or the debtor in a Chapter 12 or 13 case, also has the powers of a trustee under section 363(d). Id. §§ 1107(a), 1203, 1303.

64 For example, inventory might decrease in value due to functional or stylistic obsolescence.

65 For example, by driving a car 2,000 miles per month during the pendency of the bankruptcy, Debtor would exhaust some portion of the car’s useful life.
remain in Chapter 11 for twelve months, fail to reorganize successfully, and then convert to a
Chapter 7 liquidation. During that twelve months, the car would depreciate in value by $1,800 —
by which time the car would bring a sale price of only $3,200. Debtor’s post-petition use of the car
thus creates a threat that Bank — which could have recovered its claim in full but for the automatic
stay — will instead recover only a portion of its original secured claim. In this circumstance,
Debtor’s use of the car means that Bank’s security interest in the car is not adequately protected.

Congress provided a mechanism for a secured party such as Bank to protect itself from the risk
of depreciation during the pendency of bankruptcy. Because “cause” for relief from the stay includes
“lack of adequate protection,” Bank can request that the bankruptcy court terminate the stay and
allow Bank to foreclose on its security interest immediately, or condition any continuation of the stay
upon Debtor’s providing “adequate protection” of Bank’s security interest.66 Once Bank makes this
request,67 Debtor must either provide Bank with adequate protection of its security interest or
surrender the collateral to the secured party; if Debtor does neither, the bankruptcy court must lift
the stay and permit Bank to pursue its nonbankruptcy remedies.

The trustee/DIP enjoys some flexibility under the Bankruptcy Code in how to provide adequate
protection of a secured party’s interest. The trustee/DIP can provide adequate protection by any
action that eliminates the risk that continuation of the stay will impose a depreciation loss upon the
secured party.68 As a result, it is perhaps easiest to think of adequate protection as being similar to
“insurance” against depreciation in the collateral. To provide adequate protection of a secured
party’s interest in collateral, the trustee/DIP must ensure that the value of the secured party’s
collateral (either the original collateral or some substitute collateral) is preserved or that the secured
party is compensated for any depreciation that occurs. Section 361 provides an illustrative list of the
ways in which the trustee/DIP might provide adequate protection:

• Cash payments. If the estate has sufficient unencumbered funds, the trustee/DIP can make cash
payments to the secured party in an amount necessary to offset the expected depreciation in the
collateral’s value. The secured party would apply these payments to reduce the debt, thereby
maintaining the value of the collateral relative to the underlying debt.69

66 Although section 363(d) authorizes the trustee to use a secured party’s collateral in the ordinary course
of business, section 363(e) provides that, upon the secured party’s request, the court may prohibit or
condition the trustee’s use of the collateral “as is necessary to provide adequate protection” of the secured
party’s interest in the collateral.

67This request is typically made by way of a pleading filed with the bankruptcy court and entitled either
“Motion to Lift Stay” or “Motion for Adequate Protection.”

68Thus, for example, if the debtor has allowed casualty insurance upon the collateral to lapse, adequate
protection requires that the trustee/DIP insure the collateral up to its then-current value, and failure to do so
justifies relief from the automatic stay. In re Jones, 189 B.R. 13 (Bankr. E.D. Okla. 1995); In re Hancock,

• **Replacement lien.** If the estate has equity in another asset and the equity in that asset exceeds the anticipated depreciation of the collateral, the trustee can grant the secured party a lien upon that other asset.\(^\text{70}\)

• **The “Indubitable Equivalent.”** The trustee can provide any other form of relief that will provide the secured party with the “indubitable equivalent” of its interest in the collateral.\(^\text{71}\)

Although the term “indubitable equivalent” is vague,\(^\text{72}\) it definitely includes the existence of an “equity cushion,” meaning any surplus value (i.e., equity) in the collateral over and above the balance of the debt. For example, assume that Bank holds a security interest in Debtor’s car to secure repayment of a debt in the amount of $5,000. If Debtor’s car had a value of $9,000 on the petition date, Bank would have a $4,000 equity cushion (the car’s excess value relative to the $5,000 debt). Even if Debtor remained in bankruptcy for a full year, and the car depreciated by $150/month throughout that period, Bank would still remain fully secured; thus, as of the petition date, Debtor’s use of the car does not seriously threaten the Bank’s security interest in the car.\(^\text{73}\) Under those circumstances, the court properly should refuse to grant Bank relief from the stay, because the equity cushion provides adequate protection for Bank’s security interest.\(^\text{74}\)

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\(^\text{70}\) *Id.* § 361(2).

\(^\text{71}\) *Id.* § 361(3).

\(^\text{72}\) The phrase “indubitable equivalent” comes from an opinion by Judge Learned Hand in *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), where Judge Hand used the term “most indubitable equivalence” in attempting to explain the parameters of the term “adequate protection” as it was used under the Bankruptcy Act of 1898.

\(^\text{73}\) This statement assumes that the debtor continues to maintain adequate insurance on the car to protect against a casualty loss. If the debtor failed to maintain adequate insurance on the car, the secured party would lack adequate protection and could obtain relief from the automatic stay. *See, e.g., In re Paradise Boat Leasing Corp.*, 2 B.R. 482 (Bankr. D.V.I. 1979).

\(^\text{74}\) *In re Mellor*, 734 F.2d 1396 (9th Cir. 1984); *In re Colonial Ctr.*, Inc., 156 B.R. 452 (Bankr. E.D. Pa. 1993); *In re Shaw Industries*, Inc., 300 B.R. 861 (Bankr. W.D. Pa. 2003); *In re Steffens*, 275 B.R. 570 (Bankr. D. Colo. 2002). Over time, of course, depreciation of the collateral would eventually consume the equity cushion. Once the equity cushion is consumed and the secured party is no longer oversecured, the secured party could again request adequate protection of its interest. Thereafter, the trustee would have to provide adequate protection sufficient to satisfy sections 361-363.

Occasionally, creditors have tried to argue that the debtor must adequately protect the equity cushion itself — i.e., that the court must preserve the equity cushion at its bargained-for size. One could argue that, as an economic matter, the creditor that bargained for the security of an equity cushion may have agreed to accept a lower interest rate or may have made other concessions in return, such that protection of the equity cushion is necessary to provide the creditor with the assurance of its bargain. Courts, however, have generally rejected arguments that the trustee/DIP must provide adequate protection of the equity cushion itself. *See, e.g., In re Hanna*, 912 F.2d 945 (8th Cir. 1990); *In re Senior Care Properties*, Inc., 137 B.R. 527 (Bankr. N.D. Fla. 1992); *In re Lane*, 108 B.R. 6 (Bankr. D. Mass. 1989).
[ii] The problem of lost opportunity costs

When the debtor files for bankruptcy, it typically ceases making payments on its debts. The consequence is that any creditor holding a claim against the debtor is not collecting the interest that would otherwise accrue under the pre-bankruptcy agreement and applicable nonbankruptcy law. Outside of bankruptcy, of course, a secured party could repossess its collateral following default, liquidate the collateral, apply the proceeds to the debt, and then reinvest those proceeds in some alternative investment opportunity that would produce a return — e.g., it could re-loan the proceeds to a solvent borrower capable of paying interest. By preventing the secured party from pursuing this course of action, the stay imposes a lost opportunity cost upon the secured party. Further, as discussed earlier, bankruptcy law generally compounds this burden by disallowing claims for unmatured interest.\footnote{See § 16.02[B] supra.}

For some secured creditors, Bankruptcy Code section 506(b) partially mitigates this effect of the automatic stay. Section 506(b) provides that an oversecured creditor — i.e., a creditor with collateral that has a value exceeding the balance of its allowed claim — may collect interest upon its secured claim, up to (but not beyond) the total value of the collateral.\footnote{11 U.S.C. § 506(b). If the trustee/debtor does not pay this interest to the oversecured creditor during the pendency of the bankruptcy stay, the unpaid interest accrues and is added to the creditor’s secured claim.} But what about undersecured creditors? On the one hand, section 506(b) by its terms includes only oversecured creditors; thus, one can argue, by negative implication, that Congress did not intend for undersecured creditors to receive interest upon their secured claims.\footnote{Justice Scalia relied upon this argument in rejecting the undersecured creditor’s right to collect interest under the guise of “adequate protection” in United Savings Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988), discussed below.} On the other hand, outside of bankruptcy, an undersecured creditor could have used its state law security interest to liquidate the collateral following default and reinvest the proceeds in some alternative interest-bearing investment. Thus, one could also argue that the creditor’s right to immediate foreclosure upon default is an “interest in property” that is not adequately protected unless the creditor receives interest upon the secured portion of its claim during the pendency of the stay. During the 1980s, this debate generated a significant body of case law regarding whether “adequate protection” required the trustee to pay post-petition interest on undersecured claims. A significant number of bankruptcy court decisions held that adequate protection did require the payment of post-petition interest.\footnote{See, e.g., In re American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984) (collecting cases).}

When the issue finally reached the Supreme Court in United Savings Ass’n of Texas v. Timbers of Inwood Forest Associates, Ltd.,\footnote{484 U.S. 365 (1988).} the Court concluded that undersecured creditors were not
Commentators have criticized the *Timbers* decision both for its economic premises and its method of statutory interpretation, but the Court’s subsequent bankruptcy decisions have never questioned *Timbers*. Accordingly, *Timbers* stands for the proposition that the trustee/DIP must provide “adequate protection” only in cases where the risk of depreciation in the value of the collateral poses a threat to the secured party’s overall secured position.

[b] Other cause for relief

Section 362(d)(1) does not limit “cause” for relief from the automatic stay only to those circumstances presenting lack of adequate protection. Instead, the bankruptcy court has the discretion to grant relief from the stay in other circumstances where the harm caused by the stay outweighs the benefit to the estate and the debtor from continuing the stay’s effectiveness. Thus, courts have terminated the stay upon concluding that a debtor had filed its bankruptcy petition in bad faith or in a clear attempt to abuse the bankruptcy process. An illustrative example is *In re Dixie Broadcasting, Inc.*, where the debtor had entered into a contract to sell a radio station but later reneged when it received a better offer from another prospective purchaser. When the contract vendee sued for specific performance, the debtor filed a Chapter 11 petition to prevent the state court from ordering specific performance. The court granted the vendee’s motion to lift the stay, and the Eleventh Circuit affirmed, stating that “[t]he Bankruptcy Code is not intended to insulate financially

80 *Timbers*, 484 U.S. at 372-73 (citations omitted).


82 Justice Scalia’s statement that there is no express statutory authority for the payment of interest to undersecured creditors is dubious in light of the “indubitable equivalent” language of section 361(3). In economic terms, part of the “indubitable equivalent” of a secured party’s interest in collateral is the interest that the secured party could earn upon liquidation of the collateral and reinvestment of the proceeds.

secure sellers or buyers from the bargains they strike.”

Likewise, courts have lifted the stay against pending litigation based upon the conclusion that the litigation would be more appropriately resolved in a forum other than the bankruptcy court.


Under section 362(d)(2), a secured party can obtain relief from the stay in order to repossess and foreclose upon its collateral if “the debtor does not have an equity” in the collateral and the collateral “is not necessary to an effective reorganization.” If these grounds for relief are present, then relief from the stay is both necessary and appropriate; under such circumstances, neither the debtor nor general creditors will benefit if the collateral remains property of the estate.

[a] Does debtor have equity in the collateral?

For purposes of section 362(d)(2), the debtor has no “equity” in an asset if the sum of all encumbrances on that asset exceeds the value of the asset. To make this determination, of course, the bankruptcy court must determine the value of the collateral. The Bankruptcy Code does not specify a particular method of appraisal. Typically, the interested parties (usually the party seeking relief from stay and the trustee/DIP) present evidence regarding the value of the collateral, sometimes in the form of expert testimony. The bankruptcy court considers this evidence and makes a determination of the collateral’s value “in light of the purpose of the valuation and of the collateral’s proposed disposition or use,” with the burden of persuasion placed upon the party seeking relief from the stay.

If the court’s valuation reflects that the debtor does have equity in the collateral, the secured party’s motion for relief from the stay under section 362(d)(2) must be denied.

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84 Id. at 1028.

85 For example, the Fourth Circuit has suggested that the court can consider lifting the stay where the issues involved in pending litigation involve only state law such that the expertise of the bankruptcy court is unnecessary, and where modifying the stay to permit litigation to proceed in state court would promote judicial economy. In re Robbins, 964 F.2d 342 (4th Cir. 1992). See also In re MacDonald, 755 F.2d 715 (9th Cir. 1985) (bankruptcy court lifted stay to permit pursuit of state court spousal-support modification, in deference to state court expertise regarding family law matters); Garland Coal & Mining Co. v. United Mine Workers of Am., 778 F.2d 1297 (8th Cir. 1985) (bankruptcy courts ordinarily should lift stay to allow resolution of labor disputes through arbitration).

86 11 U.S.C. § 362(d)(2). In a liquidation proceeding under Chapter 7, the debtor is not contemplating any reorganization; thus, only the first ground (lack of equity) is relevant.

87 In re Indian Palms Assocs., Ltd., 61 F.3d 197 (3d Cir. 1995); In re Sutton, 904 F.2d 327 (5th Cir. 1990); Stewart v. Gurley, 745 F.2d 1194 (9th Cir.1984); In re Hurst, 212 B.R. 890 (Bankr. W.D. Tenn. 1997).


— as it should be, because the purpose of the stay is to protect that equity for the benefit of general creditors and the debtor’s potential reorganization.

Section 506(a)(1) requires the court to value the collateral “in light of the purpose of the valuation and of the collateral’s proposed disposition or use.” The proper interpretation of this language has generated significant litigation in the bankruptcy courts, with significant disagreement among different courts. Perhaps the best example of the divergent judicial views has involved the valuation of vehicles. For example, suppose Debtor owns an automobile subject to a properly perfected security interest in favor of Bank, securing Debtor’s obligation to Bank in the amount of $10,000. Debtor files a Chapter 13 petition and wants to retain the automobile. This particular make and model of automobile has a “bluebook” retail value of $12,000 and a “bluebook” wholesale value of $9,900. In the context of a motion to lift the stay, should the court value Debtor’s automobile at its retail value (leaving Debtor with equity in the automobile) or at its wholesale value (leaving Debtor with no equity)?

Prior to 1997, courts generally followed one of three approaches to this question. A significant number of courts argued that if a debtor proposed to retain an automobile as a part of its reorganization, the court should value the auto at its “going concern” or “retail” value. Many other courts argued that the court should value the automobile at its “wholesale” or “liquidation” value, on the theory that such a valuation more readily reflects the amount that a secured party like Bank would obtain if it foreclosed upon the automobile. Yet other courts took a third, intermediate approach, holding that courts should value the automobile at the average of its retail and wholesale values.

In 1997, the U.S. Supreme Court addressed this issue in *Associates Commercial Corp. v. Rash*. In *Rash*, the debtor proposed to retain a tractor-trailer truck to use in his Chapter 13 reorganization efforts. The Fifth Circuit affirmed the bankruptcy court’s valuation of the truck at its “net foreclosure value” (i.e., its liquidation value) rather than its “going concern” value.

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90It is more accurate to ask “which measure should be the *starting point*” for the court’s valuation. Obviously, if the auto is in below-average condition and in need of repair, the court should reduce the value of the auto below its “bluebook” value accordingly. In contrast, if the auto has low mileage and is generally in excellent condition, the court should increase the value of the auto above its “bluebook” value.

91*E.g., In re Trimble*, 50 F.3d 530 (8th Cir. 1995) (value of automobile properly based upon retail value, without deduction for costs of sale).


93*E.g., In re Hoskins*, 102 F.3d 311 (7th Cir. 1996).


95*Rash*, 90 F.3d 1036, 1044 (5th Cir. en banc 1996) (“[T]he creditor’s interest is in the nature of a security interest, giving the creditor the right to repossess and sell the collateral and nothing more…. [T]he valuation should start with what the creditor could realize by exercising that right.”).
margin, the Supreme Court reversed and remanded, holding that where the debtor proposed to retain the collateral in a Chapter 13 case, section 506(a) required the court to value the collateral at its “replacement value” — that is, “the price a willing buyer in the debtor’s trade, business, or situation would pay to obtain like property from a willing seller.”

Justice Ginsburg’s opinion suggests that this replacement-value measure is appropriate based upon the risks presented to the secured party when the debtor proposes to retain the collateral:

When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds.… 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” do not fully offset these risks. Of prime significance, the replacement-value standard accurately gauges the debtor’s “use” of the property.… The debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property’s “disposition or use.”

Just as soon as the Supreme Court “clarified” this issue by adopting the replacement-value standard, however, the Court immediately confused it again in a footnote, stating “[w]hether 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.”

The Court’s point is a legitimate one — although some debtors could only obtain a replacement vehicle through a retail dealer, other debtors could acquire a replacement vehicle at a wholesale price (such as through a private auto auction). For this latter type of debtor, “replacement value” should mean wholesale value. Furthermore, the Court also noted that even where retail value is the appropriate starting point for valuation, the court could make an appropriate downward adjustment to the value to account for the fact that the typical retail price would include some items — like warranties and reconditioning expenses — that “the debtor does not receive when he retains his vehicle.”

Courts struggled to interpret the Supreme Court’s footnote and (perhaps unsurprisingly) continued to reach different results. In the aftermath of Rash, many courts concluded that the “starting point” for valuing vehicles is the midpoint between the retail and wholesale bluebook

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96 Rash, 520 U.S. at 960.
97 Id. at 963 (citations and footnotes omitted).
98 Id. at 965 n.6.
100 Rash, 520 U.S. at 965 n.6.
values.\textsuperscript{101} A number of decisions, however, rejected this view as inconsistent with Rash’s admonition that valuation must occur on a case-by-case basis.\textsuperscript{102} Many of these decisions have instead concluded that where the debtor proposes to retain the vehicle, the “replacement value” generally means retail bluebook value, with a downward adjustment for items such as warranty or reconditioning costs.\textsuperscript{103}

In 2005, the BAPCPA added section 506(a)(2), quoted earlier in § 16.02[C], which applies in cases involving individual debtors in Chapter 7 or Chapter 13.\textsuperscript{104} Under section 506(a)(2), the property of these debtors must be valued at its replacement value as of the petition date, without deduction for costs of sale or marketing.\textsuperscript{105} If the individual Chapter 7 or 13 debtor acquired the property for personal, family, or household purposes, “replacement value” means the price that a retail merchant would charge for property in like condition.\textsuperscript{106}

[b] Is the collateral necessary for debtor’s reorganization?

If the court’s valuation reflects that the debtor has no equity in the collateral, the court must grant relief from the stay, unless the debtor can prove that the collateral is “necessary for an effective reorganization” of the debtor.\textsuperscript{107} To carry the burden of persuasion on this point,\textsuperscript{108} the debtor must prove two things. First, the debtor must prove that the particular item of collateral is “necessary” to the debtor’s reorganization effort. Courts have not read the term “necessary” too literally,
however, as is reflected in *In re Fields*. In the *Fields* case, the secured party sought relief from the stay against certain of the debtor’s assets, arguing that because the debtor had other assets it could use to reorganize, the secured party’s collateral was not “necessary” to the debtor’s reorganization. The court properly rejected this argument. Consider, for example, a debtor in the commercial airline business which owns airplanes, each financed with a different lender. No one plane is really necessary, under a literal reading of that term, but how many planes would have to be lost to stay litigation before the court finally had to draw the line and deny such motions because the remaining planes were necessary? Applying such a reading to “necessary” would reward impatient creditors while punishing creditors that exercised self-restraint and did not immediately seek relief from the stay. This approach would only encourage a post-petition race to seek stay relief, in direct conflict with clear bankruptcy policy that discourages such pre-petition races.

Instead, the court must consider the particular asset’s necessity in light of the kind of debtor involved and the kind of reorganization that the debtor contemplates. For example, assume that Waters’ Edge, Inc. sells clothing in its own stores and by mail order, and that it is attempting to reorganize in Chapter 11. If Waters’ Edge contemplates a reorganization plan whereby it will continue to sell its merchandise in its own retail stores, a court would consider the debtor’s trade fixtures (clothing racks, display shelving, counters, cash registers, etc.) to be “necessary” to the debtor’s contemplated reorganization. If Waters’ Edge plans to close its retail stores and sell only by mail order, however, the court would be more likely to consider the trade fixtures as unnecessary to the debtor’s reorganization.

Second, the debtor must prove that an “effective reorganization” is possible. As the Supreme Court noted in the *Timbers* decision, this requirement means that “there must be a ‘reasonable possibility of a successful reorganization within a reasonable time.’” If the debtor cannot prove that it is likely to reorganize successfully or within a reasonable period of time, the court should lift the stay — further reorganization efforts by the debtor under those circumstances will waste estate resources that could otherwise go to satisfy the claims of creditors. As a practical matter, the debtor’s burden of proof on this point becomes progressively harder for the debtor to meet the longer it remains in bankruptcy. As one court has explained:

> [I]n the initial stages of a Chapter 11 proceeding, the debtor should be granted significant leeway in attempting to establish that successful reorganization is a reasonable possibility. However, as the case progresses, so too does the debtor’s burden of proving that successful reorganization may be reasonably expected…. [T]he test should be viewed as a continuum

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110*Id.* at 152.

111*Id.* at 154.

112*Timbers*, 484 U.S. at 376 (quoting the Fifth Circuit’s *en banc* opinion in the *Timbers* case). Although the quoted statement was dicta in the *Timbers* case, bankruptcy courts, in subsequent cases, have followed this standard uniformly.
with the scales tipping in favor of the debtor in the early stages and the burden of proof becoming greater in the later stages.\textsuperscript{113}


The bankruptcy court does not order relief from the stay \textit{sua sponte}; a secured party seeking relief from the stay must file a motion with the bankruptcy court requesting that the court lift the stay. Under section 362(e)(1), the court must act upon the motion within 30 days; if not, the moving party automatically receives the requested relief. Typically, during this 30-day period, the court conducts a preliminary hearing, after which it either (a) enters an order granting or denying the requested relief, or (b) continues the stay temporarily, pending a later final hearing and determination of the motion.\textsuperscript{114} If the court continues the stay pending a final hearing, the court must conclude that final hearing within 30 days of the preliminary hearing, unless the court extends that 30-day period with the consent of the parties or based upon “compelling circumstances.”\textsuperscript{115}

In the 2005 amendments, Congress placed specific additional constraints upon the ability of most individual debtors to delay a final determination of a secured party’s motion for relief from stay. If the debtor is an individual and the case is a Chapter 7, 11, or 13 case, the stay terminates 60 days after the secured party’s motion, unless the court renders a final determination of the motion within that 60-day period or unless the 60-day period is extended by the secured party’s consent or by the court — but the court may only extend this 60-day period “for such \textit{specific} time as the court finds is required for good cause,” and the court must make specific factual findings justifying the extension.\textsuperscript{116}

The moving party bears the burden of persuasion on the issue of the debtor’s equity in the property.\textsuperscript{117} Accordingly, a secured party seeking relief from the stay under section 362(d)(2) bears the burden of persuasion as to the value of the collateral. The party opposing relief from the stay (typically the trustee/DIP) bears the burden of persuasion on all other issues, including the existence of adequate protection (or other “cause”) and the debtor’s prospects for reorganization within a reasonable time.\textsuperscript{118} In exceptional circumstances, the court can order relief from the stay without

\textsuperscript{113}\textit{In re} Ashgrove Apts. of DeKalb Cty., Ltd., 121 B.R. 752, 756 (Bankr. S.D. Ohio 1990).

\textsuperscript{114}11 U.S.C. \textsection{} 362(e)(1).

\textsuperscript{115}\textit{Id}.

\textsuperscript{116}\textit{Id.} \textsection{} 362(e)(2) (emphasis added).

\textsuperscript{117}\textit{Id.} \textsection{} 362(g)(1); \textit{In re} Dandridge, 221 B.R. 741 (Bankr. W.D. Tenn. 1998); \textit{In re} Food Barn Stores, Inc., 159 B.R. 264 (Bankr. W.D. Mo. 1993).

\textsuperscript{118}11 U.S.C. \textsection{} 362(g)(2); \textit{In re} Food Barn Stores, Inc., 159 B.R. 264 (Bankr. W.D. Mo. 1993).
notice if the party seeking relief would be “irreparably damaged” by the delay occasioned by notice and a hearing.¹¹⁹

¹¹⁹Id. § 362(f).