The Impact of the United States Supreme Court Opinion

of

UNITED STATES ASSOCIATION OF TEXAS
v.
TIMBERS OF INWOOD FOREST ASSOCIATES, LTD.
484 U.S. 365; 108 S.Ct. 626 and 98 L.Ed. 2d 740 (1998)

On the Conditioning of, and Obtaining Relief from, the Automatic Stay

Summarized

By

David J. Harris, Esquire, LLM
Wilkes-Barre, Pennsylvania

dh@lawofficeofdavidharris.com
davidharrisbankruptcylaw.com
(570) 823-9400

The Holding: The United States Supreme Court upheld the decision of Court of Appeals for the Fifth Circuit that an undersecured creditor in a reorganization case is not entitled to monthly payments for the use value of the loan collateral for which the bankruptcy stay prevented it from possessing.

The Issue: The Supreme Court granted Certiorari to determine whether undersecured creditors are entitled to compensation under Section 362(d)(1) of the Bankruptcy Code [1] for the delay caused by the automatic stay in foreclosing on their collateral.

The Facts: A bank extended a $4.1 Million loan to the debtor pre-petition to secure an apartment project. The underlying note was secured by a mortgage and an assignment of rents.

[1] [1] Unless otherwise indicated, all section references are to sections of the United States Bankruptcy Code, at Title 11 of the United States Code (the "Bankruptcy Code").

Shortly after the debtor filed a petition under chapter 11, the bank moved for relief from the automatic stay under Section 362(a) on the ground that there was lack of "adequate protection" of its interest within the meaning of Section 362(d)(1).

The bank was an undersecured creditor (i.e., the amount that it was owed exceeded the value of the apartment project property). The debtor had agreed to pay the bank the post-petition rent from the apartment project covered by the after-acquired property clause in the security agreement minus operating expenses. Notwithstanding, the bank contended that it was entitled to additional compensation.

The Bankruptcy Court ultimately conditioned the automatic stay upon the debtor's making monthly payments at a market rate of 12% per annum on the estimated amount realizable on foreclosure.

The bank appealed.

The Automatic Stay: "Adequate Protection of an Interest in Property":

When a bankruptcy petition is filed, Section 362(a) provides an automatic stay of, among other things, actions taken to realize the value of collateral given by the debtor.

Section 362(d) provides relief from the stay after notice and a hearing (1) for cause, including the lack of adequate protection of an interest in property of such party-in-interest; or (2) with respect to a stay of an act against property under Section (a) of this section if - (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization. (Author's emphasis.)

Section 361 provides that when "adequate protection" is required under Section 362, such adequate protection may be provided by:

(1) Requiring the trustee to make a cash payment or periodic cash payments . . . to the extent that the stay results in a decrease in the value of such entity's interest in such property;

(2) Providing to such entity an additional or replacement lien to the extent that such stay . . . results in a decrease in the value of such entity's interest in such property; or

(3) Granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

"Interest in property" includes the right of a secured creditor to have a security applied in payment of the debt upon completion of the reorganization. That interest is not adequately protected if the security is depreciating during the term of the stay.

Thus, it was agreed that if the apartment project in this case had been declining in value, the bank would have been entitled, under Section 362(d)(1), to cash payments or additional security in the amount of the decline, as Section 361 describes.

The Creditors's Argument and the Supreme Court's Response:

The bank argued that the phrase "interest in property" also included the secured party's right (suspended by the stay) to take immediate possession of the defaulted security and apply it in payment of the debt.

The Supreme Court acknowledged that term "interest in property" certainly summoned up such concepts as "fees, ownership," "life estate," "co-ownership," and "security interest" more readily than it did the notion of "right to immediate foreclosure."

With a very deep analysis, the Court found that Section 362(d)(1) was only one of a series of provisions in the Bankruptcy Code dealing with the rights of secured creditors.

The language in other provisions of the Bankruptcy Code persuaded the Supreme Court that "interest in property" protected by Section 362(d)(1) did not include a secured party's right to immediately foreclose.

Drawing from Other Provisions of the Bankruptcy Code:

Section 506:

Section 506 defines the amount of the secured creditor's allowed secured claim and the conditions for receiving post-petition interest.

According to the Court, a creditor's "interest in property" under Section 506(a) obviously means his security interest without taking account of his right to immediate possession of the collateral on default. Instead, the phrase "value of such creditor's interest" means "the value of the collateral."

The Court applied its logic to conclude that the phrase "value of such entity's interest" in Section 361(1) and (2) when applied to secured creditors, means the same as it does in Section 506(a).

According to the Court, Section 506 has the substantive effect of denying undersecured creditors post-petition interest on their claims - just as it denies oversecured creditors post-petition interest to the extent that such interest, when added to the principal amount of the claim, will exceed the value of the collateral.

The Court reasoned that, if the Code meant to give an undersecured creditor, who is thus denied interest on his claim, interest on the value of his collateral, surely this is where that disposition would have been set forth (i.e., in Section 506(a)), and not obscured within the "adequate protection" provision of Section 362(d)(1).

Section 522:

The Court also reasoned that the bank's interpretation of Section 362(d)(1) was inconsistent with Section 552, which states the general rule that a prepetition security interest does not reach property acquired by the estate or debtor post-petition. The exception is with respect to post-petition "proceeds, product, offspring, rents or profits" of the collateral only if the security agreement expressly provides for an interest in such property and the interest has been perfected under applicable non-bankruptcy law.

Section 552 therefore makes possession of the perfected security interest in post-petition rents or profits from collateral a condition of having them applied to satisfying the claims of the secured creditors ahead of the claims of unsecured creditors.

Under the bank's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under Section 362. According to the Court, it is true that Section 506(b) gives the oversecured creditor, despite lack of compliance with the conditions of Section 522, a similar priority over undersecured creditors; but that does not compromise the principle of Section 522, since the interest payments come only out of the "cushion" in which the oversecured creditor does have a perfected security interest.

Section 362(d)(2):

On the bank's theory, the undersecured creditors' inability to take immediate possession of his collateral would always be "cause" for conditioning the stay (upon the payment of a market rate of interest) under 362(d)(1), since there is, within the meaning of that paragraph, "lack of adequate protection of an interest in property." However, Section 362(d)(2) expressly

provides a different standard for relief from a stay "of an act against property" which of course, includes taking possession of collateral.

That section provides that the court shall grant relief "if . . . (A) the debtor does not have an equity in such property [i.e., the creditor is undersecured]; and (B) such property is not necessary to an effective reorganization. By applying the "adequate protection of an interest in property" provision of Section 362(d)(1) to the alleged "interest" in the earning power of collateral, the bank creates a strange consequence that Section 362 entitles the secured creditor to relief from the stay (1) if he is undersecured (and thus not eligible for interest under Section 506(b)), *or* (2) if he is not undersecured and his collateral "is not necessary to an effective reorganization." This, according to the Court, renders Section 362(d)(2) a practical nullity.

According to the Court, Section 362(d)(2) also belies the bank's contention that it will face inordinate and extortionate delay if it is denied compensation for interest lost during the stay as part of "adequate protection" under Section 362(d)(1), as the debtor has the burden to establish that the collateral at issue is "necessary to an effective reorganization." (See Section 362(g).) To do so, the debtor must show that the property is essential for an effective reorganization that is in prospect. Based on the opinions of numerous bankruptcy courts, this involves showing "a reasonable possibility of a successful reorganization within a reasonable time," which has frequently been held to be less than one year from the date of the filing of the bankruptcy petition. As a result, the delay issue is somewhat limited.

Sections 362(d)(1) and 1129(b)(2)(A)(iii) and the "Indubitable Equivalent":

The bank also contended it was entitled to the "indubitable equivalent," which connotes the right of a secured creditor to receive present value of his security -- thus requiring interest if the claim is to be paid over time.

In response to this argument, the Court concluded that there was no merit in the bank's suggestion that "indubitable equivalent" in Section 361(3) connotes reimbursement for the use value of collateral. It emphasized that it was obvious that the Section 362(d)(1) did not entitle a secured creditor to immediate payment of the principal of his collateral and that this "realization" is to "result" not at once, but only upon completion of the reorganization when then he must be assured of the "realization…of the indubitable equivalent" of his collateral.

Section 726(a)(5):

The bank argued lastly that denying it the right to interest on the secured element of its claim would be in conflict with Section 726(a)(5), which provides that post-petition interest is allowed on unsecured claims when the debtor proves solvent. It argued further it would be absurd to allow post-petition interest on unsecured claims, but not on the secured portion of undersecured creditors' claims.

While the Court acknowledged that this was a true anomaly, it noted that the harsh result would rarely occur and that issue would be alleviated since an undersecured creditor is entitled to surrender or waive his security and submit his entire claim as an unsecured one pursuant to *United States Nat. Bank v. Chase Nat. Bank*, 331 U.S. 28, 34, 67 S. Ct. 1041, 1044, 91 L.Ed. 1320 (1947). Section 726(a)(5) therefore requires no more than that undersecured creditors receive post-petition interest from a solvent debtor on equal terms with unsecured creditors rather than ahead of them which, where the debtor is solvent, involves no hardship.

Takeaway Points from the Timbers of Inwood Forest Opinion:

1. An undersecured creditor in a reorganization case is not entitled to monthly payments for the use value of the loan collateral for which the bankruptcy stay prevented it

from possessing. In other words, an undersecured creditor is not entitled to interest on its collateral during the stay to assure adequate protection under Section 362(d)(1).

2. It behooves a creditor seeking relief from the automatic stay to explore and apply all provisions of Section 362 when seeking relief from, or seeking a condition to the continuation of, the automatic stay. Here, the bank never sought relief from the stay under Section 362(d)(2) or on a ground other than lack of adequate protection. It may have been better avenues for the relief than under Section 362(d)(1).
3. Statutory construction of a Bankruptcy Code provision is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.