

## A Primer on Adequate Protection – Under Section 361 of the Bankruptcy Code

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The entitlement of a creditor to receive adequate protection under Bankruptcy Code Section 361 is a far-reaching right that stems from equitable principles. In effect, a debtor in possession or trustee is seeking permission to use property in which a creditor has a security interest. In order to compensate the creditor and to provide "adequate protection" for the debtor's use of the collateral, Section 361 stipulates that adequate protection may be provided by a variety of means, including cash payments, additional or replacement liens, or any such other relief which constitutes the "indubitable equivalent" of the creditor's interest in the property.

This article provides a preliminary analysis of those types of covenants and terms which courts have, and have not, found to constitute adequate protection. As a general rule, courts exercise flexibility in determining whether adequate protection has been provided under the "indubitable equivalent" language in § 361(3). No pre-determined formula for ascertaining adequate protection is typically applied; instead, each case is addressed based on its individual facts.

### 1. Overview

The legislative history of adequate protection clearly provides that "secured creditors should not be deprived of the benefit of their bargains." H.R. Rep. No. 595 at 339, 1978 U.S. Code Cong. & Adm. News at 6295. Sections 362, 363 and 364 of the Code permit parties to request that the court determine whether the secured creditor's interest in property is adequately protected when the trustee or debtor in possession is using, selling, leasing (§ 363) or borrowing against the property (§ 364), or when the entity is otherwise stayed from enforcing its interest (§ 362). These sections do not authorize the court to impose adequate protection. Instead, they furnish a mechanism by which parties may agree on appropriate protection, the entity may request particular protection, or the trustee or debtor in possession may propose protection that it believes is adequate. Any such agreement is subject to court approval; absent an agreement, the court must determine whether the protection is adequate. Fed. R. Bankr. P. 4001.

Section 361 delineates three methods by which adequate protection may be provided: (1) cash payment or periodic cash payments to the extent that the use under Section 363 results in a decrease in the value of an entity's interest in such property; (2) additional or replacement liens to the extent that such use results in a decrease in the value of an entity's interest in such property; and (3) such other relief as will result in the realization of the "indubitable equivalent" of the creditor's interest.<sup>1</sup>

These methods are not mandatory, but rather suggestions of how adequate protection may be provided. In *re Sheehan*, 38 B.R. 859, 864 (Bankr. S.D. 1984). Furthermore, the concept of adequate protection must be determined on a case by case basis and allows "maximum flexibility in structuring a proposal for adequate protection." *In re Martin*, 761 F.2d 472, 474 (8th Cir. 1985) (quoting *In re Am. Mariner Indus., Inc.*, 734 F.2d 426, 435 (9th Cir. 1984)).

Although different courts have utilized various methods in determining whether the protection offered is sufficient, the Eighth Circuit set forth a widely-cited general test. In *In re Martin*, 761 F.2d 472 (8th Cir. 1984), the court identified three steps to be followed when undertaking an "adequate protection" analysis:

- (1) establish the value of the secured creditor's interest, (2) identify the risks to the secured creditor's value resulting from the debtor's request for use of cash collateral, and (3) determine whether the debtor's adequate protection proposal protects value as nearly as possible against the risks to that value consistent with the concept of indubitable equivalence.

*Id.* at 477.<sup>2</sup>

Finally, with respect to the issue of adequate protection, the rule is well-settled that the debtor in possession or trustee bears the burden of proof. *In re Bradley*, 3 B.R. 313 (Bankr. E.D. Va. 1980); *In re Riviera Inn of Wallingford, Inc.*, 7 B.R. 725 (Bankr. D. Conn. 1980).

In general, caselaw offers no rule of thumb to determine whether a covenant is a measure of adequate protection alone, or whether several covenants in the aggregate may furnish adequate protection. *First Bank of Miller v. Wieseler*, 45 B.R. 871, 874-75 (D.S.D. 1985).

## 2. Covenants Which May Provide Adequate Protection Either Alone Or In Conjunction With Other Provisions

Courts have held that the following covenants may contribute to a finding of adequate protection, either alone or in concert:

- a. Requiring defendants to subject all cash collateral to segregation and an accounting (*In re Anchorage Boat Sales, Inc.*, 4 B.R. 635 (Bankr. E.D.N.Y. 1980));<sup>3</sup>
- b. Requiring defendants to pay and bring all taxes and assessments current, and keep them current, since taxes involved were a prior lien to plaintiff's first deed of trust (*In the Matter of Pleasant Valley, Inc.*, 6 B.R. 13, 17 (Bankr. D. Nev. 1980));
- c. Requiring defendants to keep and maintain insurance coverage, and requiring delivery of insuring certificates of coverage to plaintiffs' counsel showing plaintiffs as beneficiaries (*In the Matter of Pleasant Valley, Inc.*, 6 B.R. 13, 17 (Bankr. D. Nev. 1980));
- d. Requiring defendants' execution and delivery to the plaintiffs of a deed of trust on a piece of real property, further securing the balance of the principal and interest due plaintiffs (*In the Matter of Pleasant Valley, Inc.*, 6 B.R. 13, 17 (Bankr. D. Nev. 1980));
- e. Requiring defendants to pay a monthly interest payment at the present rate of accrual (not a default interest rate) (*In the Matter of Pleasant Valley, Inc.*, 6 B.R. 13, 17 (Bankr. D. Nev. 1980)); *cf. In re Colrud*, 45 B.R. 169 (Bankr. D. Ala. 1984) (increasing the interest rate on a loan from 6 percent to a 10.5 percent because 10.5 percent represented the rate that the creditor would have received on any deficiency judgment had he been allowed to foreclose, and because creditor would be forced to sell his precious metal holdings at a loss); *see also In re Cooper*, 11 B.R. 391, 394 (Bankr. N.D. Ga. 1981) (refusing to lower interest rate to rate that lender itself might be charged, as lender was a "colossal financial institution" with superior credit and able to borrow at lower rates);
- f. Requiring debtor to continue paying monthly mortgage payments (*In re Stuart Motel, Inc.*, 8 B.R. 50, 52 (Bankr. S.D. Fla. 1980));
- g. Requiring debtor to remove liens that impaired the homestead exemption, where such removal was necessary to provide adequate protection to a secured creditor with a mortgage on debtor's property (*In the Matter of Polvino*, 4 B.R. 677, 679 (Bankr. W.D.N.Y. 1980));
- h. Requiring debtor to cure all arrearages as to a debtor's pizza parlor, and also requiring the advance payment of 60-days of rent (*In re Borbridge*, 66 B.R. 998 (Bankr. E.D. Pa. 1986));
- i. Requiring debtor to submit copies of bank statements and financial reports to the creditor on a periodic basis (*In re Dahlquist*, 34 B.R. 476 (Bankr. D.S.D. 1983)); *cf. In re Swedelande Dev. Group, Inc.*, 16 F.3d 552 (3d Cir. 1994) (debtors' obligation to supply creditor with regular reports was not a substitute for the statute's more concrete protections, since creditor could not convert reports into cash);
- j. Principal's guaranteeing a debtor's obligation to a creditor, which was fully secured by state court cash supersedeas bond, was the indubitable equivalent of creditor's interests and was sufficient adequate protection (*In re Univ. Ctr. Hotel, Inc.*, No. 02-00724, 2006 WL 2347738 (Bankr. N.D. Fla. July 20, 2006)); and
- k. Finding adequate protection where creditor had an equity cushion of over \$130,000 in the secured asset which was likely to be maintained even though costs were accruing daily due to the fact that the value of the property would likely increase over time (*In re Rogers Dev. Corp.*, 2 B.R. 679 (Bankr. E.D. Va. 1980)); *cf. In re Stuart Motel, Inc.*, 8 B.R. 50 (Bankr. S.D. Fla. 1980) (court required debtor to continue to pay monthly mortgage payments, as well as all insurance and unpaid and outstanding taxes as adequate protection, where debtor's equity cushion was eroding rapidly).

### 3. Covenants Or Circumstances Which Likely Do Not Provide Adequate Protection

These covenants or circumstances have not been held to lead to a finding of adequate protection:

- a. Requiring debtor to provide periodic financial reports to the creditor (*In re Swedelande Dev. Group, Inc.*, 16 F.3d 552 (3d Cir. 1994) (by itself, debtors' obligation to supply creditor with regular reports was not a substitute for statute's more concrete protections, since creditor could not convert reports into cash));
- b. Decreasing the interest rate on periodic cash payments (*In re Cooper*, 11 B.R. 391, 394 (Bankr. N.D. Ga. 1981) (see 2(e) above));
- c. Bare replacement lien on future, non-existent crops, was deemed too speculative to constitute adequate protection (*In re Lundell Farms*, 86 B.R. 582, 592 (Bankr. W.D. Wis. 1988)); *cf. In re Ahlers*, 794 F.2d 388 (8th Cir. 1986) (a lien on a following year's crop, to the extent that the following year's crop was not otherwise encumbered, may constitute adequate protection to a secured creditor); and
- d. A federally-guaranteed mortgage does not of itself constitute adequate protection (*In re Britton*, 9 B.R. 245 (Bankr. E.D. Pa. 1981)); *cf. Pennsylvania State Employees' Retirement Fund v. Roane*, 14 B.R. 542, 546 (E.D. Pa. 1981) (federal mortgage guarantee, standing alone, may constitute adequate protection because the federal government will reimburse the mortgagee for the outstanding unpaid mortgage principal, accrued interest, and two-thirds of the foreclosure costs).

### Conclusion

Because the "indubitable equivalence" provision of Section 361(3) provides the Court with a great deal of leeway in determining the means of providing adequate protection, any evaluation of adequate protection is necessarily fact-specific and performed on a case-by-case basis. However, research reveals that those covenants which provide additional protection to the creditor on a real, and not illusory basis, are likely to be viewed as contributing to a finding of adequate protection.

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<sup>1</sup> *Bankruptcy Code Section 361 reads in relevant part:*

*When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by--*

*(1) requiring the trustee to make a cash payment or periodic cash payments to such entity . . . ;*

*(2) providing to such entity an additional or replacement lien . . . ; 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.*

*11 U.S.C. § 361 (1994).*

<sup>2</sup> *See also In re Briggs Transp. Co.*, 780 F.2d 1339 (8th Cir. 1985), which provides a more detailed adequate protection test, including analyses of: (1) whether the claim is over- or under-secured, (2) the parties' reasonable expectations, (3) the quality of the collateral, (4) the length of the stay, (5) whether the lien's value is stable, depreciating or appreciating, (6) whether taxes and other payments are being made to keep collateral free from statutory liens, and (7) whether the debtor has a high or low chance of successful reorganization.

<sup>3</sup> *In Anchorage*, the court also held that the debtor would be enjoined from taking any action to transfer, sell or dispose of cash collateral which was subject to the plaintiff's interests, although this injunction was not clearly made with reference to Section 361. *Id.* at 645.

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