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# When Is Adequate Protection Not Adequate?


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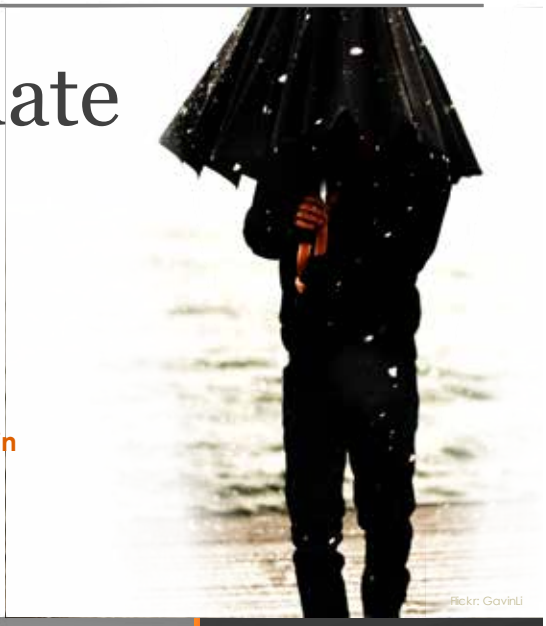


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## Basics of Adequate Protection

# Why, When, and How Must a Debtor Provide Adequate Protection?

## Adequate Protection Compensates Secured Creditors for Postpetition Declines in the Value of Their Collateral

Derived from Fifth Amendment property protections under the "due process" clause—creditors cannot be deprived of their property without due process.

A debtor must provide adequate protection when:

- the automatic stay is in effect, under section 362(d);
- it uses, sells, or leases a secured creditor's collateral, under section 363(e); or
- it proposes to prime a secured creditor's lien with an additional lien, under section 364(d).

**Determining whether a secured creditor is adequately protected requires valuation of the collateral that secures the creditor's interest.**



## How Do Debtors Provide Adequate Protection?

**Section 361 provides three non-exclusive examples of adequate protection:**

**1.**

Single payment or periodic cash payment(s) to the extent that the stay, use, sale, lease or grant of a lien on the collateral results in a decrease in value

Issue: Whether claims are oversecured or undersecured (*Avaya*)

**2.**

Replacement liens or additional liens to the extent that such stay, use, sale, lease or grant of a lien on the collateral results in a decrease in value

Issue: Extent to which collateral is available and/or may be encumbered, including avoidance actions and proceeds thereof, and cross-collateralization

# How Do Debtors Provide Adequate Protection?

## Section 361 provides three non-exclusive examples of adequate protection:

## 3.

Such other relief, other than compensation allowable under Section 503(b)(1) as an administrative expense, as will result in the realization by the secured creditor of the "indubitable equivalent" (i.e., the value) of the secured creditor's interest in the collateral

**"Such other relief" may include**

- Right to receive regular reporting or inspect debtor's operations
- Payment of "secured" creditor's legal fees
  - Issue: Availability of payments
  - Issue: Treatment of payments under cash collateral orders (*Avaya*)
- Equity cushion and/or access to non-debtor assets
  - Issue: Whether value of collateral exceeds value of "secured creditor's" claim with sufficient cushion to absorb interest accrual
  - Issue: Extent to which debtors remain fully secured at all times when payments are made (*Sabine*)



# Who Bears the Burden of Proof?

## Shifting Burden of Proof:

**Debtor** must first overcome the presumed validity of the creditor's secured claim (*Heritage Highgate)*

**Secured creditor** must then establish the amount and extent of its liens under section 506(a)—both at the outset of the case and based on alleged diminution in value of collateral during the case (*Rescap).*

- Issue: Is the collateral actually encumbered?
- Issue: Is the value of the collateral declining?
- Issue: What is the value of the collateral that must be protected?

**Debtor** must then show (by a preponderance of evidence) whether cause to modify the automatic stay does not exist because either (a) the property is not decreasing in value or (b) the "secured" creditor is absolutely protected.

- Issue: Will continuation of the stay cause affirmative harm to the collateral?
- Issue: Death traps regarding lien challenges (*Midstates*)

## How Much Protection is Enough?

Secured creditors often request excessive amounts of adequate protection.

- But, adequate protection is not designed to improve the secured creditor's position beyond the value of its collateral (*Worldcom*)
- Creditors' Committees should object to adequate protection measures that will diminish value available for unsecured creditors

Oversecured creditors entitled to protection in excess of their security interest.

- May collect postpetition interest (from petition date until effective date of a plan of reorganization) and reasonable fees, costs, and charges, and are entitled to adequate protection against decline in collateral value during the bankruptcy
- In contrast, undersecured creditors are not entitled to postpetition interest but may negotiate for it in exchange for debtor's use of their cash collateral
- Undersecured creditors may become oversecured if collateral values increase or their claim amount decreases (based upon, e.g., the application of adequate protection payments); similarly, oversecured creditors may become undersecured (and lose out on these rights) if collateral values fall (*Construction Supervision*)



## What if the Value of Collateral Erodes Over the Course of the Bankruptcy?

Section 507(b) grants secured creditors a superpriority claim ahead of all other unsecured claims (including all administrative expenses) if adequate protection granted at the outset of the bankruptcy case later proves inadequate.

- Protects a secured creditor that cannot repossess its collateral because of the automatic stay by compensating for declines in the value of its secured claim as held on the petition date (but not the value of its collateral) (*Construction Supervision*)
- Must show that (a) the DIP or trustee originally provided a form of adequate protection (not mere sufficiency of protection), (b) the protection proved inadequate, and (c) the loss incurred was solely a result of the automatic stay (*LNC Investments*)

  Issue: Ability to recoup post-petition interest, fees, and expenses

  Issue: Whether a court order is required to award superpriority claim status

**Secured creditors should diligently monitor collateral values during bankruptcy, seek adequate protection payments and object to other creditors' efforts to perfect liens on the debtor's property.**

## Impact of Intercreditor Agreements on Adequate Protection

**Prepetition arrangements between creditors may leave junior creditors unable to effectively challenge adequate protection payments to senior creditors or protect their own collateral from diminution in value.**

Intercreditor agreements typically stipulate relative priority of recovery and the parties' ability to exercise certain rights or take certain actions in respect of their claims.

- Under **Bankruptcy Code section 510**, "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."
- But, to the extent a provision in a subordination agreement purports to alter substantive rights under the Bankruptcy Code, it may be invalid.



## Typical Provisions in 1st/2nd Lien Intercreditor Agreements Related to Adequate Protection

Second Lien (2L) lenders:

- May not oppose adequate protection payments to First Lien (1L) lenders
- May not receive certain forms of adequate protection (e.g., cash payments) and/or must turn over cash payments to 1L lenders
- May not contest the validity, priority or enforceability of liens, mortgages, assignments and security interests or relative rights and duties of 1L lenders
- May not exercise rights or remedies without prior consent of 1L lenders until 1L lenders fully satisfied
- Agree as to priority of recovery in favor of 1L lenders (i.e., subordination)
- Must support any plan of reorganization consistent with the rights of the 1L lenders under the 1L security agreement, unless 1L lenders are paid in full

Issue: Use of cash collateral and allocation of diminution of value from the use of cash collateral as between senior lenders (*SemGroup*)

## Creditors Commonly Duel Over Adequate Protection in Two Main Contexts:

### A Debtor's Request to Use Cash Collateral

- Includes cash, cash equivalents, and cash proceeds of other collateral liquidated during the bankruptcy
- Provision of additional and replacement liens on postpetition inventory and receivables in exchange for use of cash collateral comes with the risk that substituted accounts may not be collectible, substituted inventory may not be saleable – may lead to litigation over sufficiency of adequate protection provided

### A Debtor's Request to Obtain DIP Financing

- Rollup of prepetition debt into a DIP loan will result in postpetition debt and entitles lender to postpetition interest – encourages lending by prepetition creditors
- Request for priming liens by new DIP lender can result in litigation over whether primed creditors are adequately protected



## Cash Collateral: Creditor Considerations

**Secured Creditors**

- Lien stipulations
- Broad replacement lien package
- Cross-collateralization
- Current payments
- Waivers
- Fixed valuation date/method?

**Unsecured Creditors**

- Lien challenge period / standing
- No liens on unencumbered property
- Carve-outs
- Ability to recharacterize or claw-back current payments

**A consensual cash collateral order allows parties to agree to forms of relief that they may not otherwise be entitled to under a strict application of Section 361 and other applicable Bankruptcy Code provisions.**

## Valuation of Adequate Protection

# How to Measure Diminution in the Value of Collateral?



## Valuation of Adequate Protection

**Bankruptcy Code section 506(a)** provides:

> "An allowed claim of a creditor secured by a lien on [estate] property . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. ***Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property***. . . ."

**Section 506 contemplates bifurcation into secured and unsecured claims based on value, but value is not defined in the Bankruptcy Code.**

## Issues

- Foreclosure Value vs. Fair Market Value (FMV)
- Aggregate vs. Asset-by-Asset
- Timing for Valuing Collateral/Measuring Adequate Protection
- Standard Methods vs. Commodity-specific
- Historical vs. Current Pricing Inputs



## Foreclosure Value vs. Fair Market Value (FMV)

Historically, courts preferred to measure diminution in value based on foreclosure value, except for when assets were actually sold (Queenan, J.)

Contemporary courts largely reject the "Queenan Doctrine"--

- ***Timbers*** (U.S. 1988) (holding that debtors have no obligation to reimburse undersecured creditors for losses suffered due to lost interest payments or other opportunity costs as a result of the delay of debtors' chapter 11 proceedings)
- ***Rash*** (U.S. 1997) (holding that replacement value, not foreclosure value, governs in cram down)
- ***ResCap*** (Bankr. S.D.N.Y. 2013) holding, based on *Rash*, that foreclosure value is an inappropriate measure for determining adequate protection)
- ***Scopac*** (5th Cir. 2010) (affirming decision that found adequate protection based on on foreclosure value but that also found, in the alternative, that secured creditor was adequately protected based on FMV, the proper measure)
- ***Heritage Highgate*** (3d. Cir. 2012) (rejecting valuation based on speculative projected revenues and holding that FVM is the proper measure)
- ***Sabine*** (S.D.N.Y. 2017) (actual foreclosure on certain E&P assets impractical)

## Aggregate vs. Asset-by-Asset

**In multi-debtor cases, there is a question of whether to evaluate a creditor's secured status—oversecured or undersecured—on an entity-by-entity basis, or based on the aggregate value of collateral across all debtors.**

» ***ResCap*** (Bankr. S.D.N.Y. 2013) (Court held oversecured/undersecured status would determine creditors' entitlement to prepetition interest and fees and that secured status should be based on **aggregate value of collateral**; Decision based largely on commercial realities of the transaction—all debtors jointly and severally liable under credit documents)

» ***See also SW Hotel Venture*** (Bankr. D. Mass. 2011)

Result may be different if **debtor and non-debtor** borrowers are involved

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## When is the Proper Date to Value Collateral/ Measure Adequate Protection?

- Courts vary on the **starting date** for measuring diminution in value:
  - Petition date
  - Date of request for adequate protection
  - Date secured creditor could have exercised remedies
- Commonly, when adequate protection is consensual, the bookends are (1) the petition date, and (2) the plan effective date
- Even where adequate protection is granted, it can be revisited later in the case based on changes in value and other factors.

**In a volatile and/or seasonal commodities business, issues can arise due to pricing changes between the date of "the deal" and confirmation, limiting the usefulness of standard valuation methods.**

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## Standard Valuation Methods vs. Commodity-specific Valuation Methods

**Special methods are employed to value debtors/assets when their value is highly correlated to price expectations of the commodities they sell or that their customers produce.**

**Example**: E&P companies

- Primary assets are oil and gas reserves (proved vs. nonproved)
- Valuation methods employed:
  - **Reserve Approach** (form of income-based valuation similar to a discounted cash flow ("DCF") model for reserves)
  - **Asset Approach** (balance sheet marked to market using the company's reserve report – the Net Asset Value Method)
  - **Market Approach** (i.e., comparable company analysis with special consideration given to factors such as size, gas/oil mix, reserve life, proved undeveloped reserves relative to total proved reserves, and areas/basins of operation in selecting guideline companies)



## Net Asset Value Approach

**Generally accepted method for valuing oil and gas assets**

- Estimates present value of a company's reserves, applies "reserve adjustment factors" to reflect the specific risk of particular reserves, and accounts for future expenses associated with those reserves
- May not be a good indicator of total enterprise value when strip price is set near cyclical peaks or troughs

Issue: accounting for price volatility when measuring diminution of value (i.e., use of average of spot prices over a range of dates, strip prices, power forward curves, reserve adjustment factors, or a combination thereof) (*Sabine; Breitburn*)

# Historical vs. Current Pricing Inputs

**Courts have held that updated pricing is generally superior, but are hesitant to award windfalls based on short term price volatility that may not justify a higher valuation.**

Current pricing close to the forecasted effective date is the most pertinent in a value determination

- ***Mirant*** (N.D. Tex. 2005) (resolving valuation fight between equity and creditors based on improvement of power forward curves during the case by ordering the recalculation of debtor's valuation—parties had submitted outdated pricing and should have used the best, most current information available)

Recent case law suggests that historical pricing may also inform value

- ***Sabine*** (S.D.N.Y. 2017) (observing that it is best to use pricing information from as close to the forecasted effective date as possible, but confirming a plan with a lower valuation based on consideration of all pricing assumptions submitted by the parties, including historical prices and strip pricing data—even though spot and forward prices for oil and gas had increased, historical strip pricing data already accounted for projected future value)