RECENT DEVELOPMENTS IN ADEQUATE PROTECTION UNDER SECTION 361

By Steven C. Krause and Andrew Zatz[*]

I. Adequate Protection Generally

"Adequate Protection" is a term that is used numerous times in the Bankruptcy Code but is not explicitly defined. Adequate protection is introduced in section 361 of the Bankruptcy Code and arises under the Bankruptcy Code in relation to: (1) the automatic stay (section 362); (2) the use, sale or lease of property (section 363); and (3) priming liens in postpetition financing (section 364).

A. Code Provisions Referencing "Adequate Protection"

1. Section 362—Adequate Protection for Imposition of the Automatic Stay

Section 362 of the Bankruptcy Code institutes the automatic stay, which prevents creditors from taking any action with respect to estate property.[1] However, section 362 provides that on "request of a party in interest and after notice and a hearing, the court shall grant relief from the stay . . . for cause, including the lack of adequate protection of an interest in property of such party in interest."[2] In the context of adequate protection, a creditor seeking relief must make a prima facie showing that its inter-

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[*]Steven C. Krause is an associate in the Insolvency and Restructuring practice group at Davis Polk & Wardwell LLP in its New York office. He received his J.D. from the Columbia University School of Law and his M.B.A. from the Anderson Graduate School of Management at UCLA. Prior to practicing law, he served in managerial and operational positions for a variety of companies. Andrew Zatz is an associate in the Financial Restructuring and Insolvency practice group at White & Case LLP in its New York office. He received his J.D. from the Fordham University School of Law where he served on the Fordham Urban Law Journal.

[1]11 U.S.C.A. § 362.

[2]11 U.S.C.A. § 362(d)(1).

est is not adequately protected, and if it makes such a showing, the burden of proof shifts to the debtor.[3]

2. Section 363—Adequate Protection for the Use, Sale or Lease of Property

Section 363 of the Bankruptcy Code provides that "on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the [debtor], the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."[4]

3. Section 364—Adequate Protection for Priming Liens in Postpetition Financing

Section 364 of the Bankruptcy Code provides that the:

[C]ourt, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if (A) the [debtor] is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on property of the estate on which such senior or equal lien is proposed to be granted.[5]

Under section 364, the debtor has the burden of proof on the issue of adequate protection.[6]

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[3]See, e.g., *In re RNI Wind Down Corp.*, 348 B.R. 286, 299, 46 Bankr. Ct. Dec. (CRR) 275 (Bankr. D. Del. 2006), subsequently aff'd, 359 Fed. Appx. 352 (3d Cir. 2010); *In re Sonnax Industries, Inc.*, 907 F.2d 1280, 1285, 23 Collier Bankr. Cas. 2d (MB) 132 (2d Cir. 1990); see generally, Patrick Jackson, Bulletproofing the Secured Creditor's Prima Facie Case for Stay Relief for Lack of Adequate Protection in Chapter 11, 27-7 ABIJ 18 (Sept. 2008).

[4]11 U.S.C.A. § 363(e). With respect to a debtor's cash assets that constitute collateral, the Bankruptcy Code conditions the debtor's use of cash collateral on either (i) consent of the secured creditor or (ii) court authorization after notice and a hearing. 11 U.S.C.A. § 363(c)(2). Absent specific challenge by a creditor, the debtor is not obligated to provide adequate protection for the use of non-cash collateral in the ordinary course of business. 11 U.S.C.A. § 363(c)(1). In either case, the debtor has the burden of proof to show that a secured creditor is adequately protected. Although proof by a preponderance of the evidence is the norm in a Chapter 11 proceeding, a few courts have required proof that the creditor is adequately protected by clear and convincing evidence. See *In re O.P. Held, Inc.*, 74 B.R. 777, 784 (Bankr. N.D. N.Y. 1987); *In re Leavell*, 56 B.R. 11 (Bankr. S.D. Ill. 1985); *In re Sheehan*, 38 B.R. 859, 11 Bankr. Ct. Dec. (CRR) 835 (Bankr. D. S.D. 1984).

[5]11 U.S.C.A. § 364(d).

[6]11 U.S.C.A. § 364(d)(2).

B. Determining Adequate Protection Is Fact-Dependent

The right to adequate protection arises from the Fifth Amendment's property interest protections.[7] Therefore, "[t]he purpose of adequate protection is to guard the secured creditors' interest from a decline in the value of the collateralized property."[8] In other words, the purpose of providing adequate protection is to insure "as nearly as possible under the circumstances of the case" that a secured creditor is provided "with the value of his bargained for rights."[9] Thus a secured party "is entitled to adequate protection as a matter of right, not merely as a matter of discretion."[10] Furthermore, the requirement to provide secured creditors with adequate protection reconciles "the competing interests of the debtor's need to reorganize and the secured creditor's entitlement to constitutional protection of its bargained-for property interests."[11] Providing adequate protection assurances to creditors affords a debtor the ability to retain its protections under the Bankruptcy Code.[12]

Although the Bankruptcy Code is not explicit as to what constitutes adequate protection, section 361 enumerates several specific examples of adequate protection:

1) requiring the debtor to make a cash payment or periodic cash payments to the extent that the automatic stay or the use, sale or lease of property 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 the automatic stay or the use, sale or lease of property results in a decrease in the value of such entity's interest in such property; or

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[7] *In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted).

[8] *In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted).

[9] *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 564, 25 Bankr. Ct. Dec. (CRR) 486, 30 Collier Bankr. Cas. 2d (MB) 1034, Bankr. L. Rep. (CCH) P 75803 (3d Cir. 1994).

[10] 3 Collier on Bankruptcy ¶ 361.02 (Alan N. Resnick and Henry J. Sommer, eds., 16th ed., 2010) (citing H.R. Rep. No. 95-595, 1st Sess. 340, 343–44 (1977); S. Rep. No. 95-989, 2d Sess. 52–53 (1978)).

[11] *In re Briggs Transp. Co.*, 780 F.2d 1339, 1341, 14 Bankr. Ct. Dec. (CRR) 48, 13 Collier Bankr. Cas. 2d (MB) 1289, Bankr. L. Rep. (CCH) P 70897 (8th Cir. 1985).

[12] *In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citing Timbers, 484 U.S. at 378).

3) granting such other relief, other than entitling such entity to compensation allowable as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.[13]

In applying section 361 of the Bankruptcy Code, courts have consistently interpreted the list of adequate protection methods enumerated therein as nonexclusive and have viewed the third option as a "catch all, allowing courts discretion in fashioning the protection provided to a secured party."[14] Courts generally determine whether relief constitutes adequate protection "on a case by case basis."[15]

C. "Indubitable Equivalent"

The third option, the indubitable equivalent standard, is the most ambiguous. Thus it can be met in a variety of ways and is evaluated on a case-by-case basis.[16] The term "indubitable equivalent," as it relates to adequate protection in bankruptcy, was introduced by Judge Learned Hand in *Metro. Life Ins. Co. v. Murel Holding Corp. (In re Murel Holding Corp.)*:

> It is plain that 'adequate protection' must be completely compensatory . . . [A] creditor who fears the safety of his principal will scarcely be content with [interest]; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[17]

Although adequate protection need not be of the most indubitable equivalence under section 361(3),[18] courts require that adequate protection be "completely compensatory" or almost

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[13]11 U.S.C.A. § 361.

[14]*In re Swedeland Development Group, Inc.*, 16 F.3d 552, 564, 25 Bankr. Ct. Dec. (CRR) 486, 30 Collier Bankr. Cas. 2d (MB) 1034, Bankr. L. Rep. (CCH) P 75803 (3d Cir. 1994).

[15]Swedeland Dev. Group, 16 F.3d at 552, 564 (citing *In re O'Connor*, 808 F.2d 1393, 1397, 15 Bankr. Ct. Dec. (CRR) 735, Bankr. L. Rep. (CCH) P 71571 (10th Cir. 1987)).

[16]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted); *In re BLX Group, Inc.*, 419 B.R. 457, 470 (Bankr. D. Mont. 2009) (citations omitted).

[17]*In re Murel Holding Corp.*, 75 F.2d 941, 942 (C.C.A. 2d Cir. 1935) (cited in Fontainebleau, 434 B.R. 716, 748–49 (S.D. Fla. 2010)).

[18]Judge Learned Hand's approach to indubitable equivalence may not be encompassed in section 361(3) of the Bankruptcy Code because that section requires only the "indubitable equivalent" and not the most indubitable

completely compensatory.[19] The U.S. Court of Appeals for the Third Circuit held that adequate protection "should as nearly as possible under the circumstances of the case provide the creditor with the value of his bargained for rights."[20] Therefore, adequate protection should provide a creditor whose collateral position is compromised "with the same level of protection it would have had if there had not been post-petition superpriority financing."[21]

D. Establishing a Prima Facie Case for a Lack of Adequate Protection

To establish a prima facie case of a lack of adequate protection, a creditor must provide evidence of the declining or threatened value of the collateralized property caused by the automatic stay.[22] The best proof of declining or threatened value is a comparison of the value of the property at the time of the hearing to the property value as of the petition date.[23] However, this is not the only acceptable proof—a prima facie case is met so long as the creditor presents evidence that "its position in the collateral is in

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equivalence as he had described in *Murel Holding*. Fontainebleau, 434 B.R. at 749 (quoting 3 Collier ¶ 361.03[4]).

[19]Fontainebleau, 434 B.R. at 716, 749 (citations omitted).

[20]Fontainebleau, 434 B.R. at 716, 749 (quoting Swedeland Dev. Grp., 16 F.3d at 552, 564 (citation and internal quotation marks omitted)).

[21]Fontainebleau, 434 B.R. at 716, 749 (quoting Swedeland Dev. Grp., 16 F.3d at 552, 564 (citation and internal quotation marks omitted)). Similarly, "[w]hen formulating adequate protection in connection with post-petition financing on a priming basis, preserving or enhancing the value of the collateral must be viewed side-by-side with the decrease in value of a creditor's interest in the property caused by the priming lien." Fontainebleau, 434 B.R. at 716, 754 (citing Swedeland Dev. Grp., 16 F.3d at 552, 566).

[22]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted); see *In re Wrecclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997) ("Therefore, an undersecured creditor does not lack adequate protection merely by reason of being undersecured." (citation omitted)); see also *In re Barkley 3A Investors, Ltd.*, 175 B.R. 755, 759, 26 Bankr. Ct. Dec. (CRR) 525 (Bankr. D. Kan. 1994) ("The court said that the value of the creditor's interest must be declining for adequate protection to be necessary. The undersecured creditor does not lack adequate protection merely by reason of being undersecured." (citing *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 16 Bankr. Ct. Dec. (CRR) 1369, 17 Collier Bankr. Cas. 2d (MB) 1368, Bankr. L. Rep. (CCH) P 72113 (1988))).

[23]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citing In re Elmira Litho, Inc., 174 B.R. at 903).

jeopardy."[24] To counter evidence of a loss of value in collateral, a debtor must either effectively refute such evidence or show that "there are sufficient protections in place to guard against it."[25] For example, the debtor in *Panther Mountain* presented sufficient evidence to refute a prima facie showing of adequate protection by providing that the value of property securing its creditor's claims was likely to continue to increase in value due, in part, to an aggressive marketing campaign to sell plots of the land and a feasible plan which provided that any plots of land not sold within a certain period of time would be sold at public auction.[26]

II. Recent Case Law Addressing Questions of Adequate Protection

Adequate protection, as provided in section 361 of the Bankruptcy Code, is often a focus in bankruptcy litigation. Given the ethereal nature of adequate protection and the dearth of specific guidance in the Bankruptcy Code, courts and practitioners regularly look to case precedent to define the parameters of adequate protection. Over the years, a number of aspects of adequate protection have become firmly imbedded in the case law. However, several recent cases address various unresolved issues in the law. Below, we discuss recent case law evaluating equity cushions and what, if any, amount of equity cushion will ensure adequate protection. These cases include *Las Torres Development*, *SunTrust Bank* and *Panther Mountain*. We also discuss *WestPoint Stevens*, a case in which the court enforced an intercreditor agreement provision providing adequate protection to junior creditors. We also discuss *Big3D*, in which the court allowed adequate protection payments only from the date the motion for adequate protection was brought and not from the petition date. The court in *Scopac*, another notable recent case, denied administrative superpriority treatment to non-cash collateral adequate protection payments under section 507(b) of the Bankruptcy Code but provided administrative priority treatment for certain cash collateral. We then address cases in which courts considered whether the collateral value of future rents and/or the future value of real estate collateral can be used as adequate protection, including *Pacific Lifestyle Homes, YL West 87th*, *But-*

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[24]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted).

[25]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010) (citations omitted); 11 U.S.C.A. § 362(g).

[26]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 193 (Bankr. E.D. Ark. 2010).

termilk Towne Center and *Las Vegas Monorail*. Finally, we discuss the *Fontainebleau* case, in which the district court held that the bankruptcy court's decision to defer consideration of a dispute between senior and junior creditors did not deprive the junior creditors to their right to adequate protection payments.

A. Evaluating an Equity Cushion

The most common factors indicating that the debtor has provided the indubitable equivalent of a collateral interest are "the sufficiency of the equity cushion, periodic payments, additional liens, or a good prospect of a successful reorganization."[27] The equity cushion, the most determinative of these factors, is a term of art for the value of the collateral less the liens in the collateral if the property declines in value during the bankruptcy proceeding.[28] The determination of whether the equity cushion in collateral is sufficient is made on a case-by-case basis.[29] Exactly what size (percentage) cushion is sufficient is a subject of much debate and has been further addressed in a number of recent cases.[30]

In *In re Las Torres Development LLC*, the Bankruptcy Court for the Southern District of Texas evaluated a creditor's objection to the debtor's use of cash collateral.[31] After resolving that the debtors had not met the thresholds to satisfy any of the criteria set forth in sections 361(1), (2) or (3), the court "conclude[d] that the Lender is nevertheless adequately protected because § 361 is

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[27]Swedeland Dev. Grp., 16 F.3d at 552, 566 (citations omitted).

[28]Swedeland Dev. Grp., 16 F.3d at 552, 566 (citations omitted); BLX Group, 419 B.R. at 470.

[29]Panther Mountain, 438 B.R. at 169, 190 (citations omitted). See, e.g., *In re Plaza De Retiro, Inc.*, 2009 WL 3633356, *3–4 (Bankr. D. N.M. 2009) (stating that a 200% equity cushion was sufficient); *In re BLX Group, Inc.*, 419 B.R. 457, 471 (Bankr. D. Mont. 2009) (holding that adequate protection was provided where the "as is" impaired value of the property serving as collateral ($73,500,000) provided a creditor with a $30,500,000 equity cushion and the creditor held additional security in properties worth $6 million to $8 million).

[30]See Wendell H. Adair, Jr. and Kristopher M. Hansen, Adequate Protection: Entitlement and Provision, Turnaround Management Association, n.9 (May 1, 2001) ("Generally, courts have held that an equity cushion of 20 percent or more is adequate, while a cushion of 11 percent or less is insufficient."); see also *In re Kost*, 102 B.R. 829 (D. Wyo. 1989) (collecting cases).

[31]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 695–96, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

not limiting."[32] Specifically, the court noted that "case law is clear that an equity cushion of 20% or more constitutes adequate protection."[33] In a footnote, the court acknowledged that dicta in Fifth Circuit precedent also suggests taking into account other factors including the likelihood of depreciation or appreciation, insurance coverage, property tax payments, and the likelihood of a successful reorganization.[34] The *Las Torres* court specifically discounted the value of metrics used by the debtor due to the lack of relevant facts on the record, but did not generally dispute their value in assessing adequate protection.[35] The court then applied the parties' conservative valuations to the collateral in question and determined that each property had an equity cushion well in excess of 20% and thus the lender was adequately protected for the use of its cash collateral.[36]

In *SunTrust Bank v. Den-Mark Const., Inc.*, the debtor had financed the purchase and development of residential real estate with prepetition loans and letters of credit from SunTrust Bank.[37] The bankruptcy court had entered orders authorizing $2.2 million of postpetition financing to fund ongoing development efforts and authorizing this postpetition financing to prime SunTrust's prepetition liens.[38] The bankruptcy court had denied a stay of the financing and found that the prepetition liens were adequately

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[32]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 696, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[33]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 967, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009) (collecting cases).

[34]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 967 n.9, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009) (citing *Matter of Mendoza*, 111 F.3d 1264, 1272, 37 Collier Bankr. Cas. 2d (MB) 1691 (5th Cir. 1997) (citations omitted)).

[35]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 967 n.9, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[36]*In re Las Torres Development, L.L.C.*, 413 B.R. 687, 967, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[37]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 687 (E.D. N.C. 2009).

[38]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 687 (E.D. N.C. 2009) (citing Den-Mark Constr., Inc., et al., Case No. 08-02764-RDD (Bankr. E.D.N.C. June 27, 2008 and Aug. 6, 2008).

protected by the debtor's equity in the underlying properties.[39] Specifically, the bankruptcy court found that an equity cushion of just under 11%, the expected increase in value of the collateral and $12,000 monthly payments reducing the prepetition debt constituted adequate protection.[40] On review, the district court noted that a 20% or more equity cushion "almost uniformly . . . constitutes adequate protection [while courts] almost as uniformly held that an equity cushion under 11% is insufficient [and are] divided on whether a cushion of 12% to 20% constitutes adequate protection."[41] Thus the district court found that "the equity cushion is [too] small and the enhancement of value too speculative" to provide the indubitable equivalent of the prepetition lender's existing security and vacated the bankruptcy court's order.[42]

While the courts in *Las Torres Development* and *SunTrust Bank* appear to agree that 20% is an appropriate threshold for a satisfactory equity cushion and that anything less is questionable, it is unclear how much less than 20% can still satisfy the adequate protection requirement described in section 361. In *In re Panther Mountain Land Development, LLC*, National Bank of Arkansas, a holder of two claims against a Chapter 11 debtor's estate secured by two pieces of property filed a motion to lift the automatic stay under section 362(d)(1).[43] National Bank argued that it lacked adequate protection because the accrual of postpetition interest

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[39]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 687, 694–5 (E.D. N.C. 2009) (citing *In re Den-Mark Const., Inc.*, 50 Bankr. Ct. Dec. (CRR) 182, 2008 WL 4526711 (Bankr. E.D. N.C. 2008)).

[40]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 700 (E.D. N.C. 2009); see also *In re Den-Mark Const., Inc.*, 50 Bankr. Ct. Dec. (CRR) 182, 2008 WL 4526711, *5 (Bankr. E.D. N.C. 2008).

[41]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 700 n.24 (E.D. N.C. 2009) (quoting *In re James River Associates*, 148 B.R. 790, 796 (E.D. Va. 1992)); see also *In re Franklin Equipment Co.*, 416 B.R. 483, 528 (Bankr. E.D. Va. 2009) (same) (quoting *In re Kost*, 102 B.R. 829, 831 (D. Wyo. 1989)).

[42]*Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 702 (E.D. N.C. 2009). See also *In re Franklin Equipment Co.*, 416 B.R. 483, 529 (Bankr. E.D. Va. 2009) (holding that a 4.87% equity cushion was insufficient taking into account postpetition interest accrued, cost of sale of collateral, accruing attorney's fees, collection costs, and evidence that collateral was overpriced and depreciating in value).

[43]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 173–76 (Bankr. E.D. Ark. 2010).

would deplete the equity cushion in its collateral.[44] The court called this line of reasoning into question, noting that postpetition interest accruals can erode an equity cushion but "can never actually impede the creditor's interest in the collateral."[45] National Bank also argued that some minimal percentage of equity cushion is required in all adequate protection cases.[46] The court disagreed with this contention, stating that "it does not follow that even the most microscopic equity cushion would automatically fail to provide adequate protection if the chances of jeopardizing the creditor's interest were also *de minimis*."[47]

Panther Mountain Land Development and *SunTrust Bank* appear to conflict. The former supports the proposition that a minimal equity cushion could be satisfactory in certain cases while the latter supports a bright-line rule requiring an 11% minimum equity cushion. However, both cases are consistent with the case-by-case nature of equity cushion analyses. The venue rather than the specific facts of a case may be the determining factor with respect to the appropriate level of equity cushion below the 20% threshold, which may eventually create a conflict among the circuit courts requiring resolution.

B. Waiver of Right to Adequate Protection

Intercreditor agreements can play a major role in the resolution of adequate protection fights. In *Contrarian Funds LLC, et al. v. Aretex LLC, et al. (In re WestPoint Stevens, Inc.)*, the bankruptcy court authorized a Chapter 11 debtor to receive postpetition financing secured by priming liens so long as both senior and junior secured creditors received adequate protection.[48] The senior lenders challenged the adequate protection payments being made to the junior secured creditors.[49] Before the petition date, the senior secured creditors and the junior secured creditors had

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[44]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 191 (Bankr. E.D. Ark. 2010).

[45]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 191 (Bankr. E.D. Ark. 2010) (citing *In re Chauncy Street Assoc. Ltd. Partnership*, 107 B.R. 7, 8, Bankr. L. Rep. (CCH) P 73118 (Bankr. D. Mass. 1989)).

[46]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 191 (Bankr. E.D. Ark. 2010).

[47]*In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 191 (Bankr. E.D. Ark. 2010).

[48]*In re WestPoint Stevens, Inc.*, 600 F.3d 231, 238, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[49]*In re WestPoint Stevens, Inc.*, 600 F.3d 231, 236, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

entered into an intercreditor agreement, which included a provision that the junior secured creditors would not be entitled to any recovery on account of their liens until the senior secured creditors were paid in full in cash.[50] The intercreditor agreement included an exception to this provision, which stated that junior secured creditors could receive adequate protection payments before the senior secured creditors were paid in full in cash.[51] The parties entered into a stipulation providing that the adequate protection payments owed to the junior secured creditors were to be held in escrow pending the reorganization or sale of the debtor's business.[52] The resolution of the case was an arduous process because the two largest secured creditors, one with a majority stake in the senior secured debt and the other with a majority interest in the junior secured debt and a minority interest in the senior secured debt, held a lengthy battle over which would control the company postconfirmation.[53] Ultimately, one emerged the victor, and subsequent to the sale, the bankruptcy court ordered that the funds held in escrow be disbursed to the junior secured creditors.[54] On appeal, the district court affirmed the bankruptcy court's release of the adequate protection payments to the junior secured creditors.[55] The United States Court of Appeals for the Second Circuit then affirmed the release of the adequate protection payments on the grounds that, in addition to the junior secured creditors' statutory right to adequate protection payments, such payments were explicitly permitted in the intercreditor agreement.[56] This case demonstrates that the right to adequate protection payments may be preserved for junior creditors under an intercreditor agreement.

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[50] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 237–38, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[51] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 238, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[52] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 238, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[53] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 236–27, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[54] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 237, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[55] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 244, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

[56] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 261, Bankr. L. Rep. (CCH) P 81718 (2d Cir. 2010).

C. When Does Adequate Protection Attach?

Courts have taken a number of approaches to the question of what date to use as the basis of calculating adequate protection. As one leading authority states, "[t]he text of the Bankruptcy Code seems to support the view that protection is provided only from the date of the request."[57] Although this has become the majority position,[58] courts have occasionally enforced adequate protection either retroactively to the petition date.[59]

In *In re Big3D, Inc.*, a creditor sought relief from the automatic stay or, in the alternative, adequate protection of its claim as of the filing of the Chapter 11 case.[60] The bankruptcy court only allowed adequate protection of the value of the collateral as of the filing of the motion for adequate protection, holding that the secured creditor had not met its burden of proof that it was entitled to adequate protection payments as of the petition date. The Bankruptcy Appellate Panel for the Ninth Circuit held that the bankruptcy court's denial of the creditor's request was not an

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[57]3 Collier on Bankruptcy ¶ 361.02[3] (Alan N. Resnick and Henry J. Sommer, eds., 16th ed., 2010).

[58]See, e.g., *In re Big3D, Inc.*, 438 B.R. 214, 216 (B.A.P. 9th Cir. 2010) (citing *In re Metromedia Fiber Network, Inc.*, 290 B.R. 487 (Bankr. S.D. N.Y. 2003); *In re Farmer*, 257 B.R. 556, 561 (Bankr. D. Mont. 2000); *Agency Services, Inc. v. Keck, Mahin & Cate*, 1999 WL 199595 (N.D. Ill. 1999); *In re Best Products Co., Inc.*, 138 B.R. 155, 22 Bankr. Ct. Dec. (CRR) 1288, 26 Collier Bankr. Cas. 2d (MB) 1709, Bankr. L. Rep. (CCH) P 74592 (Bankr. S.D. N.Y. 1992), decision aff'd, 149 B.R. 346 (S.D. N.Y. 1992); *In re Waverly Textile Processing, Inc.*, 214 B.R. 476 (Bankr. E.D. Va. 1997); *In re Walter*, 199 B.R. 390, 36 Collier Bankr. Cas. 2d (MB) 1049 (Bankr. C.D. Ill. 1996); *In re Cason*, 190 B.R. 917, 34 Collier Bankr. Cas. 2d (MB) 1476 (Bankr. N.D. Ala. 1995); *In re Dynaco Corp.*, 162 B.R. 389, 25 Bankr. Ct. Dec. (CRR) 159, Bankr. L. Rep. (CCH) P 75686 (Bankr. D. N.H. 1993); *In re Barrett*, 149 B.R. 494 (Bankr. N.D. Ohio 1993); *Matter of Continental Airlines, Inc.*, 146 B.R. 536 (Bankr. D. Del. 1992), subsequently aff'd, 91 F.3d 553, 29 Bankr. Ct. Dec. (CRR) 629, 36 Collier Bankr. Cas. 2d (MB) 785 (3d Cir. 1996)).

[59]*In re Big3D, Inc.*, 438 B.R. 214, 230 (B.A.P. 9th Cir. 2010) ("[A] review of the case law concerning the timing of adequate protection awards shows, over time, there has been a pronounced shift away from the rule announced in the early cases that emphasized the date of filing the bankruptcy petition as the starting point for payments. Clearly, the bulk of the cases decided since about 1990 favor beginning adequate protection payments at the time relief is requested by the creditor."); see, e.g., *In re Ahlers*, 794 F.2d 388, 14 Bankr. Ct. Dec. (CRR) 768, 15 Collier Bankr. Cas. 2d (MB) 111, Bankr. L. Rep. (CCH) P 71227 (8th Cir. 1986), judgment rev'd on other grounds, 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2d 169, 17 Bankr. Ct. Dec. (CRR) 201, 18 Collier Bankr. Cas. 2d (MB) 262, Bankr. L. Rep. (CCH) P 72186 (1988)

[60]*In re Big3D, Inc.*, 438 B.R. 214, 216–7 (B.A.P. 9th Cir. 2010).

abuse of discretion by the bankruptcy court.[61] The BAP clarified that its holding was consistent with the previously announced rule in the Ninth Circuit in the *Deico* case, which measures adequate protection based on when the creditor could have otherwise obtained state court remedies and affords the bankruptcy court broad discretion in determining the timing and frequency of adequate protection payments.[62] The BAP rejected the idea that, instead of the *Deico* rule, adequate protection should be measured from the date of the request for adequate protection payments, stating:

> In terms of the structure of the Bankruptcy Code, while a request is a prerequisite to determining if adequate protection should be awarded under §§ 362(d)(1)and 363(e), what constitutes adequate protection is defined in § 361. If Congress intended a temporal limitation on adequate protection that would preclude any award of adequate protection for depreciation in the value of collateral prior to the filing of a request by the concerned creditor as a matter of law, logically, that limitation should have been included in § 361. In addition, the phrase 'on request of' an entity or party in interest does not clearly state a limit on the varieties of adequate protection that can be awarded in appropriate circumstances.[63]

The BAP determined that the secured creditor's "state court order directing the sheriff to take possession of the Equipment" would not, without other actions, have allowed it to monetize its interest in the collateral, particularly because the equipment collateral was burdensome to transport and sell.[64] Also, the BAP acknowledged the bankruptcy court's finding that the debtor's use of the collateral did not contribute to its depreciation in value but, rather, that the depreciation in value was caused by "deteriorating economic conditions" and that the creditor's

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[61] *In re Big3D, Inc.*, 438 B.R. 214, 216 (B.A.P. 9th Cir. 2010).

[62] *In re Big3D, Inc.*, 438 B.R. 214, 222 (B.A.P. 9th Cir. 2010) (citing *In re Deico Electronics, Inc.*, 139 B.R. 945, 947, 23 Bankr. Ct. Dec. (CRR) 7, Bankr. L. Rep. (CCH) P 74637 (B.A.P. 9th Cir. 1992)) ("Deico ultimately concluded that: (1) adequate protection payments from a chapter 11 debtor to a secured creditor are intended to compensate a secured creditor only for those losses occasioned by the debtor's bankruptcy; (2) adequate protection is payable for only that period of time after the creditor would have exercised its state court remedies; and (3) the bankruptcy court has broad discretion in fixing the beginning date, the amount, and the frequency of adequate protection payments").

[63] *In re Big3D, Inc.*, 438 B.R. 214, 229 (B.A.P. 9th Cir. 2010).

[64] *In re Big3D, Inc.*, 438 B.R. 214, 222 (B.A.P. 9th Cir. 2010).

request for adequate protection payments had not been filed within a reasonable period of time.[65]

The BAP also considered whether its holding should cause it to clarify or modify the *Deico* rule.[66] First, the BAP noted that most recent decisions in other circuits afforded the secured creditor with adequate protection only from the date of the filing of the motion.[67] However, the BAP noted that the *Deico* court properly found that section 361 of the Bankruptcy Code simply specifies that adequate protection for the use of collateral other than cash collateral is only available upon a motion, but does not mandate that the protection applies only as of the date of such motion.[68] Given that the bankruptcy court's decision fit with the broad discretion standard in *Deico* and that *Deico* was consistent with the Bankruptcy Code, the BAP determined that the rule under *Deico* did not need to be modified.[69] However, the concurrence would have reached the same result while replacing the *Deico* standard to "align this Panel with the clear trend in the case law and establish a bright-line rule that adequate protection is not available to a secured creditor for any decline in the value of collateral occurring during a bankruptcy case prior to the filing of an appropriate request for such relief."[70] Thus the *Deico* standard still controls in the Ninth Circuit and would permit a court there to afford a creditor adequate protection for diminution prior to the filing of a motion for adequate protection.

D. Adequate Protection Deficiency as Administrative Expense Claim Under Section 507(b)

Adequate protection battles ran through the *Scopac* case,[71] culminating in the Fifth Circuit's consideration of the applicability of section 507(b) of the Bankruptcy Code to the treatment of certain secured claims at emergence.[72] Section 507(b) of the Bankruptcy Code provides that, if a creditor receives:

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[65]*In re Big3D, Inc.*, 438 B.R. 214, 214 (B.A.P. 9th Cir. 2010).

[66]*In re Big3D, Inc.*, 438 B.R. 214, 227 (B.A.P. 9th Cir. 2010).

[67]*In re Big3D, Inc.*, 438 B.R. 214, 228–9 (B.A.P. 9th Cir. 2010) (collecting cases).

[68]*In re Big3D, Inc.*, 438 B.R. 214, 229 (B.A.P. 9th Cir. 2010).

[69]*In re Big3D, Inc.*, 438 B.R. 214, 230 (B.A.P. 9th Cir. 2010).

[70]*In re Big3D, Inc.*, 438 B.R. 214, 231 (B.A.P. 9th Cir. 2010).

[71]*In re Scotia Dev., LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Jan. 18, 2007).

[72]*In re Scopac*, 624 F.3d 274, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010); see also Eric J. Fromme, Feeling Inade-

> adequate protection . . . of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.[73]

Section 507(b) provides a secured creditor with an administrative expense claim under section 503(b) "where adequate protection payments prove insufficient to compensate a secured creditor for the diminution in the value of its collateral."[74] Ultimately, after confirmation, the Fifth Circuit provided the secured lenders a super-priority administrative expense claim for insufficient adequate protection over the duration of the case.[75]

In January 2007, Scopac, which was more formally known as Scotia Pacific Co., LLC, and a number of its affiliates had filed for Chapter 11 bankruptcy protection.[76] As of the filing, Bank of America was owed $36.2 million for its first-lien debt, which was secured by a lien on substantially all of the debtor's assets, including 200,000 acres of timberland and cash.[77] Noteholders holding approximately $714 million in claims were secured by a second lien on the same assets.[78]

Early in the case, the bankruptcy court authorized the debtors to continue using these assets, subject to the adequate protection

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quate? What's Enough and When Must a Debtor Pay It?, 30-1 ABIJ 40 (Feb. 2011).

[73]11 U.S.C.A. § 507(b).

[74]*In re Scopac*, 624 F.3d 274, 282, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[75]*In re Scopac*, 624 F.3d 274, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[76]*In re Scopac*, 624 F.3d 274, 277, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[77]*In re Scopac*, 624 F.3d 274, 277, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[78]*In re Scopac*, 624 F.3d 274, 277, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

to these lienholders.[79] In January 2008, after the expiration of the debtors' exclusive period to propose a plan of reorganization, various parties-in-interest proposed competing plans of reorganization, including one by the indenture trustee for the Noteholders and another jointly proposed by Mendocino Redwood Co. and Marathon Asset Management, a hedge fund.[80] This second plan, with certain modifications, received sufficient support to be crammed-down over the objections of the Indenture Trustee and was confirmed by the bankruptcy court.[81] On direct appeal, the Fifth Circuit rejected the Indenture Trustee's challenges to the plan.[82]

However, the bankruptcy court and then the Fifth Circuit each evaluated the Indenture Trustee's asserted right, pursuant to section 507(b) of the Bankruptcy Code, to a "super-priority administrative expense claim, arguing its collateral diminished in value post-petition" and that it was not adequately protected for such diminution.[83] To the extent that a section 507(b) claim would be granted, the Noteholders would be entitled to cash pay-

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[79]*In re Scopac*, 624 F.3d 274, 278, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[80]*In re Scopac*, 624 F.3d 274, 278, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011); see also *In re Scotia Dev., LLC, Case No. 07-20027-C-11*, slip op. at 13–14 (Bankr. S.D. Tex. June 6, 2008).

[81]*In re Scopac*, 624 F.3d 274, 279, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011); see also *In re Scotia Dev., LLC, Case No. 07-20027-C-11*, slip op. (Bankr. S.D. Tex. June 6, 2008).

[82]*In re Scopac*, 624 F.3d 274, 279, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[83]*In re Pacific Lumber Co.*, 584 F.3d 229, 239, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009) ("Courts have implied in 11 U.S.C. § 507(b) a right to a super-priority administrative expense claim for the diminution of value of collateral during the operation of the automatic stay") (citing *In re Blackwood Associates, L.P.*, 153 F.3d 61, 68, 33 Bankr. Ct. Dec. (CRR) 90, Bankr. L. Rep. (CCH) P 77789 (2d Cir. 1998); *In re Carpet Center Leasing Co., Inc.*, 4 F.3d 940, 940 (11th Cir. 1993). See, e.g., *LNC Investments, Inc. v. First Fidelity Bank*, 247 B.R. 38 (S.D. N.Y. 2000), adhered to on denial of reconsideration, 44 Collier Bankr. Cas. 2d (MB) 62, 2000 WL 461612 (S.D. N.Y. 2000) (finding that a right to a superiority administrative claim would only have arisen in the Eastern Airlines case if (a) the court had ruled that the lenders were entitled to adequate protection, (b) the adequate protection had ultimately been insufficient and (c) denial of adequate protection because of the presence of an equity cushion that later turned out to be inadequate did not give rise to such a right).

ment in full of such claim upon emergence, unless they agreed to different treatment.[84]

The bankruptcy court denied the section 507(b) claim in full.[85] On direct appeal, the Fifth Circuit assessed the wording of the cash collateral orders granting adequate protection as well as the Indenture Trustee's prepetition liens.[86] In its analysis, the Fifth Circuit found that the debtors had understated the Indenture Trustee's claim by $29.7 million of cash generated from the sale of timber, which cash, in addition to the cash-on-hand as of the filing, should have been subject to their interests.[87] Therefore, the Fifth Circuit granted the Noteholders' request for an administrative expense claim for $29.7 million pursuant to section 507(b).[88]

The appeals court also considered the Indenture Trustee's assertion that the value of its non-cash collateral, the timberland, was also diminished as of confirmation and, thus, such diminution was also entitled to section 507(b) treatment.[89] For this portion of the claim, the Fifth Circuit noted that, in its prior evaluation on appeal of the confirmation order, it determined that the bankruptcy court's findings were "justified" because the value of

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[84]*In re Scopac*, 624 F.3d 274, 280–81, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011) (citing 11 U.S.C.A. § 1129(a)(9)(A)).

[85]*In re Scopac*, 624 F.3d 274, 284, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[86]*In re Scopac*, 624 F.3d 274, 283, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011) (citing Scopac's Third Final Order (Agreed) Authorizing Use of Cash Collateral Pursuant to Section 363 of the Bankruptcy Code at 10, In re: Scotia Development LLC, et al., Debtors., 2008 WL 760444 (Bankr. S.D. Tex. 2008)).

[87]*In re Scopac*, 624 F.3d 274, 283–84, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011) (citing *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 866, 26 Bankr. Ct. Dec. (CRR) 19, Bankr. L. Rep. (CCH) P 76096 (4th Cir. 1994)).

[88]*In re Scopac*, 624 F.3d 274, 284, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[89]*In re Scopac*, 624 F.3d 274, 285, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

the collateral was less than the Noteholders' asserted claim.[90] Thus the Fifth Circuit did not grant the Noteholders additional administrative expense claims based on non-cash collateral.[91]

E. Adequate Protection Provided from Commingled Properties

In *In re Las Torres Development LLC*, the court considered the secured creditor's challenge of the debtors' proposed use of its cash collateral held by one of the debtors, La Placita, for the payment of administrative expenses of both of the debtors.[92] The court distinguished joint administration in the present case from substantive consolidation and, on that basis, held that La Placita's cash collateral could not be used to satisfy the administrative expenses of its co-debtor, Las Torres.[93] The court held that "borrowing from Peter to pay Paul—is not allowed under the applicable law."[94]

F. Future Rents and Future Value as Adequate Protection

Recently, courts have considered how a debtor with a real estate asset may provide adequate protection to its creditors. In real estate asset cases, courts have generally found that continuing construction on an unfinished project does not, in itself, provide adequate protection.[95] Instead, courts have generally required such improvements be made "in conjunction with the

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[90] *In re Scopac*, 624 F.3d 274, 286, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011) (citing *In re Pacific Lumber Co.*, 584 F.3d 229, 248, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009)).

[91] *In re Scopac*, 624 F.3d 274, 286, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010), opinion modified on denial of reh'g, In re Scopac, 2011 WL 3427102 (5th Cir. 2011).

[92] *In re Las Torres Development, L.L.C.*, 413 B.R. 687, 688, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[93] *In re Las Torres Development, L.L.C.*, 413 B.R. 687, 699, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[94] *In re Las Torres Development, L.L.C.*, 413 B.R. 687, 699, 52 Bankr. Ct. Dec. (CRR) 31, 62 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Tex. 2009).

[95] *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 566, 25 Bankr. Ct. Dec. (CRR) 486, 30 Collier Bankr. Cas. 2d (MB) 1034, Bankr. L. Rep. (CCH) P 75803 (3d Cir. 1994).

debtor's providing additional collateral beyond contemplated improvements."[96]

1. The Value Created by Finishing Construction Did Not Provide Adequate Protection: *Pacific Lifestyle Homes*[97]

In one recent case, the debtor, Pacific Lifestyles Homes, was a successful real estate developer and one of the largest builders of residential properties in southern Washington and northern Oregon.[98] It was not immune to market issues facing many other real estate ventures. As a result of the "general financial and housing collapse," the debtor suspended construction in August 2008.[99] At the time of its filing, the debtor owed several banks millions of dollars, which had been used to buy and develop vacant land into homes.[100] These loans were secured by substantially all of those real estate holdings in various states of completion.[101]

The debtor sought to continue to operate postpetition. To facilitate this, the debtor's CEO, Kevin Wann, agreed to provide up to $1.7 million from a personal tax refund for postpetition debtor-in-possession financing.[102] In addition, the debtor sought to use the lenders' cash collateral to continue to convert unfinished properties into finished homes to be sold.[103] The debtor proposed using 10% of the proceeds from the sale of homes and 10% of current cash balances to fund working capital and to use net proceeds from the completion of individual houses to fund further development in the related property development and not to remit net

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[96] *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 566, 25 Bankr. Ct. Dec. (CRR) 486, 30 Collier Bankr. Cas. 2d (MB) 1034, Bankr. L. Rep. (CCH) P 75803 (3d Cir. 1994).

[97] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908 (Bankr. W.D. Wash. 2009).

[98] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *1 (Bankr. W.D. Wash. 2009).

[99] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *1 (Bankr. W.D. Wash. 2009).

[100] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

[101] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

[102] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

[103] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

proceeds to the corresponding lender until all of the houses in such development were completed.[104]

For this use of cash collateral, the debtor argued that the lenders were adequately protected because the use of cash collateral would increase the value of the real estate projects securing their loans.[105] Furthermore, the debtor proposed making adequate protection payments.[106]

The court applied the Eighth Circuit's "three-step approach to determine whether the proposed adequate protection provided the creditor with the value of his bargained for rights."[107] This test requires a court to:

> (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 risks to that value consistent with the concept of indubitable equivalence.[108]

The value of the cash collateral, approximately $8.3 million in total, was not in dispute.[109] The court recognized the risks of possible erosion in the value of the lenders' collateral.[110] Thus the court turned to evaluating whether the proposal was sufficient.[111]

The court agreed with the lenders' assertions that the debtor had not offered adequate protection satisfying either of the first two prongs of section 361 of the Bankruptcy Code. First, the court found that interest paid out of sales proceeds, on which the lenders already held liens, did not constitute adequate protection,

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[104] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

[105] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *9 (Bankr. W.D. Wash. 2009).

[106] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *7 (Bankr. W.D. Wash. 2009).

[107] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *10 (Bankr. W.D. Wash. 2009).

[108] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *10 (Bankr. W.D. Wash. 2009) (citing *In re Martin*, 761 F.2d 472, 476–77, 12 Collier Bankr. Cas. 2d (MB) 974, Bankr. L. Rep. (CCH) P 70543 (8th Cir. 1985)).

[109] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *10 (Bankr. W.D. Wash. 2009).

[110] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *10 (Bankr. W.D. Wash. 2009).

[111] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *10 (Bankr. W.D. Wash. 2009).

nor did the debtor offer "additional or replacement liens."[112] The court also noted that payments only when a house sells would not constitute "periodic cash payments [because they] are not recurring payments proposed to be made at fixed intervals."[113]

Thus the court considered whether the increase in the value of the properties from further development would satisfy the third prong of section 361 of the Bankruptcy Code by providing the lenders with the indubitable equivalent of the "present value of their Cash Collateral."[114] The court noted that the debtor's offer consisted of "its hopes and projections of future profitability" and concluded that this "speculation" was insufficient.[115] However, the court did not indicate that proposed adequate protection predicated on increasing collateral value could never be sufficient; this ruling was limited solely to its evaluation of the debtor's proposed "all or nothing" approach to the use of cash collateral.[116]

2. Undersecured Lien Cannot Be Primed to Provide Adequate Protection of DIP Financing: *YL West 87th*[117]

Prior to filing for bankruptcy, YL West 87th Holdings I LLC (Holdings) owned only one asset, a membership interest in YL West 87th Street, LLC (West).[118] West owned real property, which it had purchased to convert into a condominium.[119] This conversion was funded by certain loans borrowed by Holdings, granting the lenders a security interest in Holdings' membership interest in West.[120] Garrison Special Opportunities Fund LP, the assignee of such debt, attempted a foreclosure sale of West's property after

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[112] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *11 (Bankr. W.D. Wash. 2009).

[113] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *11 (Bankr. W.D. Wash. 2009).

[114] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *11 (Bankr. W.D. Wash. 2009).

[115] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *12 (Bankr. W.D. Wash. 2009).

[116] *In re Pacific Lifestyle Homes, Inc.*, 2009 WL 688908, *13 (Bankr. W.D. Wash. 2009).

[117] *In re YL West 87th Holdings I LLC*, 423 B.R. 421 (Bankr. S.D. N.Y. 2010).

[118] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 423 (Bankr. S.D. N.Y. 2010).

[119] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 423 (Bankr. S.D. N.Y. 2010).

[120] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 423–24 (Bankr. S.D. N.Y. 2010).

Holdings defaulted on its loan.[121] To avoid the foreclosure sale, Holdings filed for Chapter 11 and sought the protection of the automatic stay.[122] Garrison moved to lift the stay so that it could enforce its security interest.[123]

The bankruptcy court noted that Holdings had only one class of creditors and, therefore, to confirm a plan it would have to have enough equity in its membership interest in West to unimpair Garrison's interest.[124] However, the court noted that the collateral securing Garrison's debt was not West's property itself but the membership interest in West, which retained the potential upside of developing the property.[125] After both sides presented experts to testify as to the value of the property, the court concluded that the property was worth $45,845,287.50 if Holdings could obtain the financing necessary to complete the project.[126]

Therefore, Holdings moved to obtain debtor-in-possession financing in exchange for priming liens on West's property.[127] Pursuant to section 364 of the Bankruptcy Code, Holdings had to show that existing lienholders would be adequately protected if it were to provide priming liens.[128] With regards to how to prove adequate protection, the court stated:

> The existing of an equity cushion seems to be "the preferred test in determining whether priming of a senior lien is appropriate under section 364." *In re Strug-Division LLC*, 380 B.R. 505, 513, 49 Bankr. Ct. Dec. (CRR) 109 (Bankr. N.D. Ill. 2008); see Snowshoe, 789 F.2d at 1088–90; see *In re Dunes Casino Hotel*, 69 B.R. 784, 795–96, Bankr. L. Rep. (CCH) P 71614 (Bankr. D. N.J. 1986); *In re Reading*

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[121] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 424 (Bankr. S.D. N.Y. 2010).

[122] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 425 (Bankr. S.D. N.Y. 2010).

[123] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 425–27 (Bankr. S.D. N.Y. 2010).

[124] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 428 (Bankr. S.D. N.Y. 2010).

[125] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 428 (Bankr. S.D. N.Y. 2010).

[126] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 440 (Bankr. S.D. N.Y. 2010).

[127] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 440 (Bankr. S.D. N.Y. 2010).

[128] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D. N.Y. 2010) (citing *In re First South Sav. Ass'n*, 820 F.2d 700, 701-11, 17 Collier Bankr. Cas. 2d (MB) 31, Bankr. L. Rep. (CCH) P 71895 (5th Cir. 1987)).

> *Tube Industries*, 72 B.R. 329, 333–34, 15 Bankr. Ct. Dec. (CRR) 927, 16 Collier Bankr. Cas. 2d (MB) 815, Bankr. L. Rep. (CCH) P 71770 (Bankr. E.D. Pa. 1987) (Where there is no equity cushion, section 364(d)(1)(B) is not satisfied). There are also courts that have adopted a more "holistic approach" by analyzing all relevant facts "with a particular focus upon the value of the collateral, the likelihood that it will depreciate or appreciate over time, the prospects for successful reorganization of the Debtor's affairs by means of the Plan, and the Debtor's performance in accordance with the Plan." *In re Tashjian*, 72 B.R. 968, 973 (Bankr. E.D. Pa. 1987); See *In re Aqua Associates*, 123 B.R. 192, 196–97 (Bankr. E.D. Pa. 1991).[129]

The court held that the only form of adequate protection Holdings or West could provide to Garrison was the potential increase in value of West's property if it obtained the necessary financing.[130]

The bankruptcy court discussed prior case law addressing this issue. In *In re 495 Cent. Park Ave. Corp.*, the debtor sought approval for a DIP loan of $625,000 on a priming basis to fund the renovation of a property.[131] The property was valued at between $2,200,000 and $2,250,000 and was subject to a mortgage of $3,950,000.[132] The court held that the proposed renovation of the property would increase its value by approximately $800,000, stating that "there is no question that the property would be improved by the proposed renovations and that an increase in value will result."[133] This conclusion was bolstered by evidence that a new tenant was prepared to enter into a 15-year lease with the debtor after the renovation.[134] Therefore, the court approved the DIP financing because the increased value of the property was greater than the DIP financing itself.[135] The court then addressed *SunTrust*, which is summarized in detail in section

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[129] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441–42 (Bankr. S.D. N.Y. 2010).

[130] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010).

[131] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010) (citing *In re 495 Cent. Park Ave. Corp.*, 136 B.R. 626, 629–30 (Bankr. S.D. N.Y. 1992)).

[132] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010) (citing 495 Central Park, 136 B.R. 626, 628–30).

[133] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010) (citing 495 Central Park, 136 B.R. 626, 626–31).

[134] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010) (citing 495 Central Park, 136 B.R. 626, 629).

[135] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D. N.Y. 2010) (citing 495 Central Park, 136 B.R. 626, 632).

II.A above.[136] In that case, the court rejected the DIP financing because the renovations it would have funded, and which were the only adequate protection offered, were tenuous.[137] The bankruptcy court also cited, but did not discuss, other cases with similar holdings to *SunTrust*.[138]

In light of this case law, the court held that the value of West's property if the project was completed, $45,845,287.50, was still less than the $46 million secured loan plus Garrison's $20 million debt "on the level of the Debtor."[139] The court noted that, even if the valuation of the property was higher and the Debtor retained some equity in its membership interest in West, it would still deny priming of Garrison's liens because of the speculative nature of the project.[140] The renovation of West's property would have required regulatory approval, the obtaining of which was questionable, and there was no assurance as to the time the project would take, the Debtors' ability to stay within the budget of the DIP financing, the Debtors' motivation to complete the project or the ability to refinance the loan.[141] Therefore, the court held that the facts presented were closer to those in *SunTrust* than those in *495 Central Park* and denied the Debtors' request for approval of DIP financing.[142] Absent DIP financing, the Debtor failed to show that there was any likelihood of an effective reorganization and the court therefore granted Garrison's motion to lift the automatic stay.[143]

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[136]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442–43 (Bankr. S.D. N.Y. 2010).

[137]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442–43 (Bankr. S.D. N.Y. 2010).

[138]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 443 (Bankr. S.D. N.Y. 2010) (citing *In re Chevy Devco*, 78 B.R. 585, 16 Bankr. Ct. Dec. (CRR) 571 (Bankr. C.D. Cal. 1987); *In re Strug-Division LLC*, 380 B.R. 505, 514–15, 49 Bankr. Ct. Dec. (CRR) 109 (Bankr. N.D. Ill. 2008); *In re Mosello*, 195 B.R. 277, 293 (Bankr. S.D. N.Y. 1996)).

[139]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 443 (Bankr. S.D. N.Y. 2010).

[140]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 443 (Bankr. S.D. N.Y. 2010).

[141]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 443 (Bankr. S.D. N.Y. 2010).

[142]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 443–44 (Bankr. S.D. N.Y. 2010).

[143]*In re YL West 87th Holdings I LLC*, 423 B.R. 421, 445 (Bankr. S.D. N.Y. 2010).

3. Future Rents Cannot Provide Adequate Protection of Holder of Liens on All Assets: *Buttermilk Towne Center*[144]

In Buttermilk Towne Center's bankruptcy case, the debtor sought to use cash collateral that was otherwise subject to the liens of its secured lender, Bank of America, in order to pay administrative expenses, including professional fees.[145] The debtor maintained that Bank of America was adequately protected because the expected future rents pledged to Bank of America exceeded the value of its claim.[146] Contrarily, Bank of America argued that it was not adequately protected because (1) Buttermilk was not making cash payments; (2) liens on future rents were included in its collateral already and, thus, did not constitute replacement or additional liens; and (3) there was no equity cushion in the property. On June 1, 2010, the Bankruptcy Court for the Eastern District of Kentucky initially approved the debtor's use of cash collateral.[147] On June 29, 2010, the bankruptcy court clarified its prior order and found that Bank of America was adequately protected.[148]

On appeal, the Sixth Circuit Bankruptcy Appellate Panel reversed.[149] The court, looking to prior unpublished Sixth Circuit case law, found that these future rents could not constitute adequate protection for Bank of America because Bank of America already held liens on all future rents.[150]

This result may be at odds with a body of prior case law in

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[144] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010).

[145] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 560–561, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010).

[146] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 561–562, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010).

[147] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 561, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010) (citing Final Order on Use of Cash Collateral, In re Buttermilk Towne Center, LLC, Case No. 10-21162 [Dkt. No. 94] (Bankr. E.D. Ky. 2010)).

[148] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 561, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010) (citing *In re Buttermillk Towne Center, LLC*, 2010 WL 5559411 (Bankr. E.D. Ky. 2010)).

[149] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010).

[150] *In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 566, 64 Collier Bankr. Cas. 2d (MB) 1771 (B.A.P. 6th Cir. 2010) (quoting *In re Stearns Bldg.*, 165 F.3d 28 (6th Cir. 1998) (unpublished table decision) ("[T]he record does not indicate that Debtor possesses any unencumbered assets with which it can offer [the lender] adequate protection . . . [and] this court cannot accept that the use of

other jurisdictions. For example, in *In re Barkley 3A Investors*, the bankruptcy court found that, as long as rents were not decreasing over time, the secured lender was protected by its liens attaching to future rents.[151] Similarly, a Florida bankruptcy court noted that "[w]ith regards to rents, a court must look to the stream of future rents to determine whether adequate protection is required."[152] The court reached this conclusion after observing that "the lien on each month's rents replaces the lien on the prior month's rents, so there is a replacement lien of equal value under Section 361 of the Bankruptcy Code."[153] However, in that case the court held that, if the stream of rents is declining, then adequate protection payments are required in addition to the adequate protection provided by renewal rents.[154]

4. Maintenance of Properties Generating Rental Income Provided Adequate Protection of Cash Collateral: *Las Vegas Monorail Co.*[155]

In *In re Las Vegas Monorail Co.*, the secured creditor of a

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future rents to replace the expenditure of the prior month's rents somehow provides adequate protection for the secured party.")); see also, e.g., *In re Pacific Avenue, LLC*, Case No. 10-32093 (Bankr. W.D.N.C. 2010) (Judge Hodges ruled that prepetition rents could not be used to pay a retainer to special counsel retained to sue the lender that was secured by the rents.).

[151] *In re Barkley 3A Investors, Ltd.*, 175 B.R. 755, 760, 26 Bankr. Ct. Dec. (CRR) 525 (Bankr. D. Kan. 1994) (citing *In re Mullen*, 172 B.R. 473, 26 Bankr. Ct. Dec. (CRR) 66, 31 Collier Bankr. Cas. 2d (MB) 1765, Bankr. L. Rep. (CCH) P 76131 (Bankr. D. Mass. 1994)):

> Judge Queenan compares rents to receivables or inventory as handled in financing agreements. So long as the value of the stream of future accounts or inventory and their proceeds is not declining, an undersecured receivables or inventory lender is not denied adequate protection by having its lien extended to postpetition accounts and inventory. The newly generated receivables are subjected to a lien by agreement so the present proceeds can be used and there is no lack of adequate protection. The new proceeds are used to generate new collateral and new proceeds, and the lender cannot complain about the consumption of any particular proceeds. The same is true with rents. The next month's rents are automatically subject to the lien under § 552(b). Rents and receivables constantly renew themselves. So long as the debtor is not operating at a loss, or rents are not declining, the renewals provide constant value.

[152] *In re Wrecclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997) (citing *In re Megan-Racine Associates Inc.*, 202 B.R. 660, 663 (Bankr. N.D. N.Y. 1996)).

[153] *In re Wrecclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997) (citing Megan-Racine Associates, 202 B.R. 660, 663).

[154] *In re Wrecclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997).

[155] *In re Las Vegas Monorail Co.*, 429 B.R. 317, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

Chapter 11 debtor, Las Vegas Monorail Company (LVMC), sought adequate protection for the use of its cash collateral.[156] LVMC owned and operated a monorail which connected various hotels on the Las Vegas "Strip."[157] The revenues that the monorail earned LVMC were greater than LVMC's operating expenses but were not enough to service LVMC's debt.[158] The "vast majority" of LVMC's debt arose from conduit financing, a type of financing whereby a local government issues tax-free bonds and then loans the proceeds of those sales to a private party in order to build or operate a project to benefit the community.[159] The bonds used to finance LVMC's monorail were issued under an indenture between Wells Fargo Bank (the Trustee) and the Director of the Nevada Department of Business and Industry.[160] Pursuant to the indenture, the Trustee took a security interest in LVMC's cash collateral.[161] The bankruptcy court addressed a dispute between LVMC and the Trustee regarding what constituted cash collateral under the indenture and determined that the wording of the indenture (contrary to common practice) permitted LVMC to pay all operating costs before the Trustee's security interest in the cash collateral attached.[162] Both LVMC and the Trustee agreed that, to the extent the Trustee was not adequately protected for its security interest in cash collateral, it would receive replacement liens on what was defined in the indenture as "Net Project Revenues."[163] However, the Trustee insisted that it was also entitled to liens on all of LVMC's unencumbered property.[164] The court concluded that LVMC's transfer of cash deposits to the

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[156]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 322, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[157]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 323, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[158]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 323, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[159]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 323–24, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[160]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 324, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[161]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 325–26, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[162]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 339–40, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[163]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 340, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[164]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 340, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

Trustee after legitimate operational expenses adequately protected the Trustee's interest.[165] The court continued:

> Moreover, LVMC's use of the cash it generates in its operations is itself a form of adequate protection. This is because LVMC's continued investment in, and operation of, the monorail will increase, or at least maintain, the collateral's value. A shuttered monorail will not generate any revenue, but every additional rider on the monorail will generate additional cash for distribution to the Noteholders, after LVMC pays reasonable expenses. The Trustee has offered no evidence that monorail ridership is decreasing, as it would have needed to obtain additional adequate protection of its prepetition interests.[166]

The court further held that, in accordance with the holding in *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 16 Bankr. Ct. Dec. (CRR) 1369, 17 Collier Bankr. Cas. 2d (MB) 1368, Bankr. L. Rep. (CCH) P 72113 (1988), the passage of time does not, in itself, warrant adequate protection.[167] Therefore, the court concluded that "the Debtors' expenditures keep the monorail running and preserve the Trustee's expectation in net revenues as their primary collateral."[168] The court then cited to numerous cases where courts have held that a debtor's use of cash collateral in order to maintain properties earning rental income is a sufficient form of adequate protection.[169] The court concluded that the transfer of cash deposits to the Trustee after the payment of operational expenses and the providing of replacement liens

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[165]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 341, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[166]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 341, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[167]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 341, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[168]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 341, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[169]*In re Las Vegas Monorail Co.*, 429 B.R. 317, 341, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010) (citing *Federal Nat. Mortg. Ass'n v. Dacon Bolingbrook Associates Ltd. Partnership*, 153 B.R. 204, 214 (N.D. Ill. 1993); *In re 499 W. Warren Street Associates, Ltd. Partnership*, 142 B.R. 53, 58, 27 Collier Bankr. Cas. 2d (MB) 696 (Bankr. N.D. N.Y. 1992); *In re McCombs Properties VI, Ltd.*, 88 B.R. 261, 267, 17 Bankr. Ct. Dec. (CRR) 1147 (Bankr. C.D. Cal. 1988); *In re Stein*, 19 B.R. 458, 460, 9 Bankr. Ct. Dec. (CRR) 568, 6 Collier Bankr. Cas. 2d (MB) 516, Bankr. L. Rep. (CCH) P 68646 (Bankr. E.D. Pa. 1982)).

combined to satisfy the adequate protection requirement.[170]

G. Withholding of Adequate Protection Payments to Junior Creditors

In *In re Fontainebleau Las Vegas Holdings, LLC*, the Chapter 11 debtors (Fontainebleau) consisted of six entities building a hotel resort on the Las Vegas Strip.[171] Fontainebleau was forced to stop construction when the project was 70% completed because it was not able to secure new funds.[172] Fontainebleau subsequently filed for Chapter 11 protection.[173] A dispute arose between lenders who had funded the project and received first priority liens on substantially all of Fontainebleau's assets (the Term Lenders) and the builders of the project (the Statutory Lienholders) who claimed to have substantial mechanics' liens which trumped those of the Term Lenders.[174] Both the Term Lenders and the Statutory Lienholders claimed to have the higher priority.[175] Tabling the issue, the court granted certain cash collateral motions which provided the Term Lenders with replacement liens on certain of Fontainebleau's collateral because they were the only parties claiming a security right in the cash collateral.[176]

As time went on, the hopes of restructuring Fontainebleau faded, and a sale seemed imminent.[177] The bankruptcy court appointed an examiner to supervise the negotiation of the sale whose expenses would be paid from cash collateral due to priming liens senior to those of the Statutory Lienholders.[178] Later, Icahn Nevada Gaming Acquisition LLC (Icahn Nevada) entered

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[170] *In re Las Vegas Monorail Co.*, 429 B.R. 317, 346, 71 U.C.C. Rep. Serv. 2d 521 (Bankr. D. Nev. 2010).

[171] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 722–23 (S.D. Fla. 2010).

[172] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 723 (S.D. Fla. 2010).

[173] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 723 (S.D. Fla. 2010).

[174] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 723 (S.D. Fla. 2010)–24.

[175] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 723–24 (S.D. Fla. 2010).

[176] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 724 (S.D. Fla. 2010).

[177] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 727–28 (S.D. Fla. 2010).

[178] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 728 (S.D. Fla. 2010).

the case as a stalking horse bidder for Fontainebleau.[179] In exchange for possession of the Fontainebleau project, Icahn Nevada would pay $105 million in cash and provide a DIP facility of $51 million.[180] The Statutory Lienholders objected, claiming that Fontainebleau should not be able to use the funds borrowed from Icahn Nevada to repay the cash collateral to the Term Lenders, pay Fontainebleau's professionals and to pay the examiner because they were not adequately protected.[181] Despite the Statutory Lienholders' objections, the bankruptcy court approved the DIP Facility provided by Icahn Nevada and permitted the proceeds to repay the cash collateral of the Term Lenders.[182] In so holding, the court stated that funding the project benefitted all creditors in the cases.[183] Subsequently, at the demand of Icahn Nevada, certain Fontainebleau affiliates (the Retail Debtors), whose holdings were valueless on their own but added value to the overall project, filed for bankruptcy.[184] The Statutory Lienholders objected on the basis that they were not given adequate protection for their interests in the Retail Debtors' assets.[185] Pursuant to these events, Icahn Nevada was granted a superpriority administrative claim under section 364(c)(1) and first-priority priming liens and security interests in all property of Fontainebleau and the Retail Debtors.[186] The bankruptcy court subsequently entered an order approving the sale, allowing Icahn Nevada to "credit bid" its debt.[187] The Statutory Lienholders appealed, among other things, the cash collateral orders, the

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[179] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 729 (S.D. Fla. 2010).

[180] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 729 (S.D. Fla. 2010).

[181] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 729–30 (S.D. Fla. 2010).

[182] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 730 (S.D. Fla. 2010).

[183] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 730 (S.D. Fla. 2010).

[184] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 731 (S.D. Fla. 2010).

[185] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 732 (S.D. Fla. 2010).

[186] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 732 (S.D. Fla. 2010).

[187] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 732 (S.D. Fla. 2010).

examiner order and the order approving the DIP financing provided by Icahn Nevada.[188]

The District Court for the Southern District of Florida held that, under section 361, the Statutory Lienholders' liens against the Fontainebleau project exceeded the value of the project itself.[189] Therefore, the court held that the Statutory Lienholders should receive adequate protection only for the value of the collateral and that, to the extent Icahn Nevada received priming liens in the project, the Statutory Lienholders should be adequately protected.[190] As evidence for the adequate protection of the Statutory Lienholders, the bankruptcy court had highlighted that the DIP financing provided by Icahn Nevada was essential to the survival of the project and that it benefitted all creditors.[191] The district court took no issue with these statements but held that they were not relevant to the question of whether the Statutory Lienholders were adequately protected.[192] "Because the Statutory Lienholders were due to be 'primed,' the inquiry ought to have focused on compensating the Statutory Lienholders for the loss of value of their interests in the Project *caused by the priming lien*."[193] The District Court held that the bankruptcy court erred by not inquiring as to whether the Statutory Lienholders were adequately protected for the decrease in their security interest as a result of Icahn Nevada's priming liens.[194] The district court held as follows:

> [Fontainebleau] and the bankruptcy court focused on preserving the value of the Project for the benefit of all creditors. That goal was worthy and important, and the Court does not question it. But [Fontainebleau] did not try to establish, and the bankruptcy court did not find, that the decrease in the value of the Statutory Lienholders' *interests therein* caused by the priming lien was

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[188] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 733 (S.D. Fla. 2010).

[189] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 750 (S.D. Fla. 2010).

[190] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 750 (S.D. Fla. 2010).

[191] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 751 (S.D. Fla. 2010).

[192] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 751 (S.D. Fla. 2010).

[193] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 751–52 (S.D. Fla. 2010) (citations omitted and emphasis in the original).

[194] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 752 (S.D. Fla. 2010).

> compensated, replaced, or substituted in any way: to be blunt, the Statutory Lienholders were not adequately protected. The proceedings below failed to account for what a priming lien does . . . Not accounting for the decrease caused by the priming lien was fundamentally at odds with the principle of adequate protection, which must as nearly as possible under the circumstances of the case provide the creditor with the value of his bargained for rights.[195]

The district court then addressed the argument that the Statutory Lienholders' liens on the assets of the Retail Debtors could be primed because they were valueless.[196] The court held—because (1) these assets had significant value when combined with Fontainebleau's assets and (2) the Statutory Lienholders held security interests in Fontainebleau's assets—that this argument did not have merit.[197] The district court also held that the bankruptcy court erred in priming the Statutory Lienholders to pay the fees of the examiner despite the bankruptcy court's holding that such priming was "unimportant" or otherwise justified by section 506(c).[198]

The Statutory Lienholders further argued that the DIP financing provided by Icahn Nevada should not have been used to repay the Term Lenders' interests in cash collateral because the Statutory Lienholders were not adequately protected. The district court held that the priming interests provided to the Term Lenders pursuant to the cash collateral orders were not justified by section 364(d)(1) because they did not involve post-petition extensions of credit.[199] The district court acknowledged that the Term Lenders must have received adequate protection in order for Fontainebleau to use the collateral but held that it was inappropriate to prime a secured creditor to provide such adequate protection.[200] The district court concluded:

> Last, it may be true, as the Term Lenders contend, that if [Fontainebleau] did not use the cash collateral on a priming basis,

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[195] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 755 (S.D. Fla. 2010) (internal citations and quotation marks omitted).

[196] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 755 (S.D. Fla. 2010).

[197] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 755 (S.D. Fla. 2010).

[198] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 755 (S.D. Fla. 2010).

[199] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 757–58 (S.D. Fla. 2010).

[200] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 758 (S.D. Fla. 2010).

> [Fontainebleau] would have had to obtain financing from another source on a priming basis anyway. Section 363, which governs the use of cash collateral, and Section 364, which governs the obtaining of credit, are written clearly. Under the latter, priming liens are made available explicitly; under the former, they are not. Without clear authority provided either by the statutes or case law, the Court is hesitant to create what would appear to be an exception to the Bankruptcy Code. But even if the Court were to do so, what is particularly troublesome here is that [Fontainebleau] provided the Statutory Lienholders with no adequate protection to preserve the value of their interests—[Fontainebleau] provided the Term Lenders with adequate protection in the form of priming liens, but provided nothing to the Statutory Lienholders, whose liens were thereby displaced.[201]

III. Conclusion

As evidenced by recent case law, adequate protection as described in section 361 of the Bankruptcy Code spawns a great deal of litigation over nuanced issues. This article has addressed topics including: (i) sufficiency of an equity cushion, (ii) waiver of a right to adequate protection, (iii) timing of attachment of adequate protection, (iv) treatment of adequate protection deficiencies under section 507(b) of the Bankruptcy Code, (v) adequate protection provided from commingled properties, (vi) whether future rents or future value of an unfinished project can provide adequate protection, and (vii) withholding of adequate protection payments to junior creditors. These topics, and likely other as-yet unreported issues, are susceptible to differences of opinion and should engender substantial debate and controversy in the coming years.

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[201] *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 759 (S.D. Fla. 2010).