

CALIFORNIA LAW BUSINESS

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Cram Slam

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BANKRUPTCY LAW: Actual use, rather than a hypothetical foreclosure, is the proper basis for determining the value of collateral worth less than the debt amount.

A "cram down" bankruptcy plan may allow the debtor to retain and use a secured creditor's collateral over the creditor's objection if the creditor receives present value at least equal to its secured claim. 11 U.S.C. Section 1129(b) (2) (A) and 1325 (a) (5) (B).

In a Chapter 11 bankruptcy reorganization, the present-value test requires that a member of the secured claimant's class receive, as of the plan's effective date, an account of its secured-claim deferred cash payments of a value equal to no less than the claimant's interest in the estate's interest in the collateral. 11 U.S.C. Section 1129 (b) (2) (A) (ii) (II). The present-value test in a Chapter 13 case for adjustment of debts of an individual with regular income is essentially identical, except that the secured creditor under Chapter 13 may be provided any property, as of the plan's effective date, of a value equal to the allowed amount of the creditor's secured claim, rather than being restricted to deferred cash payments. See 11 U.S. C. Section 1325 (a) (5) (B) (ii).

To apply the present-value test in the context of a cram down of a secured creditor, the amount of the creditor's secured claim must be determined. This initial requirement is illuminated by the example of an under-secured creditor (a creditor whose collateral is worth less than the amount of its entire claim). Bankruptcy Code Section 506(a) divides an under-secured creditor's total claim into a secured claim to the extent of the collateral's value and into an unsecured claim to the extent of the deficiency.

"In situations involving only one creditor and only one debtor, the value of the under-secured creditor's secured claim is simply the value of the underlying collateral. The difference between the collateral's value and the amount of debt becomes an unsecured claim that is added to the existing pool of unsecured claims." *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank*, 881 F.2d 1346, 1349 (5th Cir. 1989). Section 506 applies in both Chapter 11 and 13 cases. 11 U.S.C. Section 103(a).

U.S. circuit courts have adopted three different standards for valuing a security interest in a bankruptcy case where the debtor invokes the cram down power to retain the collateral over the creditor's objection. The 5th U.S. Circuit Court of Appeals adopted a foreclosure-value standard. *In re Rash*, 90 F.3d 1036 (1996). Several other circuits followed a replacement value approach. See, e.g., *In re Taffi* 96 F.3d 1190, 1191-92 (9th Cir.1996) (en banc); *In re Winthrop Old Farm Nurseries Inc.*, 50 F.3d 72, 74-75 (1st Cir. 1995); *In re Trimble*, 50 F.3d 530, 531-32 (8th Cir. 1995). The 7th Circuit applied a standard midway between foreclosure-value and replacement

value, *In re Hoskins*, 102 F.3d 311,316-17 (7th Cir. 1996), and the 2nd Circuit allowed bankruptcy courts discretion to determine value within a range from foreclosure-value to replacement-value. *In re Valenti*, 105 F.3d 55,62 (2nd Cir. 1997).

The U.S. Supreme court granted certiorari to resolve the conflict among the circuits and to answer the question of how a secured claim should be valued when addressing a cram down plan where the debtor proposes to retain the collateral over the secured creditor's objection. *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997).

Rash was a Chapter 13 case where the debtor's plan provided for the debtor to retain and use a tractor truck in his freight-hauling business and to pay the secured creditor, over 58 months, an amount equal to the truck's present value. The debtor's alleged value was approximately 31 percent less than the amount of the creditor's claim. The creditor alleged that it was fully secured and requested the bankruptcy court grant the creditor relief from the automatic stay to allow it to repossess the truck. The debtor filed an objection to the creditor's claim.

The Supreme Court identified Section 506(a) as being central to the case's resolution. That section provides: "An allowed claim of a creditor secured by a lien on property in which the estate has an interest...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.

The 5th Circuit in *Rash* read the phrase "to the extent of the value that valuation of the secured claim be based on what the creditor could realize if it sold the estate's interest in the property by repossessing and selling the collateral. *Rash*, 90 F.3d at 160-61. This foreclosure-value approach would typically lead to a lower valuation of the collateral than would application of a replacement-value standard.

In rejecting the 5th Circuit's foreclosure-value standard, the court declared that the first sentence of Section 506(a), in its entirety, simply 'tells us that a secured creditor's claim is to be divided into secured and unsecured portions, with the secured portion of the claim limited to the value of the collateral." *Rash*, 117 S.Ct. at 1884, citing *United States v. Ron Pair Enter. Inc.*, 489 U.S. 235, 238-39 (1989).

The court explained that the determination of a claim's unsecured and secured portions involves a comparison of the creditor's claim to the collateral's value. The court commented that the comparison might be complicated. For example, the debtor might own only a partial interest in the collateral and the creditor might hold a part interest through a junior or subordinate lien in the property. Accordingly, the Supreme Court found that the first sentence of Section 506(a) merely tells the court what it must evaluate, but does not provide any direction as to *how* to value collateral.

Thus, the 5th Circuit had erred when equating the Section 506(a) language of a creditor's interest with the net value a creditor could realize through a foreclosure sale.

The Supreme Court found that the second sentence of Section 506(a), providing that value shall be determined in light of the valuation's purpose and the property's proposed disposition or use, directly addresses the question of how to value the collateral. More specifically, the court determined that the collateral's "proposed disposition or use" is of paramount importance to the valuation question under Section 506(a). Again, the Supreme Court found fault with the 5th Circuit's approach: "By deriving a foreclosure-value standard from [Section]506(a)'s first sentence, the Fifth Circuit rendered inconsequential the sentence that expressly addresses how 'value shall be determined.'" *Rash*, 117 S.Ct. at 1884.

The Supreme Court also rejected the 7th Circuit's approach in *Hoskins* of "mak[ing] two valuations, then split[ting] the difference." *Id.* At 1886. The court found that there was no basis in the Bankruptcy Code for the 7th Circuit's midpoint formulation. Further, the court rejected the 2nd Circuit's approach in *Valenti*, which allowed the use of different valuation standards based on the facts and circumstances of each case. *Id.* At 1886 n.5.

The Supreme Court concluded that the similar standards applied by the 7th and 2nd circuits were a result of the failure of those courts to comprehend that Section 506(a) directs application of the replacement-value standard. Instead, the 7th Circuit incorrectly adopted an approach based upon the economics of the situation, after concluding that the Bankruptcy Code required no valuation method. The 2nd Circuit adopted a ruleless approach based upon its perception that bankruptcy courts were free to determine the valuation standard under Section 506(a) on a case-by-case basis.

In *Rash*, the debtor chose to retain and use the collateral to generate an income stream. The Supreme Court held that actual use, rather than a hypothetical foreclosure, is the proper basis for determining the value of the collateral under Section 506(a). The court explained that the collateral's "disposition or use" depends on the alternative the debtor chooses. The choice is between whether the debtor surrenders the collateral to the creditor or whether the collateral will be retained and used by the debtor. The court found that from both the creditor's and the debtor's perspectives, surrender and retention of the collateral are not equivalent acts.

Consequently, the Supreme Court determined: "Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor's choice to surrender the property or retain it. A replacement-value standard, on the other hand, distinguishes retention from surrender and renders meaningful the key words 'disposition or use.'" *Id.* At 1885.

Accordingly, valuation under Section 506(a) must be tied to the actual proposed use of the property under the cram down plan and is not to be based on various dispositions or uses that might have been proposed. On that basis, the Supreme Court in *Rash* held that the value of the debtor's truck and, thus, the amount of the creditor's secured claim under Section 506(a) "is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." *Id.* At 1884. The court identified the approach it was applying as the "replacement-value" approach.

In *Taffi*, decided prior to the Supreme Court's decision in *Rash*, the 9th Circuit considered the appropriate valuation method in a Chapter 11 cram down where the collateral (the debtor's home) was to be retained and used by the debtor. As the Supreme Court subsequently did in *Rash*, the 9th Circuit rejected consideration of hypothetical foreclosure-value, costs of repossession and sales costs. The 9th circuit stated: "When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral." *Taffi*, 96 F.3d at 1192.

Like the Supreme Court, the 9th Circuit concluded that the valuation is to be done based upon the actual situation presented. Therefore, when the plan provides for the debtor to retain and use the collateral, the "value has to be the fair market value of what the debtors are using." The 9th Circuit continued by defining fair market value as "the price which a willing seller under no compulsion to sell and a willing buyer under no compulsion to buy would agree upon after the property has been exposed to the market for a reasonable period of time." However, apparently viewing replacement value and fair-market value standards as distinct and incompatible, the 9th Circuit panel stated that the "fair market value is not 'replacement value' because the house is not being replaces." *Id.*

In reaction to the 9th Circuit's use of terminology, the Supreme Court in *Rash*, said that it was not suggesting that a creditor is entitled to recover what it would cost the debtor to purchase the collateral brand new. Instead, the court stated that "the term replacement value is consistent with the Ninth Circuit's understanding of the meaning of fair-market value: by replacement value, we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition." *Rash*, 117 S.Ct. at 1884 n.2.

The Supreme Court explained that when a debtor keeps the property and continues to use it (as in *Rash* and *Taffi*), the creditor does not obtain the property nor its value and is exposed to double risks that the debtor may default and that the property may deteriorate from extended use. In contrast, when the debtor surrenders the property, the court recognized that the "creditor obtains it immediately, and is free to sell it and reinvest the proceeds." Under these circumstances, the court found that the replacement-value standard most accurately reflects the reality of the debtor's "use" of the property. *Id.* At 1885-86.

The Supreme Court stated that a simple rule of valuation is needed to serve the interests of predictability and uniformity. Nonetheless, the court recognized that it had to leave to bankruptcy courts, as triers of fact, identification of the best means of determining replacement value based upon the evidence presented. The court stated: "Whether replacement value is the equivalent of retain value, wholesale value, or some other value will depend on the type of debtor and the nature of the property" *Id.* At 1886-87 n.6.

The Supreme Court concluded by explaining that in certain circumstances replacement value should not include items that fall outside the scope of the collateral's value when retained by the debtor, such as items representing the value of retail seller's services (e.g., with respect to a vehicle, items such as warranties, inventory storage and reconditioning) or modifications or accessories to the property to which a creditor's lien would not extend under state law.

