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Turning the Page: The Demise of the “Queenan Doctrine” Requiring the Adoption of a Foreclosure Valuation Methodology in Chapter 11 Cases

Harrison Denman*

This Article traces the evolution of the default standard applied by bankruptcy courts to valuing a secured lender’s collateral under section 506(a) for purposes of determining whether a “diminution in value” has occurred sufficient to trigger the need for adequate protection. Historically, bankruptcy courts applied a standard premised on the scholarship of Judge Queenan of the Bankruptcy Court for the District of Massachusetts. That standard called for, absent contractual language to the contrary, application of a foreclosure valuation methodology regardless of the actual or anticipated use of such collateral during the chapter 11 cases. In recent years, there has been a trend away from Judge Queenan’s rigid methodology in favor of a more flexible standard that takes its cue from the particular facts relating to the collateral’s use in each chapter 11 case—leading, typically, to the application of a fair market value standard.

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I. INTRODUCTION

Chapter 11 bankruptcy cases with large capital structures frequently feature a common form of dispute—a valuation fight between secured creditors and unsecured creditors over the appropriate value of a secured creditor’s collateral. The reason for this dispute is fundamental to Chapter 11—any value not attributed to a secured creditor’s collateral will usually be attributed to unencumbered assets and thereby be available for pro rata distribution to an estate’s general unsecured creditors.

Section 506(a)(1) of the Bankruptcy Code governs these disputes over the valuation of a secured creditor’s collateral. That section provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor’s interest or the amount so subject to setoff 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, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.¹

¹ 11 U.S.C. § 506(a)(1).

The valuation under section 506(a) can be undertaken by the court in any of various contexts. When the valuation is undertaken to determine whether a secured creditor's collateral has diminished in value over the course of a Chapter 11 case, it implicates the bankruptcy concept of adequate protection. Adequate protection is not defined by the Bankruptcy Code. Generally speaking, the concept is meant to conform the various provisions of the Bankruptcy Code with the preservation of a secured creditor's private property rights enshrined in the Fifth Amendment of the Constitution.²

Three different sections of the Bankruptcy Code require that a secured creditor's interest in an asset of the debtor be "adequately protected" during the debtor's Chapter 11 cases. First, section 362(d) of the Bankruptcy Code permits a bankruptcy court to lift the automatic stay and permit a secured creditor to take action against its collateral, to the extent the secured creditor demonstrates that its interest in that collateral is not adequately protected.³ Second, section 363(e) of the Bankruptcy Code requires that a secured creditor receive adequate protection of its interest in an asset in connection with the debtor's use, sale or lease of the asset during the Chapter 11 case.⁴ Third, section 364 of the Bankruptcy Code permits a bankruptcy court to approve post-petition financing that primes the lien of a pre-petition secured creditor to the extent that the pre-petition secured creditor receives adequate protection of its interest in that property.⁵ Section 361 of the Bankruptcy Code, in turn, specifies three

² See U.S. CONST. amend. V (" . . . nor shall any person be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."); see also *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273 (1940); H.R. Rep. No. 95-595, at 339 (1977) ("The concept is derived from the fifth amendment protection of property interests.").

³ 11 U.S.C. § 362(d)(1) ("On request of a party in interest . . . the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying or conditioning such stay—(1) for cause, including the lack of adequate protection of an interest in property of such party in interest.").

⁴ 11 U.S.C. § 363(e) ("[O]n request of an entity that has an interest in property . . . proposed to be used, sold, or leased, by the trustee, 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.").

⁵ 11 U.S.C. § 364 ("The court, 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—(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.").

forms of adequate protection that may be provided to a secured creditor to satisfy sections 362(d), 363(e), or 364.⁶

As a matter of practice, such adequate protection rights may be memorialized in a court order at the outset of a bankruptcy case approving the debtor's use of cash collateral. At the outset of a Chapter 11 case, a debtor would seek court approval to use its cash which, under most circumstances, would constitute collateral of its secured lenders. Such court orders will typically condition the continued use of such cash collateral on the continued adequate protection of the secured lenders' interests in such cash to the extent of any subsequent diminution in value. Such court orders could in theory memorialize an agreement between the parties of the proper valuation standard to be used in the event of any subsequent dispute over these adequate protection rights. There is no reason to think that any such agreement would not be respected by a bankruptcy court in the event of a subsequent valuation dispute.

That said, absent the memorialization of such a standard in a cash collateral order, bankruptcy courts, historically, have calculated such a diminution in value using one of two different valuation methodologies. Some bankruptcy courts favored using a fair market valuation methodology for calculating adequate protection of a secured creditor's interest in an asset that was retained and used by a debtor. These bankruptcy courts concluded that the actual fate of the asset dictated the use of fair market valuation methodology, given that the second sentence of section 506(a) emphasizes the "proposed disposition or use" of the asset to be valued.⁷ Other bankruptcy courts, however, favored using a foreclosure valuation methodology for calculating adequate protection of a secured creditor's interest in an asset, even where that asset was retained and used by a debtor. Relying on the scholarship of the former Chief Judge Queenan of the United States Bankruptcy Court for the District of Massachusetts, these bankruptcy courts concluded that the first sentence of section 506(a), which emphasized the contractual "interest" of the creditor in the asset to be valued, required the default application of a foreclosure value methodology.⁸

The search for a particular valuation methodology in the absence of governing language one way or the other necessarily has profound but divergent consequences for creditor recoveries in a Chapter 11 proceeding.

⁶ 11 U.S.C. § 361 ("When adequate protection is required under section 362, 363, or 364, of this title of an interest of an entity in property, such adequate protection may be provided by . . .").

⁷ *In re Tenney Village Co.*, 104 B.R. 562, 566 (Bankr. D. N.H. 1989) (emphasis added); *Robbins*, 119 B.R. 1, 3-4 (Bankr. D. Mass. 1990).

⁸ See James F. Queenan, *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 30 (1987).

A hypothetical foreclosure valuation requires a bankruptcy court to value the subject assets as if the secured creditor had foreclosed outside of bankruptcy. For this reason, the hypothetical foreclosure valuation methodology has been referred to as a valuation of assets “in the hands of the secured creditor” or its collateral agent. Adoption of this methodology will almost always result in a relatively low valuation of the subject assets.⁹ This is because a secured creditor often lacks the operational requirements needed to manage the assets: manpower, expertise, or liquidity. And even if the secured creditor is operationally capable of managing the assets, it may lack the proper regulatory consents necessary to manage regulated assets.

On the other hand, adoption of a fair market valuation typically results in a higher valuation of the secured creditor’s collateral. Measuring the value of the assets in the debtor’s hands means that the bankruptcy court need not apply a discount to account for the secured creditor’s lack of operational abilities or regulatory consents.

Uncertainty surrounding the appropriate valuation methodology was addressed in two recent Supreme Court decisions—*Timbers*¹⁰ and *Rash*.¹¹ Although neither case addressed the valuation of collateral under section 506(a) for adequate protection purposes, each emphasized the “proposed disposition or use” language in the second sentence of section 506(a) at the expense of the “creditor interest” language in the first sentence of section 506(a)—contrary to Judge Queenan’s preferred default construction. In the aftermath of *Rash*, nearly every authority that addressed the issue advocated the adoption of a fair market valuation when such an asset was actually retained, used, or sold by the debtor.¹²

The issue was again litigated in the *Residential Capital LLC* Chapter 11 cases, where the bankruptcy court ultimately declined to resurrect the Queenan default doctrine of requiring foreclosure valuation of a secured creditor’s interest in collateral.¹³ As a result, the *Residential Capital* decision, discussed *infra*, may have signaled the end of the practice of defaulting to require a foreclosure valuation standard for calculating diminution in value when a debtor continues to use or sell the assets at issue.

⁹ *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 962 (1997) (8-1 decision).

¹⁰ *Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988).

¹¹ *See Rash*, *supra* note 9.

¹² *See infra* § III (B).

¹³ *In re Residential Capital, LLC, et al.*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

II. THE “QUEENAN DOCTRINE” AS A DEFAULT STANDARD

Historically, absent specified language one way or the other in the governing cash collateral order, some bankruptcy courts applied the “hands of the creditor” valuation methodology when valuing collateral for adequate protection purposes.¹⁴ These cases largely ascribe to a line of reasoning which was championed in the 1980s by former Chief Judge of the Bankruptcy Court for the District of Massachusetts, James F. Queenan. Judge Queenan believed that the language in the first sentence of section 506(a), related to the creditor’s interest, was determinative, and that the second sentence (including the “proposed disposition or use” of the assets to be valued) had no bearing on the appropriate valuation methodology.¹⁵

In his landmark article, Queenan argued that “with one exception [i.e., the proposed sale of the collateral] the selection of a standard for valuation of security and mortgage interests in Chapter 11 should be based upon an analysis of the rights and obligations of the secured creditor at foreclosure rather than upon considerations such as the business prospects of the debtor, the value of the collateral apart from the security interest, or the purpose of the valuation.”¹⁶ Judge Queenan reached his conclusion, in part, by focusing on the secured creditor’s interest in collateral rather than the purpose of the valuation or the use or disposition of the collateral: “[I]t would appear that, with one exception [i.e., the proposed sale of the collateral], there is no reason for the purpose of the valuation to be more

¹⁴ See *In re Case*, 115 B.R. 666, 670 (B.A.P. 9th Cir. 1990) (held, in a chapter 12 plan confirmation case, that costs should not be deducted from a fair market valuation when a debtor retains collateral but, in dicta, speculating as to the appropriate methodology in the adequate protection context: “If we were attempting to value fmHA’s interest in the property for adequate protection purposes, the possibility of forced liquidation would be assumed and a deduction for selling costs would be logical”); *In re Ralar Distribs., Inc.*, 166 B.R. 3, 5 (Bankr. D. Mass. 1994) (evaluating a 507(b) claim related to a piecemeal liquidation of the debtor’s assets), *aff’d*, 182 B.R. 81 (D. Mass. 1995) (affirming on other grounds and ignoring the adequate protection issue), *aff’d*, 69 F.3d 1200 (1st Cir. 1995) (same); *In re Sharon Steel Corp.*, 159 B.R. 165, 169 (Bankr. W.D. Pa. 1993) (using liquidation value when debtor’s business had no prospects of reorganization); *In re Keystone Camera Prods. Corp.*, 126 B.R. 177, 183–86 (Bankr. D.N.J. 1991) (declining to adopt going concern value for purposes of adequate protection because debtor’s business had no prospects of reorganization); *In re Rich Int’l Airways, Inc.*, 50 B.R. 17, 18 (Bankr. S.D. Fla. 1985) (recounting the legislative history of section 361); *La Jolla Mortg. Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283, 289 (Bankr. S.D. Cal. 1982) (“[I]n this regard, we must evaluate the collateral, being the adequate protection in the hands of the claim holder. It is the creditors’ expected costs to liquidate the property that is relevant, not those of the debtor.”).

¹⁵ James F. Queenan, *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 30 (1987) (“We are concerned here not with valuation of the property that constitutes collateral but rather, in the words of the statute, with valuation ‘of such creditor’s interest in the estate’s interest in such property.’”).

¹⁶ *Id.* at 20.

than a neutral factor in determination of the valuation standard, as compared to the more descriptive statutory phrase ‘proposed disposition or use.’¹⁷

Indeed, many of Judge Queenan’s decisions reflect his approach to section 506(a), focusing on the secured creditor’s interest in collateral and ignoring the purpose of the valuation and the intended use or disposition of the collateral.¹⁸ By focusing on the “value of such creditor’s interest in property,” and ignoring the second sentence of section 506(a), Judge Queenan repeatedly interpreted section 506(a) to require valuation based on the creditor’s contract right to foreclose.¹⁹

Judge Queenan recognized that his preferred valuation methodology was only appropriate under certain circumstances. For one thing, his interpretation of section 506 in the adequate protection context as always requiring a foreclosure valuation in the hands of the creditor would not apply when the assets to be valued were actually sold.²⁰ In Judge Queenan’s words, “where the valuation is made in the context of the sale of the debtor’s business as a going concern and the secured claim is to be paid from the proceeds[,] . . . it would be ludicrous to adopt another

¹⁷ *Id.* at 28; *see also id.* at 29 (limiting discussion of the “use or disposition” language to actual dispositions, liquidated or otherwise, contemplated in the case); *id.* at 30 (“We are concerned here not with valuation of the property that constitutes collateral but rather, in the words of the statute, with valuation ‘of such creditor’s interest in the estate’s interest in such property.’”); *id.* at 33 (stating that decisions applying retail value or going concern value in the use context “lose sight of the fact that it is the creditor’s interest in the collateral, and not the collateral, that is being valued.”); *id.* at 36 (“That the debtor is an operating business, even one with excellent chances for a successful reorganization, may make it less likely that foreclosure will take place, but it has relatively little to do with valuation of the secured party’s rights in the collateral.”)

¹⁸ *See, e.g., In re Ralar Distributors, Inc.*, 166 B.R. 3, 7 (Bankr. D. Mass. 1994) (“Because section 506(a) determines the amount of a claim, this reference is clearly not to the value of the collateral.”); *In re Robbins*, 199 B.R. 1, 3 (Bankr. D. Mass. 1990) (“The phrase ‘the value of such creditor’s interest’ is not equivalent to the value of the collateral.”); *In re Tenney Village Co.*, 104 B.R. 562, 565 (Bankr. D. N.H. 1989) (“Section 506(a) requires, however, a determination not of the value of the collateral but of ‘the value of such creditor’s interest in the estate’s interest in such property . . .’ This interest consists primarily of the right to foreclosure, and where the Uniform Commercial Code controls, the obligations to do so in a commercially reasonable manner . . . That a debtor appears to be a viable business having going concern value might make foreclosure unlikely, but it has previous little to do with valuation of the security interest. A security interest is worth what it will bring at foreclosure.”); *In re T.H.B. Corp.*, 85 B.R. 192, 196 (Bankr. D. Mass. 1988) (“Legislative history indicates that the reference in § 506(a) to the ‘proposed disposition or use’ of the collateral was intended merely to make it clear that a valuation in one setting would not be binding upon a valuation in another.”).

¹⁹ *See Ralar*, 166 B.R. at 7; *In re Tenney Village Co., Inc.*, 104 B.R. 562, 565 (Bankr. D.N.H. 1989) (Queenan, C.J.).

²⁰ Queenan, *supra* note 15, at 28.

standard or, if an actual sale has been negotiated, to use any value other than the agreed price. That seems obvious.”²¹

Some bankruptcy courts disagreed with the Queenan approach even outside of a sale context. These bankruptcy courts instead held that that the second sentence of section 506(a) is determinative for purposes of adopting a default valuation methodology. Cases using this approach focused on the “use or disposition” of the collateral and held that, where the collateral was to be used or retained by the debtor, bankruptcy courts should, absent language in an order to the contrary, adopt a fair market valuation to determine the extent of that asset’s diminution in value.²²

III. SECTION 506(A) VALUATION AFTER QUEENAN

This split in authority—between Judge Queenan’s interpretation of section 506(a) as requiring foreclosure value even for assets that were retained and used, on the one hand, and those courts that instead adopted default valuation methodologies based on the actual use or disposition of the assets to be valued, on the other hand—was thereafter the subject of two Supreme Court cases, *Timbers* and *Rash*.

A. *Timbers and Rash*

In *Timbers*, the U.S. Supreme Court interpreted section 506(a) and held that “the phrase ‘value of such creditor’s interest’ in section 506(a) means ‘the value of the collateral.’”²³ This was a direct reproach to the statutory interpretation relied upon by Judge Queenan’s minority approach, which had relied on the “creditor interest” sentence in section 506(a) to hold that liquidation value in the hands of the creditor was (absent a sale) always the appropriate valuation methodology for an

²¹ See also *In re Tenney Village Co.*, 104 B.R. 562, 566 (Bankr. D. N.H. 1989) (emphasis added); *Robbins*, 119 B.R. 1, 3-4 (Bankr. D. Mass. 1990) (“The words ‘proposed disposition’ would also have significance if the Debtor were attempting to sell the property. It would then make sense to use fair market value as the base and discount that value to reflect whatever the possibility might be that foreclosure would preempt the sale.”).

²² See, e.g., *In re QPL Components, Inc.*, 20 B.R. 342, 345-46 (Bankr. E.D.N.Y. 1982) (“QPL is an ongoing business. The collateral involved is principally inventory. Applying the law as discussed infra, the . . . liquidation value is clearly inappropriate.”); see *Bank Hapoalim B.M. v. E.L.I., Ltd.*, 42 B.R. 376, 379 (N.D. Ill. 1984) (affirming bankruptcy court’s utilization of an executed sale contract for valuation of sold collateral under section 506(a) to determine whether the secured creditor was adequately protected); *In re Kids Stop of Am., Inc.*, 64 B.R. 397, 401-02 (Bankr. M.D.Fla. 1986) (construing section 506(a) in the adequate protection context, and concluding that secured creditor is entitled to adequate protection because the collateral as of petition date was worth the amount actually realized from asset sales during the case).

²³ *Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988).

adequate protection valuation. In the aftermath of *Timbers*, the First Circuit expressly overruled several of Judge Queenan's pre-*Timbers* decisions and adopted a fair market value methodology when the collateral to be valued was proposed to be retained and used by the debtor.²⁴

After *Timbers*, but before *Rash*, two Circuit Courts sought to resolve the continuing split in authority regarding valuation methodologies under section 506(a). In *Winthrop*, the First Circuit cited numerous cases on both sides of the issue of the appropriate methodology to use when valuing collateral proposed to be used or retained by the debtor, holding that the appropriate methodology in such instances was fair market value.²⁵ In *Taffi*, the Ninth Circuit similarly considered the issue of whether to always deduct hypothetical foreclosure expenses and held that, if the collateral is proposed to be used or retained by the debtor, such expenses should not be deducted.²⁶ Although *Winthrop* and *Taffi* limit the use of liquidation value, they cannot be read to mean that liquidation value in the hands of the creditor is never appropriate, but rather that, absent governing contractual language one way or the other, liquidation value in the hands of the creditor should be limited to cases where the debtor proposes to surrender the collateral or will be forced to surrender the collateral because there is little chance of reorganization.²⁷

Thereafter, in *Rash*, the Supreme Court again revisited section 506(a) and again rejected Judge Queenan's approach.²⁸ In *Rash*, the Supreme Court again directly refuted Judge Queenan's interpretation of section 506(a), and stated the following: "We do not find in the §506(a) first sentence words—'the creditor's interest in the estate's interest in such property'—the foreclosure-value meaning advanced by the Fifth Circuit. Even read in isolation, the phrase imparts no valuation standard: A direction simply to consider the "value of the creditor's interest" does not expressly reveal *how* that interest is to be valued."²⁹ The Supreme Court

²⁴ *In re Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Savings, et al.*, 50 F.3d 72, 74-75 (1st Cir. 1995) (rejecting Judge Queenan's article and cases); *Bank Rhode Island v. Pawtuxet Valley Prescription & Surgical Ctr.*, 386 B.R. 1, 4, n.3 (listing cases overruled by *Winthrop*, including those authored by Judge Queenan).

²⁵ *In re Winthrop Old Farm Nurseries*, 50 F.3d at 74.

²⁶ *In re Taffi*, 96 F.3d 1190, 1193 (9th Cir. 1996) (finding that by adopting fair market value as the valuation methodology when a debtor retains and uses its property, the court "put this circuit in harmony with all other circuits, except the Fifth, that have considered the question.").

²⁷ *See, e.g., In re Sharon Steel Corp.*, 159 B.R. 165, 169 (Bankr. W.D. Pa. 1993) (using liquidation value where "any hope of recovery in excess of liquidation value from the Debtor's assets is minimal"); *In re Keystone Camera Prods. Corp.*, 126 B.R. 177, 186 (Bankr. D.N.J. 1991) (using liquidation value where "there is not a reasonable chance of reorganization").

²⁸ *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 962 (1997).

²⁹ *Id.* at 961.

held that the “proposed use or disposition” prong was of “paramount importance to the valuation question.”³⁰ The Supreme Court ultimately held that, because the Chapter 11 debtor proposed to retain collateral under a proposed plan, the replacement value standard “rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property’s ‘disposition or use.’”³¹ Although *Rash* concerned a Chapter 13 case, its direction that bankruptcy courts interpret section 506(a) to require valuation of an asset in accordance with its disposition or use necessarily applies to any valuation under section 506(a).³²

B. 506(a) Valuations in the Adequate Protection Context after Rash

Outside of the adequate protection context, bankruptcy courts after *Rash* overwhelmingly looked to the actual value realized on assets for determining the value of those assets under section 506(a).³³ As the court in *SW Boston Hotel Venture* held, “[t]his case is similar to *Urban Communicators* in that . . . an actual postpetition sale of a substantial portion of Prudential’s collateral occurred in an arm’s length transaction. . . . Under the rationale set forth in *Urban Communicators*, the Hotel Sale price is the best evidence of the value of the Hotel and establishes that Prudential was oversecured throughout these bankruptcy proceedings.”³⁴

Bankruptcy courts after *Rash* have likewise declined to apply foreclosure value in the adequate protection context when a debtor actually uses assets as part of a going concern.³⁵ In *Salyer*, for example, the

³⁰ *Id.* at 962.

³¹ *Id.* at 963.

³² See *In re SK Foods*, 487 B.R. 257, 262 n.11 (E.D. Cal. 2013) (rejecting an attempt “to distinguish *Rash* by arguing that it involved a ‘cram-down’ provision of the Bankruptcy Code” because “the reasoning and holding of *Rash* applies” to the adequate protection context).

³³ See, e.g., *In re SW Boston Hotel Venture, LLC*, 479 B.R. 210, 223 (B.A.P. 1st Cir. 2012) (determining that the sale was “the best evidence of the value” of the collateral); *In re Urban Communicators*, 379 B.R. 232, 241 (Bankr. S.D.N.Y. 2007), *rev’d on other grounds*, 394 B.R. 325 (S.D.N.Y. 2008) (“The ‘disposition or use’ of such property was (and with hindsight still is) the eventual sale of that property[.]”). *In re Motors Liquidation Co.*, 482 B.R. 485, 490 (Bankr. S.D.N.Y. 2012) (rejecting application of a hypothetical liquidation value, and noting that “because the [secured creditor] did not receive control of the [collateral], each side, understandably, recognizes that the fair market value would not be the value on liquidation.”).

³⁴ *In re SW Boston Hotel Venture, LLC*, 479 B.R. 210, 223 (B.A.P. 1st Cir. 2012).

³⁵ See, e.g., *Bank Rhode Island v. Pawtuxet Valley Prescription & Surgical Ctr.*, 386 B.R. 1 (D. R.I. 2008); *In re Savannah Gardens-Oaktree*, 146 B.R. 306 (Bankr. S.D. Ga. 1992) (construing section 506(a) prior to *Rash* in the adequate protection context and adopting going concern valuation for collateral to be retained and used); *In re Automatic*

bankruptcy court was asked to reject a Rule 9019 settlement that was premised on the secured creditor receiving contractual adequate protection measured against going concern value of its collateral on the petition date. As found by the district court on appeal, “the Bankruptcy Court did rely upon the “going-concern” valuation of Debtors’ collateral that were “fixed assets.” The Bankruptcy Court found that a going-concern sale of those assets “is what was intended from the outset, [and] it was the basis on which [creditor] had agreed to the debtor’s use of cash collateral, and it is the scenario that actually resulted.”³⁶

Likewise, in *Pawtuxet*, the District Court affirmed a bankruptcy court’s adoption of going-concern value as the appropriate methodology for valuing assets for adequate protection purposes. The bankruptcy court concluded that the “proposed disposition or use” of the assets were of primary importance in an adequate protection valuation “because the reorganizing debtor proposes to retain and use the collateral, [and] it should not be valued as if it were being liquidated; rather courts should value the collateral ‘in light of’ the debtor’s proposal to retain it and ascribe to it its going concern or fair market value”³⁷ Given that the assets valued in *Pawtuxet* were used rather than sold, the District Court approved the bankruptcy court’s adoption of going-concern value as the fair market value of those assets for adequate protection purposes.³⁸

Similarly, bankruptcy courts after *Rash* likewise declined to apply foreclosure value in the adequate protection context when a debtor actually sells assets.³⁹ As one court noted, “the evidence of the agreed value of the

Voting Machine Corp., 26 B.R. 970 (Bankr. W.D.N.Y. 1983) (for purposes of determining whether secured creditor was adequately protected, rejecting evidence of liquidation value and holding that going concern methodology is appropriate when collateral is to be retained and used); *In re Deep River Warehouse, Inc.*, No. 04-52749, 2005 Bankr. LEXIS 1090, at *20-23 (Bankr. M.D. N.C. Mar. 14, 2005) (unpublished) (construing section 506(a) in the adequate protection context, and finding secured creditor to be adequately protected based on real property’s going concern value in light of debtor’s proposal to retain property as a going concern); *In re Davis*, 215 B.R. 824, 825-26 (Bankr. N.D.Tex. 1997) (construing section 506(a) in the adequate protection context in light of *Rash*, and holding that secured creditor was adequately protected based on the car’s fair market value as of the petition date when debtor intended to retain and use the collateral).

³⁶ See *In re SK Foods, L.P.*, 487 B.R. 257, 261 (E.D. Cal. 2013).

³⁷ *Id.* at 4 (quotation omitted).

³⁸ *Id.*; see also *S.K. Foods*, 487 B.R. at 263 (affirming Bankruptcy Court’s approval of settlement, which “as required by *Rash*, properly relied upon the going-concern value for those assets which were to be sold as part of the business as a going concern”); *Bank Hapoalim B.M. v. E.L.I., Ltd.*, 42 B.R. 376, 379 (N.D. Ill. 1984) (affirming bankruptcy court’s utilization of an executed sale contract for valuation of sold collateral under section 506(a) to determine whether the secured creditor was adequately protected).

³⁹ *In re Eskim, LLC*, No. 08-509, 2008 WL 4093574, at *2-4 (Bankr. N.D. W. Va. Aug. 28, 2008) (unpublished) (permitting debtor to use collateral to bridge to a going concern sale, and finding secured creditor adequately protected given that “the court’s accepted

Property by the parties at the time of the respective acquisitions is the more persuasive evidence of value offered at trial.”⁴⁰ In *Pelham*, the bankruptcy court construed section 506(a) in the adequate protection context in light of *Rash* and rejected estimated liquidation value of collateral in the hands of creditor given undisputed evidence that the collateral was actually used as part of debtor’s going concern.⁴¹

C. Post-Timbers and Rash Holdouts

Even after *Timbers* and *Rash*, however, some authority continued to default, in the absence of specific language in court order to the contrary, to valuing assets that were retained and used based on their foreclosure values for purposes of measuring the extent of any diminution in value that may give rise to a need for adequate protection. The first instance, a bench decision in the *Scotia Pacific* Chapter 11 cases did not mention *Rash* and relied on Judge Queenan’s construction of section 506(a) in the adequate protection context.⁴² The second instance was Colliers’ discussion of section 506(a) valuation methodologies, which advocated a textual approach to construing section 506(a) for purposes of valuing collateral absent specific governing language in a cash collateral order.⁴³

1. Scotia Pacific

The first such holdout was a bench decision issued by Judge Richard Schmidt of the Bankruptcy Court for the Southern District of Texas in the *Scotia Pacific* Chapter 11 cases on July 7, 2008.⁴⁴ That case presented Judge Schmidt with a dispute centered along the familiar battle lines – to ascertain whether certain noteholders were entitled to an administrative claim under a cash collateral order, the bankruptcy court had to determine whether or not the noteholders’ collateral had diminished in value over the course of the case. Implicitly relying on the Queenan doctrine for valuation in the adequate protection context, Judge Schmidt identified the issue as

valuation of the property depends on its being sold at a going concern value—not one of foreclosure”); *In re Walck*, No. 11-37706 MER, 2012 WL 2918492, at *2 (unpublished) (Bankr. D. Colo. Jul. 17, 2012) (construing section 506(a) in the adequate protection context and holding, in light of *Rash*, that secured creditor is adequately protected based on the fair market value of collateral projected to be earned by sale).

⁴⁰ *In re Pelham Enters., Inc.*, 376 B.R. 684, 690-93 (Bankr. N.D. Ill. 2007).

⁴¹ *Id.*

⁴² *In re Scotia Dev., LLC*, No. 07-20027, slip op. at 23–24 (Bankr. S.D. Tex. July 7, 2008), *aff’d in part by In re SCOPAC*, 624 F.3d 274, 285 (5th Cir. 2010).

⁴³ 4 *Collier on Bankruptcy*, ¶ 506.03[6][b], at 506-37 (16th ed. 2013) (emphasis added).

⁴⁴ *In re Scotia Dev., LLC*, No. 07-20027, slip op. at 23–24 (Bankr. S.D. Tex. July 7, 2008), *aff’d in part by In re SCOPAC*, 624 F.3d 274, 285 (5th Cir. 2010).

“whether or not *their interests* have been diminished.”⁴⁵ In accordance with that doctrine, Judge Schmidt then proceeded to identify foreclosure value “in the hands of the creditors” as the appropriate valuation methodology:

The case law suggests that the Code provision for protection for loss of secured creditors – the Code protects the loss of secured creditors’ interest in the property. With non-cash property, the interest that secured creditor has a right to is the right to foreclose. Therefore, the caselaw suggests that the appropriate value to protect is the foreclosure value of the property and not the fair market value of the property. Now, both sides have cited the *In re Stembridge* case out of the Northern District of Texas which states, even though it was reversed on other grounds, it states: ‘With regard to the provision of adequate protection, a secured creditor is entitled to have his interest protected against diminution by reason of the estate’s ongoing possession and use of creditor’s collateral. The interest of the secured creditor is properly valued from the secured creditor’s perspective. In other words, the secured creditor must be protected such that the total realizable from its collateral through foreclosure does not decrease as a result of the delay imposed by the bankruptcy case or the enforcement of its rights.’⁴⁶

Judge Schmidt went on, however, to conclude that even applying a fair market valuation methodology, the creditors’ interests had not diminished in value:

In fact, there’s been no evidence as to a decline in the foreclosure value of the case, but even looking at the fair market value, the evidence showed that from filing to confirmation, the forests grew so that there are more trees. . . . However, despite the increase in the forests and the decrease in the discount rate, the Court believes that the value of the forests has remained relatively constant since the filing.⁴⁷

⁴⁵ *Id.* at 22 (emphasis added).

⁴⁶ *Id.* at 22-23.

⁴⁷ *Id.* at 25-26.

In fact, the next day Judge Schmidt clarified that the conclusion reached in his bench ruling relied on both foreclosure value and fair market value, on alternate grounds.⁴⁸

On appeal, the Fifth Circuit noted that fair market value would be the appropriate methodology, but declined to reverse because the Bankruptcy Court's alternate holdings meant that its statements with respect to foreclosure value did not constitute legal error:

In general, when valuing a secured claim under 11 U.S.C. 506(a)(1), fair-market value is the appropriate measure . . . The Bankruptcy Court's ruling from the bench belies the argument that it looked exclusively to foreclosure value . . . [Fair-market value] is the proper comparison, and no legal error occurred.⁴⁹

Thus it appears that the Scopac bench ruling's decision concerning the use of foreclosure value is of questionable precedential value going forward.

2. Colliers on Bankruptcy

Colliers on Bankruptcy constituted the second authority to advocate, in the absence of specific language in a cash collateral order, the adoption of foreclosure value even in the "retain and use" context notwithstanding *Rash*. It does not, however, advocate in support of Judge Queenan's conclusion that the "creditor's interest" in the first sentence of section 506(a)(1) requires the adoption of foreclosure value. Instead, Colliers argues – without any case support – that the inclusion of the term "purpose" in the second sentence of section 506(a) requires the adoption of foreclosure value in the adequate protection context.⁵⁰

As an initial matter, when the assets to be valued are sold, Colliers agreed with Judge Queenan that the actual fair market value received for the sold asset should be determinative of their value even in the adequate protection context. According to Colliers:

[b] Value of Property Disposed of by Sale. Before addressing the application of section 506 in contexts other than the one presented in *Rash*, it is important to point out

⁴⁸ See Brief of Appellees Mendocino Redwood Co. and Marathon Structured Finance Fund L.P. at n. 19, *In re SCOPAC*, et al., No. 09-40307, 2010 WL 4601367 (5th Cir. 2010) ("Now, keeping in mind I compared the amount you're getting for what I thought was fair market value, I mean I think the test would be the amount you're getting compared to foreclosure value. But I didn't hold them to that.").

⁴⁹ *In re Scopac*, 624 F.3d 274 (5th Cir. 2010).

⁵⁰ 4 *Collier on Bankruptcy*, ¶ 506.03[6][b], at 506-37 (16th ed. 2013) (emphasis added); see also *id.* at ¶ 506.03[4][a], at 506-22.

that, *regardless of the purpose of the valuation*, if an actual sale (or equivalent disposition) is to occur, the value of the collateral should be based on the consideration to be received by the estate in connection with the sale, provided that the terms of the sale are fair and were arrived at on an arms-length basis.⁵¹

But when the assets to be valued are to be retained and used (and not sold), Colliers endorsed the adoption of foreclosure valuation methodology, notwithstanding *Rash*'s emphasis on the actual "use" of such assets. Specifically:

As explained in the legislative history to section 361, the purpose of the adequate protection requirement is to protect the creditor from loss occasioned by the Debtor's use, sale or else of the collateral while attempting to liquidate or reorganize. The value to be protected is thus the value of the creditor's current interest viewed from the perspective of equivalent value

...

Selecting the creditor's hypothetical use as the appropriate benchmark for resolving the valuation question mirrors the purpose of adequate protection. Selecting the creditor's hypothetical use best ensures that, if the debtor does not pay the secured claim, the secured creditor will be able to receive the same value that the creditor would have received if the secured creditor had exercised its enforcement rights against the collateral. It is not realistic to assume that the secured creditor will be able to recover from the collateral any higher value based on the debtor's use of the collateral if the debtor is not able to reorganize or liquidate in such a way as to obtain that higher value

...

⁵¹ 4 *Collier on Bankruptcy*, ¶ 506.03[6][b], at 506-37 (16th ed. 2013) (emphasis added); *see also id.* at ¶ 506.03[4][a], at 506-22 n.60 ("Of course, if the collateral is actually sold during the course of the bankruptcy proceedings or pursuant to a confirmed plan, the consideration received from the sale will almost always resolve the question of value."); *id.* at ¶ 506.03[4][a][i].

Accordingly, for adequate protection purposes, the better view is that the value of the collateral should be determined in accordance with a hypothetical foreclosure sale method. In applying that method, it is appropriate to deduct any applicable costs of sale in arriving at the ultimate value.⁵²

IV. IN RE RESIDENTIAL CAPITAL, LLC

The *Residential Capital* Chapter 11 cases featured litigation over precisely this issue. Over the course of their Chapter 11 cases, the ResCap Debtors used, pursuant to a consensual cash collateral order, approximately \$600 million of cash collateral.⁵³ As is typical, that order entitled those bondholders to adequate protection claims to the extent of any diminution in value of that collateral.⁵⁴ Critically, the order did not specify one way or another the proper standard for measuring such diminution in value. Moreover, the Debtors had retained and used and sold the assets at issue over the course of the ResCap chapter 11 cases.⁵⁵

The ResCap Debtors commenced an adversary proceeding seeking a declaratory judgment that the noteholders' adequate protection claims had no value because there had not been any diminution in value.⁵⁶ For purposes of determining whether the secured lenders' collateral diminished in value, the ResCap debtors argued that the Bankruptcy Court must adopt a valuation of the noteholders' collateral based on its value in the event of a hypothetical foreclosure. They did not base their argument on Judge Queenan's construction, instead relying on Colliers' point that the "purpose" language in the second sentence of section 506(a) required the adoption of foreclosure value when valuing assets in the adequate protection context.⁵⁷

⁵² 4 *Collier on Bankruptcy* ¶ 506.03[7][a][iii] (16th ed. 2013).

⁵³ Proposed Findings of Fact of the Ad Hoc Group of Junior Secured Noteholders and UMB Bank, N.A. at ¶ 173, *In re Residential Capital, LLC, et al.*, No. 12-12020 (MG) (Bankr. S.D.N.Y. Nov. 1, 2013), ECF No. 137.

⁵⁴ Final Order under 11 U.S.C. §§ 105, 361, 362, 363(c), 364(c)(1), 364(c)(2), 364(c)(3), 364(d)(1) and 364€ and Fed. R. Bankr. P. 2002, 4001, and 9014 (I) Authorizing Debtor to Obtain Post-Petitions Financing, (II) Authorizing Debtor to Use Cash Collateral, and (III) Granting Adequate Protection to Prepetition Secured Parties ("Dip Financing Order"), *In re SCOTIA Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex. June 5, 2008).

⁵⁵ *Id.*

⁵⁶ First Amended Complaint to Determine Extent of Liens and for Declaratory Judgment, *In re Residential Capital LLC, et al.*, No. 12-12020 (MG) (Bankr. S.D.N.Y. June 19, 2013), ECF No. 8.

⁵⁷ Adv. Pro. 13-01343, ECF 134 (Plaintiffs' Proposed Conclusions of Law) at 42-43.

The secured lenders, on the other hand, argued that the fair market value of their collateral on the petition date—not the hypothetical foreclosure value of those same assets in the hands of their collateral agent—was the appropriate valuation methodology to apply for assets that are not turned over but rather are retained and used by a debtor, consistent with *Timbers* and *Rash*.⁵⁸

Ultimately, the bankruptcy court declined to adopt the “hands of the creditor” valuation methodology.⁵⁹ The bankruptcy court relied on *Rash* and rejected the Queenan interpretation of section 506(a):

In calculating the value of the lender’s secured claim, the Court looked at the first sentence of section 506(a) and observed that the phrase ‘value of such creditor’s interest’ did not explain how to value the interest. Therefore the Court looked to the second sentence of 506(a) and held that ‘the proposed disposition or use’ of the collateral is of paramount importance to the valuation question. Based on the proposed disposition of the property in that case, the Court held that foreclosure value could not be the proper methodology for valuing the secured creditor’s claim. Rather, the court applied replacement value, the amount a willing buyer would have paid a willing seller for the collateral. Although this case involves the consensual use of cash collateral in the context of a sale under chapter 11, the reasoning of *Rash* is equally applicable here.⁶⁰

The bankruptcy court issued its ruling in light of its making a factual finding that the “proposed disposition or use” of the assets to be valued was always to be the use of such assets by the debtors to bridge to a going concern sale—not to turn the assets over to the noteholders for foreclosure.⁶¹

V. CONCLUSION

ResCap recognized that *Rash* finally rejected Judge Queenan’s interpretation of section 506(a) in the adequate protection context. Moreover, by declining to elevate the significance of the “purpose” language in the second sentence of section 506(a) above that of “proposed

⁵⁸ Adv. Pro. 13-01343, ECF 138 (Defendants’ Proposed Conclusions of Law) at 35-36.

⁵⁹ *In re Residential Capital, LLC, et al.*, 501 B.R. 549, 592 (Bankr. S.D.N.Y. 2013).

⁶⁰ *Id.*

⁶¹ *Id.*

disposition or use” in the second sentence of that section, the bankruptcy court refrained from endorsing Judge Queenan’s judicial philosophy.

Implicit in *ResCap*’s holding is the textual recognition that, absent language in a cash collateral order specifying one way or the other, the “default” interpretation recommended by the Plaintiffs and Colliers would have overstated and distorted the true meaning of the “purpose” language in section 506(a) in the adequate protection context. According to Colliers, on the other hand, the “purpose” of adequate protection is singular – that is, it is always intended to protect the secured creditor on account of its contractual right to foreclose as a result of the imposition of the automatic stay.

ResCap’s holding is consistent with the text in the Code itself. A careful review of the “purpose” behind the Bankruptcy Code’s adequate protection provisions reveals that the concept is intended to accomplish different objectives depending on its context, *i.e.*, the “purpose” of adequate protection in the context of a secured creditor’s lift stay motion under section 362 differs significantly from the “purpose” of adequate protection in the context of a Debtors’ use of collateral under section 363. And in the absence of any contractual language, when a secured creditor never moved to take possession of its collateral, and where a Debtor never sought to turn over its assets, the “purpose” of adequate protection should not be to protect a creditor’s foreclosure value but rather to ensure that it is not economically prejudiced from the debtors’ use of that collateral.

Section 361 of the Bankruptcy Code neither defines “adequate protection” nor identifies its intended “purpose.”⁶² Indeed, section 361 is not operative but rather tracks other Code provisions.⁶³ And while the legislative history of section 361 refers opaquely to the need to assure a secured creditor of the “benefit of its bargain,” it provides no guidance as to whether that benefit consists only of a creditor’s immediate right to foreclosure or rather its right not to be prejudiced by the Debtors’ affirmative use of its collateral post-petition.⁶⁴ To the contrary, the legislative history for section 361 specifically provides that the “purpose”

⁶² 11 U.S.C. § 361 (“When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by . . .”).

⁶³ Compare 11 U.S.C. § 361(1) (requiring adequate protection when a creditor moves to lift stay under section 362), with 11 U.S.C. § 362(2) (requiring adequate protection when a debtor seeks to use creditor collateral).

⁶⁴ See H.R. REP. NO. 95-595, at 339 (1977), *reprinted in* U.S.C.C.A.N. 5963, 6295 (“[T]hough the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.”).

of adequate protection in certain contexts is to protect something higher than foreclosure liquidation value.⁶⁵

With no statutory or congressional guidance, bankruptcy courts routinely conclude that the “purpose” of adequate protection under section 361 differs depending on whether adequate protection is sought under section 361(1) or section 361(2)—i.e., the “purpose” of providing adequate protection to compensate for the Debtors’ use of collateral under section 363 (as opposed to compensating for the imposition of the stay under section 362) encompasses something other than just ensuring the creditor of its right to immediate foreclosure.⁶⁶

The differing “purposes” of adequate protection when compensating for the use of collateral under section 363 as opposed to the imposition of the stay under section 362 was directly addressed in *In re Alyucan Interstate Corp.*⁶⁷ In that case, a secured creditor moved to lift the stay to take possession of its collateral.⁶⁸ The bankruptcy court noted that while adequate protection under section 362 is intended to protect a creditor “from any impairment in value attributable to the stay,” under “sections 363 and 364 the answer would be [to protect] from any impairment in value attributable to the use, sale, or lease or grant of a lien on the interest of property.”⁶⁹ The court found the secured creditor to be adequately protected, and explained:

Some cases have interpreted adequate protection more in terms of contractual benefits than economic values. They have focused on language in the legislative history suggesting that secured creditors must receive the ‘benefit of their bargain.’ H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 339 (1977). Congress, however, was not referring to the contractual bargain between creditors and debtors

⁶⁵ S. REP. NO. 95-989, at 54 (1978), *reprinted in* U.S.C.C.A.N. 5787, 5840 (“Neither is it expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value.”).

⁶⁶ *See, e.g., In re* 495 Cent. Park Ave. Corp., 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992) (adequate protection is designed “to safeguard the secured creditor from diminution in the value of its interest during the Chapter 11 reorganization”); *In re* DeSardi, 340 B.R. 790, 804 (Bankr. S.D. Tex. 2006) (“The purpose of adequate protection is to assure that the lender’s economic position is not worsened because of the bankruptcy case.”); *In re* Hollins, 185 B.R. 523, 528 (Bankr. N.D. Tex. 1995) (“Adequate protection seeks to protect a creditor from an [sic] decline in the value of its collateral . . .”); *see also* Harvey R. Miller & Martin J. Bienenstock, *Adequate Protection in Respect of the Use, Sale or Lease of Property*, 1 BANKR. DEV. J. 47, 76 (1984) (“Generally, going concern value is most compatible with rehabilitation cases.”).

⁶⁷ 12 B.R. 803, 808 (Bankr. D. Utah 1981).

⁶⁸ *Id.*

⁶⁹ *Id.* at 808, n. 11a (citing to section 361).

because the next portion of the House Report acknowledges ‘there may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section (Section 361) recognizes the availability of alternate means of protecting a secured creditor’s interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.⁷⁰

The long term impact of the *Residential Capital* ruling with respect to the interpretation of section 506(a) remains unclear. As an initial matter, parties are always free to agree on language in a cash collateral order specifically memorializing one type of valuation standard or another. There is no reason to think that such language would not be respected to the extent subsequently challenged in court.

Absent such specified language in the governing court order, it appears that the ultimate fate of the asset at issue is dispositive for purposes of the appropriate valuation methodology to be adopted by the Court. Adoption of a foreclosure valuation methodology, for example, may make perfect sense – and would be consistent with *Timbers* and *Rash* – to the extent that the actual use or disposition of such assets was a foreclosure for the secured lenders. In this sense, *Residential Capital* merely ratifies what many bankruptcy courts have previously recognized – that, post-*Rash*, the default standard for valuing an asset is in accordance with its actual disposition or use. But in extending the *Rash* valuation default analysis to the adequate protection context, it appears that *Residential Capital* has rendered obsolete the last remaining authority adhering to Judge Queenan’s now-defunct default standard that required in all circumstances, regardless of the actual use of collateral, the adoption of a foreclosure valuation standard for purposes of applying section 506(a) of the Bankruptcy Code.

⁷⁰ *Id.*