VALUATION IN BANKRUPTCY: EXAMINING VALUATION METHODS, EVIDENTIARY REQUIREMENTS AND OTHER CONSIDERATIONS

OVERVIEW OF THE LAW RELATING TO PROPERTY VALUATIONS IN CHAPTER 11

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Valuation issues permeate the entire bankruptcy process and may be determined in various contexts and for different purposes throughout the case. Some of the most critical areas include secured claim valuation, adequate protection, lack of equity and plan confirmation. An awareness of these issues early in the process, along with knowledge as to how valuation applies to each, is important when evaluating the practical and strategic implications of valuations in bankruptcy.

A. Section 506(a): Secured Collateral Valuation

Whether a secured creditor's collateral is adequately protected from diminution during the bankruptcy process is a key question that a court must answer when faced with whether to permit a debtor to: (i) overcome a lender's request to lift the automatic stay; (ii) use cash collateral; and (iii) enter into DIP financing. Answering these questions requires understanding Bankruptcy Code §506. The first sentence of §506 directs the court to divide a secured creditor's claim "into secured and unsecured portions, with the secured portion of the claim limited to the value of the collateral." ***Associates Commercial Corporation v. Rash***, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997). The relevant section of the Code reads:

> 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.

11 U.S.C. §506(a).

A secured creditor has an allowed secured claim to the extent of the value of its collateral and an unsecured claim for any balance. 11 U.S.C. § 506(a). The unsecured portion of the debt is called the "deficiency." If all of the collateral value is secured by higher priority liens the creditor's claim is unsecured. For purposes of §506(a), a valuation hearing may be necessary to determine to what extent a claim might be bifurcated into separate secured and unsecured claims.

The second sentence of § 506(a) directs the manner for assessing value, stating as follows:

> 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.

According to the legislative history for § 506(a), "'value' does not necessarily contemplate forced sale or liquidation value of the collateral; nor does [ ]it always imply a full going concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case." ***In re Expertus Health, LLC,*** 2024 Bankr. LEXIS 2845 (Bankr. W.D. TN 2024), *quoting,* H.R. REP. 95-595, 356, 1978 U.S.C.C.A.N. 5963, 6312 (1977).

The Supreme Court's decision in ***Rash*** confirms that bankruptcy court valuations under § 506(a), must be calculated based on debtor's actual proposed use of the property, and not the various dispositions or uses that might have been proposed." ***Associates Commercial Corporation v. Rash***, 520 U.S. 953, 964, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997). Although ***Rash*** was decided in the context of a Chapter 13 case, courts consistently have held that its rationale is equally applicable in Chapter 11. ***In re Creekside Sr. Apartments, LP***, 477 B.R. 40, 55 (B.A.P. 6th Cir. 2012). In this case, the debtors proposed retention of the collateral and cramdown of the creditor's claim under § 1325(a)(5)(B). The Supreme Court held that a replacement-value standard should be used in valuing property that was being retained by debtor. ***Rash*****,** 520 U.S. at 960. Under this standard, "the value of the property (and thus the amount of the secured claim under § 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***. The ***Rash*** Court left "to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented." ***Id***. at 965 n.6. "Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property." ***Id.***

The court in ***Sears Holdings*** explained that ***"Rash*** contemplated that one *particular* use or disposition must be proposed, and that this proposal must guide the valuation exercise." ***ESL Invs., Inc. v. Sears Holdings Corp. (In re Sears Holdings Corp.),*** 51 F.4th 53, 62 (2d Cir. 2022) (Holding that bankruptcy court wisely "decided to assess the value of the second-lien holders' collateral in light of what the Debtors would likely be able to recoup from the collateral using the [net orderly liquidation value approach], which assessed the collateral somewhere between a forced liquidation and its full retail price."). Although there are several methods for valuing assets, the court must select the approach that is most consistent with debtor's use of them. ***Bay Point Cap. Partners II LP v. Thomas Switch Holding, LLC (In re Virtual Citadel, Inc.),*** 113 F.4th 1304, 1311 (11th Cir. 2024) (Debtor developed real estate for bitcoin mining, so the bankruptcy court properly applied §506(a) by valuing the real estate as a special purpose property consistent with debtor's bitcoin mining use.).

Neither the Code nor the Rules of Bankruptcy Procedure allocates the burden of proof as to the value of secured claims under § 506(a). Based on the context in which the valuation takes place, the burden of proof may lie with the secured creditor, party challenging the value, or involve a burden-shifting framework. In ***In re Heritage Highgate, Inc***., 679 F.3d 132, 139-140 (3d Cir. 2012), the Third Circuit identified three possible approaches, variously placing the burden on the secured creditor or the party seeking to value the claim. The ***Heritage Highgate*** court ultimately adopted a burden-shifting framework, placing the initial burden on the party challenging the secured claim (there, the debtor) to present evidence sufficient "to overcome the presumed validity and amount of the creditor's secured claim," which, once met, shifts the ultimate burden of persuasion to the creditor "to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim." ***Heritage Highgate*****,** 679 F.3d at 140

The time for determining valuation of collateral is not established by the Code or the Bankruptcy Rules. "Courts have the flexibility to select the valuation date so long as the bankruptcy court takes into account the purpose of the valuation and the proposed use or disposition of the collateral at issue." ***In re Houston Regional Sports Network, LP,*** 886 F.3d 523, 530-31 (5th Cir. 2018). Courts have chosen different times to determine the secured status of a claim, including: (1) plan confirmation date, (2) plan effective date, (3) date of valuation hearing, and (4) petition date. ***Fin. Sec. Assur. Inc. v. T-H New Orleans Ltd. P'ship. (In re T-H New Orleans Ltd. P'ship),*** 116 F.3d 790, 798 (5th Cir. 1997).

Notably, the value of the secured creditor's interest in the property can change over the life of a bankruptcy. The principal causes of variance include: (1) payments made during the course of the bankruptcy case in reduction of the secured claim; (2) fluctuations in the value of the collateral for market reasons; and (3) changes in the applicable method of valuation as required by § 506(a). ***In re Ponce de Leon, 1403, Inc***., 523 B.R. 349, 371, 395 (Bankr. D.P.R. 2014). Accordingly, courts have generally held that a valuation at one point in the proceedings has no binding effect on valuations performed at other points and for other purposes. ***Prudential Ins. Co. of Am. v. SW Boston Hotel Venture, LLC (In re SW Boston Hotel Venture, LLC),*** 748 F.3d 393 (1st Cir. 2014).

B. <u>Section 362 (d)(1) & (2): Relief of The Automatic Stay</u>

The bankruptcy petition automatically enjoins all creditor activity and operates as a stay preventing secured creditors with liens from enforcing them. The secured creditor must bring forward a motion to modify the stay under § 362(d) (1) or (2) to proceed with foreclosing on its collateral. To obtain relief under § 362(d)(1), the secured creditor must demonstrate "cause" for granting relief because its interests lack "adequate protection". To succeed on § 362(d)(2) claim, it must establish the debtor has no "equity" in this property and the property is not necessary to an effective reorganization. Sections 362(d)(1) and (d)(2) are disjunctive. This means that the Court must lift the stay if the movant prevails under either of the two grounds.

1. Section 362(d)(1): Lack of "Adequate Protection"

A secured creditor is entitled to "adequate protection" of its interest in estate property during the pendency of the case. Under § 362(d)(1), a lack of adequate protection for a creditor's property interest is "cause" for granting relief from the automatic stay. The concept of adequate protection seeks to maintain the status quo between the secured creditor and the debtor while the debtor attempts to reorganize. Adequate protection ensures that a creditor receives the value for which it bargained prebankruptcy. ***MBank Dallas, N.A. v. O'Connor (In re O'Connor)***, 808 F.2d 1393, 1396 (10th Cir. 1987).

The Code does not define "adequate protection," however §361 provides examples of what can constitute adequate protection, such as periodic payments, replacement liens or "indubitable equivalent." Although the existence of an equity cushion as a method of adequate protection is not specifically mentioned in § 361, it is the classic form of protection for establishing adequate protection. An "equity cushion" is the surplus of value remaining after the amount of indebtedness is subtracted from the fair market value of the property securing same. An oversecured creditor is not entitled to be compensated for an erosion in an equity cushion and is not entitled to additional adequate protection for lost opportunities in the use of funds. ***United Sav. Ass'n v. Timbers of Inwood Forest Assocs.,*** 484 U.S. 365, 374-75, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988). For adequate protection purposes, the court can disregard the junior liens. ***In re Indian Palms Assocs., Ltd***., 61 F.3d 197, 207 (3d Cir. 1995). Additionally, some courts hold the court can consider other property pledge to the secured creditor, even if the property is not owned by debtor, such as property held by guarantors. ***In re SW Bos. Hotel Venture LLC,*** 449 B.R. 156, 177-78 (Bankr. D. Mass. 2011)

Many courts consider the existence of an "equity cushion" to adequately protect a creditor's interest. ***Baybank-Middlesex v. Ralar Distributors, Inc.,*** 69 F.3d 1200, 1203 (1st Cir. 1995). Where an equity cushion is greater than 20%, it is nearly universally held that the creditor's interest is adequately protected. ***In re Mellor,*** 734 F.2d 1396 (9th Cir. 1984). Case law has almost uniformly held that an equity cushion under 11% is insufficient to constitute adequate protection. ***In re McKillips,*** 81 B.R. 454, 458 (Bankr. N.D. Ill. 1987) (surveying the cases which show that an equity cushion of more than 20% is adequate but less than 11% is not). If the value cushion is between 11% and 20%, the determination of adequate protection will be based on the specific facts and circumstances of the case (e.g., trends in value indications and projections regarding the subject market). ***Drake v. Franklin Equip. Co. (In re Franklin Equip. Co.),*** 416 B.R. 483, 528–29 (Bankr. E.D. Va. 2009); ***Kost v. First Interstate Bank of Greybull (In re Kost),*** 102 B.R. 829, 831–33 (D. Wyo. 1989). Where the debtor's collateral does not adequately protect the creditor's lien the debtor may provide adequate protection by other means.

2. Section 362(d)(2): Lack of "Equity" in the Property

Under § 362(d)(2) of the Code, the bankruptcy court will grant relief from the stay if: (i) the debtor does not have equity in the property; and (ii) the property is not necessary for an effective reorganization. Equity is the value above all secured claims against the property, that can be realized from the sale of the property for the benefit of the unsecured creditors. ***In re Matter of Sutton,*** 904 F.2d 327, 329 (5th Cir. 1990); ***Stephens Industries, Inc. v. McClung,*** 789 F.2d 386, 392 (6th Cir. 1986). To make this assessment, the court must account for all secured claims against the subject property, even if such claims are not held by the party seeking relief from the automatic stay. Even junior liens are included. ***In re Indian Palms Assocs., Ltd***., 61 F.3d 197, 207 (3d Cir. 1995). Thus, a debtor has no equity in property when the debts secured by liens on the property exceed the value of the property.

The secured creditor seeking relief from an automatic stay under § 362(d)(2) has the initial burden of proving the lack of equity in the property and then the burden shifts to the debtor to establish that the property is necessary for an effective reorganization. 11 U.S.C. § 362(g). ***First Agricultural Bank v. Jug End in the Berkshires, Inc. (In re Jug End in the Berkshires, Inc.)***, 46 Bankr. 892, 901 (Bankr. D. Mass. 1985);). ***United Sav. Ass'n v. Timbers of Inwood Forest Assocs.,*** 484 U.S. 365, 375-76, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988)(Property is necessary for reorganization if there is "a reasonable possibility of a successful reorganization within a reasonable time.")

C. Section 363: Use of "Cash Collateral"

Under § 363, a debtor may not use a secured creditor's "cash collateral" without first obtaining the consent of the secured party or authorization by the court. 11 U.S.C. § 363(a). "Cash collateral" includes a security interest in the debtor's cash and cash equivalents (e.g., cash in a bank account, the proceeds of accounts receivable, rents from an office building or hotel*).* ***In re Buttermilk Towne Center, LLC,*** 442 B.R. 558, 566 (B.A.P. 6th Cir. 2010) (Holding that a post-petition replacement lien on future rents does not provide adequate protection for the debtor's expenditure of prior months rents when there is no equity in the building and the secured lender already had a lien on the rents.). The extent of a creditor's security interest in collateral is determined by looking at the totality of the language in the security agreement to determine the parties' intent. ***In re Partners In Hope, Inc.***, 660 B.R. 366, 380 (Bankr. D. S.C. 2024).

If a creditor does not consent to the use of cash collateral, its use may be granted only to the extent that the court determines that the creditor's interest in the collateral is adequately protected. See 11 U.S.C. § 363(e). Adequate protection can be met by providing one of the options under § 361 or proving that there is an equity cushion. ***In re The West Nottingham Academy in Cecil County,*** 662 B.R. 103 (Bankr. D.Md. 2024). The debtor has the burden of proof on adequate protection and the creditor has the burden of proof on the issue of validity, priority, or extent of such interest. 11 U.S.C. §363(p).

D. Section 364: DIP Financing

Debtor-in-possession ("DIP") financing is oftentimes crucial to a Chapter 11 debtor in financial distress by providing much needed cash during the reorganization process. Due to the high risk of lending monies to a distressed debtor in bankruptcy, DIP lenders require special security of their interests. A debtor can request to incur secured debt under §364 to prime, or subordinate, the lien of an existing senior creditor. To obtain DIP financing that involves a "priming" lien on encumbered property, the DIP must show that: (1) it was unable to obtain credit without granting such liens; and (2) the value of the prepetition lender's lien that will be primed by the DIP lender's lien is adequately protected. § 364(d)(1). ***In re Reading Tube Indus.,*** 72 B.R. 329, 332 (Bankr. E.D. Pa. 1987). The debtor bears the burden of proof on the issue of adequate protection. § 364(d)(2).

A debtor's use of the credit obtained through a priming lien should be more likely than not to benefit the estate and improve the debtor's ability to reorganize. Conceivably, an increase in the value of the collateral generated by the improvements resulting from the superpriority financing could constitute adequate protection. ***In re YL W. 87th Holdings I LLC,*** 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010); ***In Re Sky Valley, Inc.,*** 100 B.R. 107, 113 (Bankr. N.D.Ga. 1988). In general, courts have denied financing that included a priming lien where adequate protection relied on increased value in highly speculative circumstances, where time periods for value increase were tight, where a debtor faced red tape or other hurdles. ***Vander Vegt,*** 499 B.R. 631, 638 (Bankr. N.D. Iowa 2013).

E. Section 506(b): Allowance of Post-Petition Interest & Fees

A secured creditor whose collateral is worth more than its claim is "oversecured." An oversecured creditor is entitled to be paid interest and attorneys' fees provided for in its agreement with the debtor as part of its secured claim. 11 U.S.C. § 506(b). ***Unsecured Creditors' Committee v. Walter E. Heller & Company,*** 768 F.2d 580 (4th Cir. 1985) (Attorneys' fee agreements were held enforceable under § 506(b) notwithstanding contrary state law.). Most courts hold that oversecured status for allowing interest and attorneys' fees is gauged at or near the end of the case. ***Ford Motor Credit Co. v. Dobbins,*** 35 F.3d 860, 870(4th Cir. 1994). The party contending that there is a dispute over whether a creditor is entitled to interest and fees under §506(b) must motion the bankruptcy court to make such a determination. The creditor bears the ultimate burden to prove by a preponderance of evidence its entitlement to post-petition interest based on its claim being oversecured. ***Fin. Sec. Assurance Inc. v. T-H New Orleans Ltd. P'ship (In re T-H New Orleans Ltd. P'ship),*** 116 F.3d 790, 797 (5th Cir. 1997).

F. Section 1129: Valuations for Plan Confirmation Under Traditional Chapter 11

1. Section 1129(b)(2)(A): "Fair and Equitable" Secured Creditor Treatment

At the confirmation stage, valuation plays a critical role in determining whether a Chapter 11 plan can be confirmed and, if so, how much each class of creditors will receive on its claim.

Section 1129 of the Bankruptcy Code governs confirmation of a Chapter 11 plan. If all the general requirements of confirmation under § 1129(a) are met, the plan may nevertheless be confirmed over the objection of a dissenting impaired class. Such a **"**cramdown" must not "discriminate unfairly" and must provide "fair and equitable" treatment of the secured creditors claims. Section 1129(b)(2)(A) provides three alternatives for what is "fair and equitable" treatment for a secured claim. The secured creditor must:

> (i) Retain its lien and receive cash payments which total at least the allowed amount of its secured claim and which has a present value equal to the value of its collateral; or
>
> (ii) Retain its lien on any proceeds if the collateral is sold free and clear of the secured lien, so long as the creditor has a right to credit bid at the sale; or
>
> (iii) Realize the "indubitable equivalent" of its claim.

11 U.S.C. §1129(b)(2). In short, creditors are entitled to maintain whatever secured interests they have in their collateral, and they will be paid the present value of their secured claims over the life of the plans.

In the context of chapter 11 plan confirmation, the collateral is most likely going to be valued around the time of the confirmation hearing. This issue was addressed in ***Heritage Highgate*** which affirmed the bankruptcy court's determination that the debtor's residential subdivision development was to be valued according to its fair market value as of the date of plan confirmation. The court rejected the creditors argument that the valuation should be valued based on the income the debtor might realize in the future as additional lots were sold. ***In re Heritage Highgate, Inc.*****,** 679 F.3d 132, 146 (3d Cir. 2012). The court reasoned that the appropriate standard for valuing collateral must depend upon what is to be done with the property — whether it is to be liquidated, surrendered, or retained by the debtor. The ***Heritage Highgate*** debtor was retaining the property, so the replacement value of the property applied. This approach reflected the fair market value of what a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition. ***Id.*** at 142. The Third Circuit found the secured creditor's proposed valuation -- based on what the court called a "market-based, or wait-and-see, approach to valuation -- was inconsistent with the replacement value standard required under §506(a) and ***Rash*****.**

Under §1129(b)(2)(A)(iii), an impaired secured creditor can be forced under a cramdown to accept the "indubitable equivalent" of its claim. The Bankruptcy Code does not define "indubitable equivalent," but courts interpreting the term have defined it as, among other things, "the unquestionable value of a lender's secured interest in the collateral." ***In re Philadelphia Newspapers, LLC*****,** 599 F.3d 298, 310 (3d Cir. 2010).

A "dirt-for-debt" plan may be used to satisfy the fair and equitable requirement by providing a secured creditor with the "indubitable equivalent" of its lien. This method involves debtor giving the a secured creditor its collateral property (like real estate, often referred to as "dirt") as full or partial payment for their debt. Plans may include: (a) a "full" dirt-for-debt plan in which the debtor returns to the creditor all of its collateral in satisfaction of the creditor's claim; or (b) a "partial" dirt-for-debt claim, in which the debtor returns only a portion of a secured creditor's collateral in partial or full satisfaction of the creditor's claim. In "dirt-for-debt" plans, the debtor uses Section 506(a) of the Bankruptcy Code to value property and determine whether the property to be surrendered provides the indubitable equivalent of the secured claim. Therefore, the success of a dirt-for-debt plan is predicated entirely on the court's valuation of the collateral. Courts have favored valuing property at its "highest and best use" instead of its current physical condition, in a dirt-for-debt setting. ***In Bate Land & Timber LLC,*** 877 F.3d 188, 192-193 (4th Cir. 2017).

2. Section 1129 (a)(7)(A)(ii): The "Best Interest of the Creditors" Test

Section 1129 requires that a chapter 11 plan satisfy the "best interests of creditors" test. A bankruptcy court may confirm a plan under this section only if each holder of an impaired claim "will receive or retain . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." 11 U.S.C. § 1129(a)(7)(A)(ii). This test requires bankruptcy courts value the payment to creditors under a hypothetical chapter 7 liquidation and then compare that amount to what the same creditors would receive under the chapter 11 reorganization. ***In re Lason,*** 300 B.R. 227, 232 (D. Del. 2003).

The analysis requires assessing what a chapter 7 trustee could potentially recover in a liquidation as required by his or her duties and powers. 11 U.S.C. § 704(a)(1). This means that chapter 7 trustees often must sell property for less than the amount that a private, solvent seller could realize. On the other hand, the court may include potential preference and other recoveries in the analysis if a chapter 7 trustee could pursue such claims. ***Schoenmann v. Bank of the West (In re Tenderloin Health*), 849 F.3d 1231**, **1235** (9th Cir. 2017). Although the valuation must be based on evidence, by its nature, it is inherently speculative and is often replete with assumptions and judgments. ***In re PC Liquidation Corp.*,** 383 B.R. 856, 868 (E.D.N.Y. 2008). The proponent of the plan bears the burden of showing by a preponderance of the evidence that the best interest of creditors has been satisfied. ***In re Eletson Holdings Inc.,*** 664 B.R. 569 (S.D. N.Y. 2024).

G. Section 1191: Valuations for Plan Confirmation Under Subchapter V of Chapter 11

Many of the usual chapter 11 confirmation requirements apply in a small business case filed under subchapter V of title 11. Subchapter V confirmation of a plan is governed by a combination of §1129 and new §1191. Section 1191(a) provides that the following subsections of § 1129 do not apply in a subchapter V case: 1129(a)(15) (means test in individual chapter 11 cases);

1129(b) (cram down provisions); 1129(c) (court may confirm only one plan); and 1129(e) (requirement that plan in small business case be confirmed within 45 days).

A Subchapter V plan must meet the "fair and equitable" standards from §1129(b)(2)(A) and the value of that collateral is to be determined under §506. 11 U.S.C. § 1191(c)(1); ***In re James Pine & Son Trucking LLC,*** 2024 Bankr. LEXIS 2368 (Bankr. D.N.J. 9/27/24). Where the subchapter V debtor will retain the collateral for its post-confirmation business operations, the property should be valued near the date of the confirmation hearing. ***In re S-Tek 1, LLC,*** 2021 Bankr. LEXIS 3361 (Bankr. N.M. 2021). Likewise, §1191(a) provides that the court will confirm a plan under subchapter V only if it meets the "best interest of creditors" test under §1129(a)(7)(A)(i)**.** ***In re Boteilho Haw. Enters.,*** 2023 Bankr. LEXIS 2736 (Bankr. D. HI 11/8/23).