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Cramdown Under the Bankruptcy Code of 1978: Effect Upon the Soft Collateral Lender

*Richard L. Epling**

I. INTRODUCTION

The Bankruptcy Reform Act¹ (hereinafter "Code"), effective October 1, 1979, wrought significant and comprehensive changes in the bankruptcy laws. Among the more important reforms of the Code is the consolidation of the corporate and business reorganization chapters, *i.e.*, Chapters X, XI and XII, into a single chapter denominated Chapter 11.² Under the new Chapter 11, upon filing a reorganization petition under the Code, the debtor may continue to operate its business as a debtor-in-possession³ and may exercise extensive prerogatives in preparing and formulating a plan for repayment of its debts,⁴ while generally remaining free from creditor lawsuits.⁵ In its reorganization plan the debtor may propose to affect secured as well as unsecured debt and may, under certain circumstances, impose the plan upon dissenting classes of secured⁶ or unsecured⁷ creditors. This power to confirm a reorganization plan over the opposition of dissenting creditor classes, found in section 1129(b) of the Code,⁸ is commonly known as "cramdown."

There has been extensive and excellent commentary on the effect of cramdown provisions upon secured creditors with fixed asset collateral.⁹ This commentary sheds no light, however, upon the

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1. Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2682 (1978) (codified at 11 U.S.C. and in other scattered sections of U.S.C., particularly Title 28).

2. 11 U.S.C. § 1101 *et seq.* (Supp. III 1979).

3. 11 U.S.C. § 1108 (Supp. III 1979).

4. U.S.C. §§ 1106, 1107 (Supp. III 1979).

5. Section 362 of the Code imposes an automatic stay against lien enforcement or creditor suits unless the stay is dissolved or modified in accordance with § 362(d). 11 U.S.C. § 362 (Supp. III 1979).

6. 11 U.S.C. § 1129(b)(2)(A) (Supp. III 1979).

7. 11 U.S.C. § 1129(b)(2)(B) (Supp. III 1979).

8. *See notes 6 and 7 supra.*

9. W. Blum, *The "Fair and Equitable" Standard for Confirming Reorganizations Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165 (1980) [hereinafter cited as

unique problems cramdown creates for secured creditors whose collateral comprises accounts receivable and inventory, so-called "soft" collateral. Because loan transactions secured by soft collateral are fundamentally different from fixed asset loans, the impact of cramdown provisions upon soft collateral lenders requires special analysis.

The purpose of this article is to address two broad areas of specific concern to the soft collateral lender faced with a cramdown attempt. The first is the finality of court orders issued early in bankruptcy proceedings to protect the lender from dissipation of collateral. The second is the effect of alternative cramdown methods upon the lender's collateral interest. After a short review of the special nature of soft collateral lending, the available protective devices and the effect of these devices upon the debtor's reorganization plan will be analyzed. Finally, the three methods of cramdown sanctioned by the Code for the secured creditor and their application to the soft collateral lender will be evaluated.

II. THE SPECIAL NATURE OF SOFT COLLATERAL LENDING

The structure of loans secured by accounts receivable and inventory differs fundamentally from loans against fixed assets. A loan collateralized by real estate or other fixed assets usually contemplates a single, one-time advance of money, often for the purchase of the asset. The loan is then repaid in regular, predetermined installments. Repayment terms are often tied to the asset's anticipated useful life and the borrower's future net profits.

Soft collateral lending, by contrast, involves a continuous series of loans made on a frequent basis, *e.g.*, daily or weekly, which are repaid from the proceeds of the collateral as accounts are collected or inventory is sold for cash. This lending arrangement is often referred to as "revolving credit." The extent of the loan is determined by the amount of the borrower's accounts and inventory, in accordance with ratios set out in the loan agreement. The collateral is fluid: it changes daily as old inventory is sold, new accounts are created, old accounts are paid, and new inventory is acquired. As the amount of new accounts or inventory increases, new loans can be made, thereby increasing the debt. If the collateral is

Blum]; K. Klee, *All You Ever Wanted to Know about Cramdown Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979) [hereinafter cited as Klee]. Kenneth Klee was associate counsel to the House Judiciary Committee during the time the committee considered the new Bankruptcy Code.

turned into cash proceeds and not replaced by new collateral, however, the principal balance of the loan must be repaid from collections of accounts or cash sales of inventory. The debt is reduced accordingly.

When and if the loan eventually is paid in full depends upon the nature and liquidity of the business.¹⁰ If the business is seasonal, the loan might be paid in full during slack periods when the company's inventory requirements are low, and receivables are being collected. The company would begin to borrow again when it requires new inventory in anticipation of its peak season. Non-seasonal businesses or companies that cannot build up sufficient working capital to finance their operations will often have soft collateral loans outstanding for many years. They may reduce their loans by collection of accounts, but will constantly require new loans to finance inventory purchases. The business and the loan are in trouble when inventory cannot be sold or accounts cannot be collected. This often precipitates bankruptcy.

III. PROTECTION FOR THE SOFT COLLATERAL LENDER AFTER A CHAPTER 11 FILING

Once a business' degree of debt greatly surpasses its ability to make timely repayment, a Chapter 11 petition may be considered. In such a petition, the business, called the debtor under the Code,¹¹ seeks permission from the bankruptcy court to remain in operation but defer all debt reduction until a more convenient plan of repayment can be proposed. The filing of the petition operates as an automatic stay against all creditors.¹² While they remain subject to the stay, creditors may do nothing to secure payment of the pre-filing debt.¹³ Thus, although the debtor might continue to col-

10. Where the loan agreement does not contain a commitment by the lender to provide loans for a specific period of time, the loan might also be paid in full at any time upon the lender's demand.

11. 11 U.S.C. § 101(12) (Supp. III 1979).

12. 11 U.S.C. § 362 (Supp. III 1979).

13. The automatic stay provision prohibits:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate;

lect accounts and sell inventory, the soft collateral lender could not receive payments to reduce its loan. Since cash proceeds are easily subject to dissipation, the Code provides for means to protect the soft collateral lender. These provisions later may affect the debtor's plan of repayment.

A. *Adequate Protection*

Although the debtor is permitted to use, sell or lease its property after filing a Chapter 11 petition,¹⁴ cash collateral¹⁵ may not be utilized by the debtor without consent from the secured creditor¹⁶ or court authorization after notice and hearing.¹⁷ Where the debtor cannot obtain the lender's consent,¹⁸ he is required to seek court approval in order to use collections from accounts or proceeds from cash sales of inventory as a source of working capital.¹⁹ The lender also can protect itself from collateral dissipation by filing a complaint or other "request" with the bankruptcy court for adequate

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- (4) any act to create, perfect, or enforce any lien against property of the estate;
 - (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
 - (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
 - (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
 - (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

11 U.S.C. § 362 (a)(Supp. III 1979).

14. Section 1107 gives the debtor all the rights and powers of a trustee, if none is appointed pursuant to § 1104. 11 U.S.C. § 1107 (Supp. III 1979); 11 U.S.C. § 1104 (Supp. III 1979). The trustee has the power to use, sell or lease the debtor's property. 11 U.S.C. § 363(c)(1) (Supp. III 1979).

15. Cash collateral is defined in § 363(a) as "cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents in which the estate and any entity other than the estate have an interest." 11 U.S.C. § 363(a) (Supp. III 1979). Although accounts and inventory are not themselves "cash collateral," cash or other negotiable proceeds of this property clearly fall within the protection of § 363(a). It is interesting that, while inventory is not cash collateral, it may be converted into cash collateral by the issuance of warehouse receipts.

16. 11 U.S.C. § 363(c)(2)(A) (Supp. III 1979).

17. 11 U.S.C. § 363(c)(2)(B) (Supp. III 1979).

18. This will often happen where the debtor gave the lender no prior indication that a Chapter 11 filing was imminent.

19. The debtor requires the use of the cash collateral to continue operating his business. Although he has the right to sell inventory and collect accounts, this is not of much benefit unless he can utilize the proceeds to purchase more inventory and thereby create more accounts.

protection against the debtor's use of cash proceeds²⁰ or, in the alternative, for relief from the automatic stay.²¹

In order to receive the court's permission to use the lender's cash collateral, the debtor-in-possession must furnish the lender "adequate protection."²² The Code spells out two of the three forms which such protection should assume. Adequate protection may be furnished by periodic cash payments to the lender,²³ or by a replacement lien on other collateral.²⁴ The third method requires the debtor to provide the lender with the "indubitable equivalent" of the collateral.²⁵ Cases of "indubitable equivalent" protection probably will be rare in reorganizations where accounts and inventory are the collateral.

B. Refinancing

Refinancing²⁶ is another method of providing protection for the soft collateral lender as well as giving the debtor the opportunity to utilize the cash collateral. Where the lender has been closely monitoring the loan and has become aware of the debtor's difficulties, he may agree to finance the debtor's newly arising accounts and inventory after the Chapter 11 case is filed. The lender will

20. 11 U.S.C. § 363(e) (Supp. III 1979).

21. Failure to provide adequate protection is a ground for dissolving the automatic stay "for cause." 11 U.S.C. § 362(d)(1) (Supp. III 1979).

22. "Adequate protection" is defined in § 361. 11 U.S.C. § 361 (Supp. III 1979). This is a term of art under the Code. The concept derives from the fifth amendment protection of property interests. See *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935). It is equally based, however, upon the policy that secured creditors should not be deprived of the benefit of their bargain. See COLLIER, BANKRUPTCY CODE Part 3, 121 (pamphlet ed. A. Herzog & L. King, 1979).

In general, the concept requires the debtor to furnish the secured creditor with alternate means of protecting the creditor's interests before the cash proceeds of accounts and inventory may be used by the debtor in conducting its business. See text accompanying notes 23-25 *infra*.

23. 11 U.S.C. § 361(1) (Supp. III 1979).

24. 11 U.S.C. § 361(2) (Supp. III 1979). Adequate protection can also be satisfied by a combination of the methods described in 11 U.S.C. §§ 361(1) and 361(2).

25. 11 U.S.C. § 361(3) (Supp. III 1979). This provision allows the courts to formulate novel methods to protect the creditor, if the available methods are inappropriate under the circumstances. Asa Herzog and Lawrence King suggest that under this provision, the court might approve the guarantee of a third party outside the judicial process for any losses the creditor might sustain. COLLIER, BANKRUPTCY CODE Part 3, 121 (pamphlet ed. A. Herzog & L. King, 1979). Another alternative might be abandonment of the collateral to the secured creditor. See 124 CONG. REC. H11,104 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,421 (daily ed. Oct. 6, 1978).

26. The granting of secured and unsecured credit to a debtor-in-possession is governed by 11 U.S.C. § 364 (Supp. III 1979).

often find this procedure advisable, because the Code vitiates the effect of the creditor's floating lien and denies the creditor a security interest in "after-acquired" property²⁷ the debtor procures after filing of the petition.²⁸ Thus, post-petition inventory and accounts are unencumbered property in which the debtor may grant new security interests.²⁹

Normally, the debtor-in-possession, upon notice³⁰ to the official or unofficial creditors' committee,³¹ will apply to the court for authority to enter into a secured lending arrangement. This authority will be embodied in a court order. Such a financing order will usually grant the lender a first priority security interest in the unencumbered, post-petition accounts and inventory,³² together with an administrative priority³³ to the extent the collateral is insufficient to satisfy the debt. The financing order may also provide that the post-petition accounts and inventory stand as collateral for the

27. "After acquired" property is accounts and inventory acquired by the borrower after the first loan advance is made pursuant to the security agreement. The lender's lien "floats," attaching to the new collateral as the old inventory is sold and accounts are collected. See U.C.C. § 9-204 (1978 version).

28. 11 U.S.C. § 552 (Supp. III 1979). This provision overrules prior case law as enunciated in *Dubay v. Williams*, 417 F.2d 1277 (9th Cir. 1969) and *Grain Merchants of Indiana, Inc. v. Union Bank & Savings Co.*, 408 F.2d 209 (7th Cir. 1969).

29. Even though the effects of the "floating lien" are terminated by § 552, newly arising accounts and inventory may still be subject to the creditor's security interest to the extent they may be traced as proceeds in accordance with § 9-306 of the Uniform Commercial Code. U.C.C. § 9-306 (1978 version).

30. Section 364 requires "notice and a hearing" before post-petition credit may be granted on a priority or secured basis. At least one court has approved a notice period as short as five days, where the debtor could demonstrate that the failure to receive new loans would seriously jeopardize the viability of the reorganization. *In re Sullivan Ford Sales*, 5 Bankr. Ct. Dec. 1288, 1292 (Bankr. Ct. D. Me. 1980).

31. The Code provides for the appointment of creditor committees for each "class" of creditor, e.g. secured, unsecured. 11 U.S.C. § 1102 (Supp. III 1979). The court must create a committee for unsecured creditors "as soon as practicable" after the court has granted the debtor's petition. 11 U.S.C. § 1102(a)(1) (Supp. III 1979). Other committees may be appointed "if necessary to assure adequate representation of creditors." 11 U.S.C. § 1102(a)(2) (Supp. III 1979).

32. 11 U.S.C. § 364(c) (Supp. III 1979).

33. An administrative priority, in general, entitles the holder of such claim to payment in full before the payment of any unsecured claims. The kind of administrative priority granted by a financing order is expressly sanctioned by 11 U.S.C. §§ 364(c) and 507(b) (Supp. III 1979). Section 507(b) also provides that a creditor granted adequate protection by the court for the use of its collateral shall have the same administrative priority as the post-petition lender to the extent that the protection afforded proves to be inadequate. See text accompanying note 26 *supra*. Sections 507(a) and (b) set forth chronologically the order of priorities. 11 U.S.C. §§ 507(a),(b) (Supp. III 1979). Section 1129(a)(9) provides that these priority claims, to the extent allowed by the court, must be paid in full, although deferred payments are allowed for certain types of priorities. 11 U.S.C. § 1129(a)(9) (Supp. III 1979).

prepetition debt.³⁴

C. The Effect of Adequate Protection and Refinancing upon the Debtor's Reorganization Plan

A court order to protect the soft collateral lender, under the rubric of adequate protection or pursuant to a refinancing, is likely to be entered relatively early in most Chapter 11 cases. The order will give the soft collateral lender a security interest in post-petition accounts and inventory, an administrative priority for all or a portion of the debt, the right to receive certain cash payments, or a combination of the foregoing rights. The effect that the existence of such orders will have upon the debtor's later attempt to cram a plan of reorganization down upon a dissenting soft collateral lender is an unanswered question under the Code.

When the debtor submits his reorganization plan to the court and his creditors, he may wish to alter the rights the soft collateral lender earlier received under a financing or adequate protection order.³⁵ To achieve this, the debtor might argue that such an order is "administrative" in nature and thus can be altered by the bankruptcy court or by an appellate court at any time.³⁶ This argument

34. This is called "cross-collateralizing." Some persons believe that a recent Second Circuit decision specifically disapproved of "cross-collateral" clauses in financing orders. *In re Texlon*, 596 F.2d 1092 (2d Cir. 1979). The court's language, however, belies this conclusion:

In order to decide this case we are not obliged, however, to say that under no conceivable circumstances could "cross-collateralization" be authorized. Here it suffices to hold that, despite the absence from Section 344 of the specific requirement of notice contained in Section 116(2), see note 3 *supra*, a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order, where the bankruptcy court relies solely on representations by a debtor in possession that credit essential to the maintenance of operations is not otherwise obtainable.

596 F.2d at 1098.

The court in *Texlon* voided the financing order because it had been entered without notice and a hearing. *Id.* The decision was based upon a procedural due process rationale rather than upon an analysis of the vagaries of cross-collateral provisions in court orders.

35. At the time the order is originally entered, the debtor probably is amenable to almost anything, just to be able to obtain the cash collateral to run the business. See note 19 *supra*. When a plan of reorganization is prepared, however, the debtor probably realizes that he will have to live with this plan for a long time to come. Arrangements he was eager to make for the short term may not appear so attractive to the debtor over the long term.

36. This concept has been coined the "administrative order doctrine." It derives from the old Bankruptcy Act of 1898, when bankruptcy cases were comprised of two distinct types of proceedings. Certain proceedings, denominated "controversies," were administrative in character, dealing with measures relating to the debtor's estate and keeping the debtor in business. 11 U.S.C. § 46 (repealed 1978). The second type of proceeding, denominated an "adversary" proceeding, dealt with actual disputes among the debtor, trustee, and

rests heavily upon the analysis contained in *In re Texlon*,³⁷ where the Second Circuit negated the effects of a financing order entered under the old Chapter XI of the Bankruptcy Act of 1898. The court's resort to the outmoded "administrative order" doctrine has been criticized.³⁸ More importantly, this doctrine is inappropriate in light of Code provisions that specifically require the bankruptcy court to grant adequate protection to creditors whose collateral is being consumed by the debtor-in-possession³⁹ or who are taking risks by lending new monies to a company in reorganization⁴⁰ in reliance upon the enforceability of these prior orders.⁴¹ Even the

creditors and had the character of a lawsuit in the bankruptcy court. 11 U.S.C. § 46 (repealed 1978). The rule developed that any court orders issued in an administrative matter were not final and could be modified or changed at any time during the pendency of the bankruptcy of reorganization case. An order entered in an adversary proceeding, in contrast, had the effect of a judgment, and could be appealed notwithstanding the pendency of the bankruptcy case. This distinction was abolished by the Bankruptcy Code of 1978. 28 U.S.C. § 1471 (1978).

37. 596 F.2d 1092 (2d Cir. 1979).

38. See, e.g., R. Ordin, *In re Texlon Corporation: Finality of Order of Bankruptcy Court*, 54 AM. BANKR. L.J. 173 (1980). *Texlon* may also be distinguished on the basis that the financing order was altered because it had been entered without notice and a hearing. See note 34 *supra*. Furthermore, the secured creditor had been repaid all of its post-petition debt, as well as a substantial portion of the pre-petition debt. The creditor was seeking to collect the unsecured portion of its pre-petition debt ahead of the other unsecured creditors. This behavior appears to have disturbed the appellate court. 596 F.2d at 1095. The case should be limited on its facts.

39. 11 U.S.C. §§ 361, 362(d), 363, 507(b) (Supp. III 1979).

40. 11 U.S.C. §§ 361, 364, 507(b) (Supp. III 1979).

41. The lower court in *Texlon* upheld the financing order and denied the challenge to its validity upon the ground that the creditor had lent new monies and changed position in reliance upon the order:

But to have said what has been said does not require vacatur of the November 1, 1974 order. Judicial reversal may "work hardship to those who [had] trusted to its existence", *Linkletter v. Walker*, 381 U.S. 618, 624 (1965). "The past cannot always be erased by a new judicial declaration", and "the effect of the subsequent ruling as to invalidity may have to be considered in various aspects". *Chicot County Drainage District v. Baxter State Bank*, 308 U.S. 371, 374 (1940).

So, while it is undoubtedly true that the bankruptcy court has the power to modify or vacate its prior orders "upon reasonable application and before rights have vested on the faith of its action", *Wayne United Gas Co. v. Owens-Illinois Glass Co.*, 300 U.S. 131, 137 (1937); *Feldman v. Transeast Air, Inc.*, 497 F.2d 352 (2d Cir. 1974), and the trustee's application when originally filed was seasonable, the existence of the power does not mandate its inevitable exercise. The elements of reliance on the order by MHCC, and the rights which vested because of such reliance, support this court's judgment that the order should be left in repose. "Absolute retroactive invalidity", *Chicot County Drainage District v. Baxter State Bank*, *supra*, at 374, is not called for here.

In re Texlon, 3 Bankr. Ct. Dec. 1013, 1017 (Bankr. Ct. S.D.N.Y. 1977).

The appellate court agreed with this exposition of the law, but disagreed that the secured

Texlon court conceded that the finality of a bankruptcy court order could only be disturbed " 'if no intervening rights will be prejudiced by this action'."⁴²

The Code expressly provides that where a creditor lends new money or changes his position in reliance upon a court order, and that order is subsequently reversed or vacated on appeal, the debt incurred or the lien granted under the order remains valid.⁴³ Thus, the Code now protects the reliance and expectation interests of the secured creditor and legislatively disapproves the questionable administrative order doctrine.⁴⁴ Where an adequate protection or financing order has been properly entered upon notice and a hearing and has become final,⁴⁵ its provisions are immune from later collateral attack by the debtor in the reorganization plan by application of *res judicata* principles.⁴⁶

IV. APPLICATION OF CRAMDOWN POWER TO SHIFTING COLLATERAL AND DEBT

The foregoing framework does not wholly insulate the soft collateral lender from a cramdown. A financing or adequate protection order will, in general, only define the creditor's rights with respect to *post-petition* debt and collateral.⁴⁷ The creditor's right to retain and collect post-petition accounts and inventory, and to insist upon payment of any shortfall as a priority claim,⁴⁸ is unassail-

creditor had been prejudiced by application of these principles to the facts before it. *In re Texlon*, 596 F.2d 1092, 1101 (2d Cir. 1979).

42. *Id.* at 1100 (2d Cir. 1979), citing *Wayne United Gas Co. v. Owens-Illinois Glass Co.*, 300 U.S. 131 (1937).

43. 11 U.S.C. § 364(e) (Supp. III 1979). The debt or lien may be affected, however, by a stay, pending appeal, of the original order. Presumably, the party seeking the stay will be required to post a supersedeas bond. See Rule 805 of the Rules of Bankruptcy Procedure. Fed. R. Bankr. P. 805.

44. See note 36 *supra*.

45. Rules 801, 802 and 803 of the Rules of Bankruptcy Procedure require, in general, that a bankruptcy court order be appealed within ten days of the date it is entered. Fed. R. Bankr. P. 801, 802, 803.

46. *Chicot County Drainage District v. Baxter State Bank*, 308 U.S. 371, 374-78 (1940); see 1B MOORE, FEDERAL PRACTICE ¶ 0.419, 2991-99 (1980).

47. See the discussion of cross-collateral clauses at note 34 *supra*. The secured party may, in addition, have entered evidence into the record at the financing or adequate protection hearing to support its pre-petition debt and liens. From this evidence the court may have made findings of fact and conclusions of law pursuant to Rule 752 of the Rules of Bankruptcy Procedure. Fed. R. Bankr. P. 752.

48. Priority claims, except certain tax claims, must be paid in full at confirmation, unless the claimant agrees to take a deferred or lesser amount. 11 U.S.C. §§ 507(a)(1), 507(b), 1129(a)(9)(A) (Supp. III 1979).

able. To the extent that the value of the creditor's pre-petition collateral is less than the amount of its pre-petition debt, however, its rights may be impaired.⁴⁹ Yet a reorganization plan that maintains this impairment could be confirmed over the secured lender's objection, if the requirements of section 1129(b) of the Code are met.⁵⁰

In order for the debtor to cram a plan of reorganization down upon a dissenting class of secured creditors,⁵¹ the plan must meet the "fair and equitable" standard of the Code.⁵² Three methods of

49. Section 1124 provides that a claim or class of claims will be deemed impaired under a plan, unless the plan:

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest;

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—

(A) cures any such default, other than a default of a kind specified in section 365(b)(2) of this title, that occurred before or after the commencement of the case under this title;

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or applicable law; and

(D) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest;

(3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to—

(A) with respect to a claim, the allowed amount of such claim; or

(B) with respect to an interest, if applicable, the greater of—

(i) any fixed liquidation preference to which the terms of any security representing such interest entitle the holder of such interest; and

(ii) any fixed price at which the debtor, under the terms of such security, may redeem such security from such holder.

11 U.S.C. § 1124 (Supp. III 1979).

50. 11 U.S.C. § 1129(b) (Supp. III 1979). This is the "cramdown" provision. It provides that, regardless of whether the plan impairs or is unacceptable to any particular class of creditors, see 11 U.S.C. §§ 1129(a)(8)(A) and (B), the plan may be confirmed if it does not discriminate unfairly and is fair and equitable with respect to that class.

51. 11 U.S.C. § 1129(b)(1) (Supp. III 1979). Care should be taken to distinguish between a dissenting individual creditor who is a member of a class that has approved the plan and a class of creditors that has voted against the plan. The former situation is governed by § 1129(a), which provides, generally, that the dissenter must be given property of a value not less than such creditor would receive were the debtor to be liquidated. 11 U.S.C. § 1129(a)(7) (Supp. III 1979). This determination does not involve application of the cramdown power. Cramdown is intended to deal with the latter situation where a class of creditors has rejected the plan.

52. See note 50 *supra*.

cramdown provided by the Code satisfy the "fair and equitable" standard as to the secured creditor.⁵³ The unresolved issue in applying these cramdown methods is how and when to determine the rights of the soft collateral creditor whose debt and collateral bases are constantly changing.

A. *Sale of Collateral by Debtor*

One cramdown method is the sale of the secured creditor's collateral free and clear of liens, with liens to attach to the proceeds of sale.⁵⁴ The creditor receives the proceeds either immediately in cash or in deferred payments with a present value equal to the amount of the sales price of the collateral.⁵⁵ Since the retention of accounts and inventory is essential to the perpetuation of most businesses as going concerns, a reorganization plan will rarely use this method with respect to a soft collateral lender. Additionally, accounts are not usually sold in bulk, even where the intent is liquidation of the business.⁵⁶ Rather, accounts are collected individually from the account debtors as they become due, by litigation if necessary. Because this cramdown method is unlikely to be used in regard to soft collateral, the effects of this method upon accounts and inventory need not be considered further.

B. *Abandonment of Collateral to Lender*

The second method of cramdown permitted by the code is to give the secured creditor the "indubitable equivalent" of his allowed⁵⁷ secured claim.⁵⁸ The legislative history accompanying this

53. These methods are described in 11 U.S.C. § 1129(b)(2)(A) (Supp. III 1979). They are roughly analogous to the four approaches to cramdown contained in Chapters X and XII of the Bankruptcy Act of 1898. 11 U.S.C. § 616(10), 861(11) (Repealed).

54. 11 U.S.C. § 1129(b)(2)(A)(ii) (Supp. III 1979).

55. 11 U.S.C. § 1129(b)(2)(A) (Supp. III 1979).

56. A bulk sale of accounts would necessarily involve a discount factor. It is questionable whether a sale at a discount would fairly yield a market value for the accounts and satisfy the fair and equitable standard of § 1129.

57. Under 11 U.S.C. § 1111(b) (Supp. III 1979), a partially secured creditor, whose collateral value is less than the amount of the debt, may exercise an election to have its claim treated as if it were fully secured. If the election is not made, then the "allowed amount" of the claim is the value of the collateral; if the election is made, the "allowed amount" is the amount of the debt. The election is available

only if the security is not of inconsequential value and, if the creditor is a recourse creditor, the collateral is not sold under section 363 or to be sold under the plan. Sale of property under section 363 or under the plan is excluded from treatment under section 1111(b) because of the secured party's right to bid in the full amount of his allowed claim at any sale of collateral under section 363(k) of the House amendment.

provision states: "Abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence, as would a lien on similar collateral."⁵⁹ Application of this approach to a soft collateral lender would be entirely consistent with the framework outlined earlier.⁶⁰ Upon confirmation of the plan, the pre- and post-petition accounts would be turned over to the creditor for direct collection, and the inventory would be turned over for sale. To the extent provided in the adequate protection or financing order, the creditor would have a priority claim⁶¹ for any shortfall between the amount of the debt and the amount realized from the sale or collection of the collateral. In the case of a refinancing, the pre-petition shortfall will often be an unsecured debt, while a post-petition deficiency will have priority status.⁶² Where an adequate protection order has been entered, the treatment of a deficiency is less clear. The debtor-in-possession will have consumed the pre-petition accounts and inventory in the ordinary course of business, and this property will have been replaced by a lien on post-petition collateral. The creditor who was fully secured at the date of the petition should be accorded full priority status for any deficiency that may later exist upon confirmation of a plan proposing to abandon the collateral. Where the creditor was only partially secured at the time of filing, a deficiency existing at confirmation should be treated as an unsecured debt to the extent that it is less than or equal to the deficiency at the date of the petition,⁶³ it should be considered as a priority claim to the extent that it is greater than the deficiency. Such an approach would preserve the *status quo* and allow any appreciation in value of the post-petition accounts and inventory occurring *pendente lite* to inure to the benefit of the

124 CONG. REC. H11,103 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,420 (daily ed. Oct. 6, 1978). Thus, the creditor will make the election to be fully secured if it is contemplated that the value of the collateral will appreciate to the amount of the debt. Where such appreciation in values is not anticipated, the election will, in general, not be exercised.

58. 11 U.S.C. § 1129(b)(2)(A)(iii) (Supp. III 1979).

59. 124 CONG. REC. H11,104 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,421 (daily ed. Oct. 6, 1978).

60. See text accompanying notes 11-46 *supra*.

61. 11 U.S.C. §§ 507(a)(1), 507(b), 1129(a)(9) (Supp. III 1979).

62. This analysis assumes that the pre-petition collateral has been used up and the financing order contains no cross-collateral provisions. See 11 U.S.C. § 364(c)(1) (Supp. III 1979), which authorizes the court to grant a Chapter 11 lender "priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title."

63. This treatment assumes that the partially secured creditor has not elected to be treated as fully secured under § 1111(b). 11 U.S.C. § 1111(b) (Supp. III 1979). See note 55 *supra*.

creditor in accordance with established pre-Code case law.⁶⁴

As a practical matter, unless a plan of liquidation is being considered,⁶⁵ few reorganization plans are likely to propose a total abandonment of the accounts and inventory. In some cases where a refinancing has been arranged, however, the debtor may propose to abandon the remaining pre-petition accounts and inventory to the creditor, retaining the post-petition lending relationship.⁶⁶

C. Long-Term Deferred Payments

The third cramdown method allows the secured creditor to retain his security interest to the extent of the "allowed amount" of his claim.⁶⁷ The Code requires that the reorganization plan provide for the creditor to receive deferred cash payments totaling at least the allowed amount of his claims.⁶⁸ This has been described as the "principal amount" test.⁶⁹ Moreover, the payments must have a present value, as of the effective date of the plan, generally equal to the value of the collateral.⁷⁰ This has been called the "present value" test.⁷¹ This cramdown method is by far the most likely to be encountered by partially secured creditors in Chapter 11 cases.

There are numerous problems in attempting to apply this third method of cramdown to a soft collateral lender with a revolving loan. First, analytically it works best with a fixed asset such as real estate or equipment. The "principal amount" test is most easily applied to a series of fixed amounts to be paid to the creditor over regular periods of time. Receivable and inventory lending, however, contemplates an ever-changing loan balance and collateral base.⁷² Even in the more static situation of a soft collateral lender who has been granted adequate protection, although the amount of pre-petition debt is fixed at the filing date, the collateral continues

64. See *In re Pine Gate Associates, Ltd.*, 3 Bankr. Ct. Dec. 813, 838 (Bankr. Ct. N.D. Ga. 1977).

65. Liquidating Chapter 11 cases are sanctioned by the Code. See 11 U.S.C. § 1123(b)(4) (Supp. III 1979).

66. In any event, the foregoing treatment of the deficiency will be equally applicable to the partially secured creditor facing the third cramdown method. See text accompanying notes 46-96 *infra*.

67. 11 U.S.C. § 1129(b)(2)(A)(i)(I) (Supp. III 1979). If the § 1111(b) election is not made, the "allowed amount" is the value of the collateral; if the election is made, the "allowed amount" is the amount of the debt. See note 57 *supra*.

68. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (Supp. III 1979).

69. Klee, *supra* note 9, at 155.

70. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (Supp. III 1979).

71. Klee, *supra* note 9, at 155.

72. See text in section II *supra*.

to be consumed. Thus, to be fair and equitable, the reorganization plan should tie the principal payments to the reduction of the collateral base by consumption. To permit otherwise would render a fully secured creditor undersecured almost immediately after confirmation or would increase the deficiency of a partially secured creditor.⁷³ Such an approach would wholly vitiate the adequate protection order. A reorganization plan with this effect is hardly fair and equitable.

In the more dynamic case of a Chapter 11 refinancing, the post-petition debt and collateral are protected from alteration under a reorganization plan by the *res judicata* effects of the financing order.⁷⁴ The post-petition portion of the loans and collateral cannot be disturbed by collateral attack, even when the financing order had been entered *ex parte*.⁷⁵ Additionally, the ongoing loan commitment cannot be made binding by a plan of reorganization, and a lender cannot be compelled to make loans against its will.⁷⁶ The lender is consequently entitled to principal and interest repayments in accordance with the terms of the financing order, at least with respect to the post-petition loans.⁷⁷ With respect to pre-petition debt and collateral, repayment of principal should be tied to the reduction of the pre-petition accounts and inventory in the same manner as the creditor given adequate protection.⁷⁸

73. At least one recent cramdown case has suggested that debt reduction be tied to the consumption or probable dissipation of collateral. The debtor's plan in *In re Antilles Yachting, Inc.*, 6 Bankr. Ct. Dec. 616 (Bankr. Ct. D. Virgin Islands 1980), proposed to pay a fully secured mortgagee in 60 level payments. The court denied confirmation, holding the plan to be not in the "best interest of creditors," in large measure because the debtor's future cash flow depended upon accounts receivable whose collectibility was uncertain.

These earnings would quickly disappear if some of the receivables went bad, many of which are over 90 days old. If it [the debtor] is forced to pay all its taxes and other Government obligations, it will probably run out of working capital and be forced to shut down. Thus to be feasible, any reorganization will require substantial additional working capital.

6 Bankr. Ct. Dec. at 617.

74. See text accompanying note 43 *supra*.

75. See *In re Texlon*, 496 F.2d 1092 (2d Cir. 1979). The court stated that the refinancing creditor "has not suffered any actual loss from reliance on the financing order as the factored accounts more than sufficed to reimburse [the creditor] for the Chapter XI advances against them as well as for all interest charges, factoring commissions and other expenses." 596 F.2d at 1101 (emphasis added).

76. The Code makes it clear that loan agreements are not executory contracts which may be assumed by the debtor-in-possession and made binding upon the lender *in futuro*. 11 U.S.C. § 365(c)(2) (Supp. III 1979).

77. This discussion again assumes the absence of a cross-collateral clause in the financing order.

78. See text accompanying notes 72-73 *supra*.

Another critical problem in applying the third type of cramdown is the *time* when collateral is valued. Cramdown cases decided prior to the Code made it clear that the value of collateral is fixed at the time of the confirmation hearing, and that any appreciation in value inures to the benefit of the secured creditor.⁷⁹ *In re Pine Gate Associates Ltd.*⁸⁰ and other recent cramdown cases decided under prior law⁸¹ all have held that collateral is to be valued at "going concern" rather than "liquidation" amounts. There is nothing in section 1129(b) which indicates that this practice of valuation should not continue under the Code.

The partially secured creditor who is granted an adequate protection order will be entitled to a valuation⁸² of the aggregate pre- and post-petition accounts and inventory on the date of confirmation. This creditor will obtain the benefit of any increase in the value of its collateral, which will reduce the deficiency existing at the filing date. To the extent the filing date deficiency has been increased, this creditor is entitled to an administrative priority for the increment. The balance of the deficiency will be treated as unsecured, provided a section 1111(b) election has not been made.⁸³ The creditor making new advances under a financing order is entitled to enforce its contractual rights in post-petition debt and collateral without being otherwise affected by the plan. To the extent

79. See note 81 *infra*.

80. 2 Bankr. Ct. Dec. 1978 (Bankr. Ct. N.D. Ga. 1976), 3 Bankr. Ct. Dec. 301, 813 (Bankr. Ct. N.D. Ga. 1977).

81. *In re KRO Assoc.*, 4 Bankr. Ct. Dec. 462 (Bankr. Ct. S.D.N.Y. 1978); *In re Castle Village Co.*, 4 Bankr. Ct. Dec. 730 (Bankr. Ct. S.D.N.Y. 1978); *In re Pine Gate Assoc. Ltd.*, 3 Bankr. Ct. Dec. 813 (Bankr. Ct. N.D. Ga. 1977); *In re Hartsdale Assoc.*, 3 Bankr. Ct. Dec. 460 (Bankr. Ct. S.D.N.Y. 1977); *In re Georgetown Apartments*, 3 Bankr. Ct. Dec. 512 (Bankr. Ct. M.D. Fla. 1977).

82. The subject of valuation of various types of collateral is a topic deserving of separate treatment and is beyond the scope of this article. Factors which would be relevant, however, to a determination of value for accounts would include: the age of such collateral; disputes with account debtors on major accounts; the collection history for the accounts in the past (see, e.g., *In re Antilles Yachting, Inc.*, 6 Bankr. Ct. Dec. 616, 617 (Bankr. Ct. D. Virgin Islands 1980)); and profitability of the debtor in general, based upon a capitalization of income (see, e.g., *In re Pine Gate Assoc., Ltd.*, 3 Bankr. Ct. Dec. 301, 313-15 (Bankr. Ct. N.D. Ga. 1977)). Valuation factors relevant to inventory would include: the age or obsolescence of the goods, which would be affected by whether sales are made "first in, first out" or "last in, last out"; the wholesale or other price for which the goods are purchased; the retail price at which the goods are sold; actual and projected future gross sales; current market conditions for goods of this type; and profitability of the debtor, based upon a capitalization of income. This list is not exhaustive, but is merely a point of departure.

83. See note 57 *supra* for a discussion of the effects of § 1111(b) upon the allowed amount of a partially secured claim.

such a creditor was only partially secured at the date of the petition, however, the pre-petition debt and collateral should be treated in the same manner as the debt and collateral of the partially secured creditor granted adequate protection.⁸⁴ That is, the creditor should receive the benefit of any appreciation in value or increase in collectibility accruing to the pre-petition accounts and inventory. The creditor should also receive a priority claim to the extent that the pre-petition deficiency has increased by the time of confirmation.

The final conceptual problem posed by the treatment of soft collateral under the third cramdown method is the applicability of the "present value" test to a shifting amount of collateral securing a debt calculated upon floating rates of interest.⁸⁵ The application of the present value and principal amount tests to the creditor granted adequate protection, or to the pre-petition debt and collateral of a refinancing secured creditor, may be illustrated by two simple hypothetical examples.⁸⁶ In Case 1, the refinancing creditor has a debt, on the date of filing, of \$1,000,000.00. The value of the pre-petition collateral on the filing date was \$600,000.00,⁸⁷ but has now been reduced, through diligent collection efforts, to \$200,000.00 on the date of confirmation.⁸⁸ The pre-petition debt has been reduced by 80 percent⁸⁹ of the \$400,000.00 collected and is now \$680,000.00. The plan proposes to return the principal value of the remaining collateral to the creditor in five yearly installments of \$60,000.00 each.⁹⁰ The prevailing rate of interest, or capi-

84. This analysis assumes that the financing order contains no cross-collateral provision.

85. Loans secured by accounts receivable and inventory generally carry interest rates that are "tied to prime." When the lender and borrower first enter into the loan transaction, the interest rate is set at the prevailing prime rate or at one or more percentage points over prime. The interest rate then "floats" with the prime rate. As the prime rate rises, the interest rate on the loan increases; as the prime rate drops, the interest rate on the loan decreases.

86. Klee, *supra* note 9, provides a much more detailed analysis of an *entire* confirmation scheme in his excellent article.

87. It is important to keep in mind that, in order to value the collateral for purposes of cramdown, the collateral picture must be frozen at some point in time. The most appropriate time to take this measurement is at confirmation. See text accompanying note 79 *supra*.

88. This example assumes existence of ongoing Chapter 11 refinancing not affected by the cramdown provisions of the plan and not cross-collateralized with the pre-petition debt.

89. Most advances on accounts receivable in current credit markets are made at rates between 70 and 85 percent of the face value of new accounts.

90. The example is chosen for simplicity. More realistically, the plan should propose to pay the creditor \$1,500.00 per week for 200 weeks to more closely correspond with projected collection of the accounts.

talization rate, is proven to be fifteen percent.⁹¹ A section 1111(b) election has not been exercised.

The principal amount test is satisfied in this case, since the creditor will receive payments totalling \$300,000.00 over the subsequent five years, well in excess of the \$200,000.00 value of the remaining collateral.⁹² The future value of these payments is approximately \$201,126.90,⁹³ also in excess of the \$200,000.00 secured portion of the claim. Thus, the plan can be confirmed,⁹⁴ provided the creditor is, in addition, afforded a priority administrative claim of \$80,000.00, the amount by which the pre-petition deficiency increased during the pendency of the case. The remaining \$400,000.00 would be an unsecured claim, entitling the creditor to be a member of and vote with the class of unsecured creditors.

In Case 2, the creditor has been granted adequate protection by means of a replacement lien on all new post-petition accounts and inventory, coupled with an administrative priority for any deterioration in its secured position. On the date of the petition, the debt is again \$1,000,000.00, and the value of the collateral is \$600,000.00. During the course of the case, the pre-petition inventory is largely consumed, and only \$100,000.00 remains at confirmation. New accounts and inventory of \$600,000.00 have arisen, however, from business operations. The plan proposes to pay the creditor \$800,000.00 in five yearly installments of \$160,000.00 each. Since the creditor has benefited from an appreciation in the collateral base,⁹⁵ the allowed amount of the secured claim, assuming no section 1111(b) election, is \$700,000.00. The principal amount test is therefore satisfied. The plan cannot be confirmed, however, due in part to the appreciation of the collateral. The future value of the five payments is only \$536,338.46,⁹⁶ significantly short of the

91. Such a capitalization rate yields a future value factor of 3.352115. This rate is also assumed for Case 2, *infra*.

92. The \$100,000.00 difference between the secured amount of the claim and the total payments to be received over five years represents an interest factor, although not the interest factor set by the loan contracts.

93. This calculation is achieved by multiplying the future value factor for five periodic installments (3.352115) by the amount of a single installment (\$60,000.00). The computation yields the \$201,126.90 amount.

94. Had the creditor elected, under § 1111(b), to be fully secured in this example, *see* note 57 *supra*, the allowed amount of its claim would be \$680,000.00, and the plan would fail to meet both tests of 11 U.S.C. § 1129(b)(2)(A)(i) (Supp. III 1979).

95. The amount of the debt at confirmation will still be \$1,000,000.00, since only a fully secured creditor may charge post-petition interest, and only to the extent of the value of the collateral. 11 U.S.C. § 506(b) (Supp. III 1979).

96. This value is achieved by multiplying the future value factor for five periodic install-

\$700,000.00 secured claim. In this situation, the present value test has not been met.

A remaining troublesome aspect of the third cramdown method is the freezing of the capitalization rate at a given point in time. Prevailing rates of interest at confirmation probably will not prevail several years, or even several months, after confirmation. The typical accounts and inventory loan is made at a rate which is tied to the prime rate of interest and floats with prime.⁹⁷ Where the creditor is only partially secured, the prohibition against charging post-petition interest⁹⁸ provides a rationale for fixing what had been a fluctuating interest rate. New loans made under a financing order to the debtor-in-possession or made after confirmation to the reorganized entity should not be subject to such interest rate restrictions. First, the court should protect the finality of financing orders.⁹⁹ More critically, refinancing usually contemplates making loans after confirmation at prevailing rates of interest. Since this continuing transaction is a purely voluntary undertaking on the part of the lender, which the court cannot make binding *in futuro*,¹⁰⁰ the parties should be left free on new loans to charge whatever rate of interest is warranted by changing market conditions.

V. CONCLUSION

Much judicial interpretation of the cramdown provisions in the new Bankruptcy Code will be forthcoming in the next decade. Soft collateral lenders should advocate two developments in particular. First, the finality and enforceability of adequate protection or financing orders should not be affected by a subsequent reorganization plan. Post-petition financing transactions with the debtor-in-possession ought not be subject to *sub rosa* renegotiation or collateral attack in the plan. Second, to the extent that the lender is only partially secured on the date of the petition, that deficiency should not be allowed to increase, and the creditor should receive the benefit of any appreciation in the value of the pre-petition or replacement collateral occurring during the pendency of the case.

ments (3.352115) by the amount of a single installment (\$160,000.00).

97. See note 85 *supra*.

98. See note 95 *supra*.

99. See text accompanying note 43 *supra*.

100. 11 U.S.C. § 365(c)(2) (Supp. III 1979).

These two approaches will provide a more “fair and equitable” cramdown for the soft collateral lender.

