CHAPTER 5:
Priming DIP Facilities: Adequate Protection and Diminution of Value

I. Overview of Adequate Protection Requirement in DIP Financing Context

In the post-petition financing context, a debtor or trustee is only permitted to grant liens that are *pari passu* with, or senior to, an existing lien on the same property if the criteria of Bankruptcy Code § 364(d) are met. Section 364(d) sets forth two minimum requirements. First, the debtor or trustee must be otherwise unable to obtain financing.[235] Second, the debtor or trustee must provide "adequate protection of the interest of the holder of the lien on the property."[236] The purpose of § 364(d)'s adequate-protection requirement is to shield the existing lienholder from any decrease in the value of its security interest resulting from the priming—or *pari passu*—lien.[237] The concept

235 11 U.S.C. § 364(d)(1)(A).
236 11 U.S.C. § 364(d)(1)(B).
237 Although beyond the scope of this manual, the Bankruptcy Code also requires adequate protection of a lienholder's interest in cash collateral as a prerequisite to the debtor's use of the same. 11 U.S.C. § 363(c)(2) and (e). This chapter's discussion of the various forms of

of adequate protection is rooted in the notion that a failure to preserve such value can result in an unconstitutional taking of a property interest.[238] Section 364 makes clear that the burden of establishing "adequate protection" falls on the debtor or trustee.

In undertaking an adequate-protection analysis, it is important to understand the actual value entitled to protection. Under § 346(d), the amount of value protected is limited to the lienholder's interest in the collateral vis-à-vis the size of its claim. For example, if a lienholder has a claim against the debtor in the amount of $1 million secured by collateral valued at $500,000, the value of the lienholder's interest requiring protection is only $500,000.[239] To the extent the debtor or trustee grants a priming lien to secure $2 million in DIP financing, the value of the original lienholder's interest would be completely wiped out absent the provision of adequate protection. In this scenario, the debtor or trustee would need to provide adequate protection to the extent of the diminution in value of the lienholder's interest in the collateral—*i.e.,* $500,000 worth of adequate protection.

The mere existence of a pre-petition lien does not automatically give rise to a right of adequate protection in the DIP financing context. To be entitled to adequate protection, the pre-petition lien must have actual value. Thus, where a pre-petition lien is junior to liens securing claims that are greater than the value of the collateral, the debtor or trustee will have no obligation to provide adequate protection to the junior lienholder.[240] Of course, the value of the underlying collateral—and the proper method of valuation—are often subject to debate. For example, parties frequently dispute the date on which

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adequate protection is equally applicable in the cash-collateral context.

238 *See, e.g.*, *In re Townley,* 256 B.R. 697, 700 (Bankr. D.N.J. 2000) ("The right of a secured creditor to the value of its collateral is a property right protected by the Fifth Amendment…. [T]hat property right is protected by the requirement of Code section 361 for adequate protection.").

239 Alternatively, if a lienholder has a $1 million claim against the debtor secured by collateral valued at $2 million, the value of the lienholder's interest requiring protection would be limited to the amount of the claim: $1 million.

240 *See In re Levitt & Sons, LLC,* 384 B.R. 630, 639-40 (Bankr. S.D. Fla. 2008) ("[The] junior lien creditors' liens have no value because there is no value in the collateral beyond the [senior secured] debt…. Thus, the junior lien claimants are not entitled to adequate protection pursuant to 11 U.S.C. § 364(d) because…they have a zero value lien."); *In re Gateway Access Solutions Inc.,* 368 B.R. 428, 433 (Bankr. M.D. Pa. 2007) (explaining that because contract rejection depreciated the value of creditor's collateral to zero, there was no need to provide adequate protection to creditor).

the collateral should be valued. Courts themselves are divided on this issue, with some courts requiring collateral to be valued as of the bankruptcy filing[241] and other courts holding that value is to be measured as of the date that adequate protection is sought.[242]

Also at issue in valuing collateral for purposes of analyzing adequate protection is whether the collateral should be valued on a going-concern basis, liquidation basis or some alternative basis. For guidance on this issue, Bankruptcy Code § 506(a)(1) provides that valuation of a secured creditor's interest in collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property...." The legislative history of § 506 further indicates that valuation of collateral should be determined on a case-by-case basis.[243] Most courts hold that where a debtor is operating as a going concern, the collateral should be valued as such.[244] However, a common theme expressed by courts is that unless there is a reasonable chance of reorganization within a reasonable amount of time, existing lienholders should not be required to bear the risk of a potentially inflated going-concern value.[245] Experts are often necessary for purposes of establishing collateral value, which is frequently litigated.

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241 *See, e.g.*, *Chase Manhattan Bank USA NA v. Stembridge* (*In re Stembridge*), 394 F.3d 383, 387 (5th Cir. 2004) ("Adequate protection, properly defined, is the amount of an asset's decrease in value from the petition date."); *see also id.* ("A later valuation date would eviscerate value of the secured creditor's claim for a depreciating asset—for each day after the filing, the value of the collateral decreases, and the deficiency is neither captured through adequate protection nor, under the bankruptcy court's test, the confirmation plan itself. Moreover, the bankruptcy court's order can result in an extra penalty to the creditor.").

242 *See, e.g.*, *In re Continental Airlines Inc.,* 146 B.R. 536, 542 (Bankr. D. Del. 1992) ("The Trustees are only entitled to adequate protection if their collateral declined in value after the adequate protection motion was filed. Therefore, the court need only determine if the collateral has actually decreased in value since the motion date."), *aff'd*, 91 F.3d 553 (3d Cir. 1996).

243 H.R. Rep. No. 95-595, at 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6312.

244 *See, e.g.*, *Assocs. Commercial Corp. v. Rash,* 520 U.S. 953, 961 (1997) ("As we comprehend § 506(a), the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question.").

245 *In re Phoenix Steel Corp.,* 39 B.R. 218, 226-27 (D. Del. 1984) ("Given the speculative projections entangling this case, it is impossible to obtain precision in valuation. For the purposes of this opinion, the Court will value the French banks' collateral at the mean of liquidation value and going concern value.").

II. Procedure for Providing Adequate Protection

Under Bankruptcy Rule 4001(c), any priming or *pari passu* liens under Bankruptcy Code § 364(d) require court approval. Bankruptcy Rule 4001(c) requires the debtor's motion seeking such approval to describe the "nature and extent" of the liens requested and the proposed adequate protection to be provided.[246] Prior to any hearing on the debtor's motion, existing lienholders will have the opportunity to object to the requested liens and to the proposed adequate protection of their interests. During the hearing on the debtor's motion, the court will address the disputes (discussed above) such as the proper means of valuing collateral and the date on which the collateral is to be valued. In advance of the hearing, the debtor and existing lienholders can stipulate as to the form of adequate protection to be provided. Bankruptcy Rule 4001(d) still requires court approval of any such arrangement.[247]

Courts have recognized that pre-petition lenders are an important source of DIP financing.[248] In order to avoid adequate-protection disputes, debtors often obtain DIP financing from existing pre-petition lenders. In such instances, issues of adequate protection of the lenders' pre-petition liens are typically resolved on a consensual basis.

III. Forms of Adequate Protection in DIP Financing Context

Bankruptcy Code § 361 provides that adequate protection can take multiple forms, including additional or replacement liens, periodic cash payments, or any other method that provides the lienholder with the "indubitable equivalent" of its interest in the collateral. Each of these methods of adequate protection is discussed below.[249]

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246 Fed. R. Bankr. P. 4001(c).

247 *Id.* at 4001(d).

248 *Modanlo v. Ahan* (*In re Modanlo*), Civil Action No. DKC 2006-1181, 2006 WL 4606303, at *5 (D. Md. Aug. 16, 2006) (recognizing importance of pre-petition lenders as source of post-bankruptcy financing and holding that DIP loan from estate's largest creditor did not undermine the chapter 11 trustee's status as a "disinterested person").

249 In determining the appropriate type of adequate protection, courts have flexibility to require any combination of types of adequate protection.

A. Additional or Replacement Liens

Providing additional or replacement liens is a straightforward way of providing adequate protection. Under this method, the debtor or trustee compensates an existing lienholder for the diminution in value of its lien by providing replacement or additional collateral. For example, to the extent a lienholder's security interest in equipment having a value of $1 million is primed by a § 364(d) lien, the debtor can grant a replacement lien in inventory having a value of $1 million. Although seemingly simple, there may be disputes between the debtor and lienholder as to the sufficiency or value of the replacement collateral.

Moreover, this form of adequate protection is only feasible if the debtor has unencumbered assets on which to grant liens. Often, debtors entering chapter 11 have already encumbered substantially all of their pre-petition assets. Although Bankruptcy Code § 552(a) provides that post-petition property is not subject to pre-petition security agreements, § 552(b) excepts from this limitation any "proceeds, products, offspring, or profits" of pre-petition collateral to the extent (1) such proceeds, products, offspring or profits are covered by the underlying security agreement and (2) the "equities of the case" do not warrant a different result.

B. Periodic Cash Payments

Making periodic cash payments is yet another means of providing adequate protection to an existing lienholder in the *pari passu* or priming lien context. Frequently, this method of adequate protection will take the form of monthly payments equivalent to the interest due under the governing pre-petition debt documents. One issue arising in connection with this method of adequate protection is whether the payments should be credited to the secured or unsecured portion of the creditor's claim. Most courts to address this issue have concluded that the payments should be credited to the creditor's secured claim.[250] This result avoids paying the unsecured portion of the credi-

250 *See, e.g.*, *First Fed. Bank of Cal v. Weinstein* (*In re Weinstein*), 227 B.R. 286, 296 (B.A.P. 9th Cir. 1998) ("The majority of courts have held that payments intended to provide adequate protection should be credited toward reducing the secured portion of the creditor's total claim where there is no depreciation in the value of the collateral.").

tor's claim with 100-cent dollars—a treatment that is unlikely to be accorded to other unsecured creditors.

Yet another issue to arise in this context is whether the periodic cash payments should be allocated to principal or interest. On this issue, courts have held that payments should be applied to interest only to the extent that the creditor's claim is oversecured.[251] This conclusion follows because under Bankruptcy Code § 506(b), only oversecured creditors are entitled to post-petition interest.[252]

C. Indubitable Equivalent

In addition to the specific examples of replacement liens and cash payments, Bankruptcy Code § 361(3) provides that adequate protection can be provided by any other means that "will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property." Section 361(3) has been interpreted as a "catch all, allowing courts discretion in fashioning the protection provided to a secured party."[253] Although § 361(3) casts a wide net, it expressly provides that the granting of an administrative claim under Bankruptcy Code § 503(b)(1) does *not* satisfy the "indubitable equivalent" standard.

One example of adequate protection provided under § 361(3) is the existence of a so-called "equity cushion" in the underlying collateral (*i.e.,* value in excess of all claims secured by the property). Courts consider multiple factors in determining whether an equity cushion is a sufficient form of adequate protection for purposes of a *pari passu* or priming lien under § 364(d). Such factors include: (1) whether the accrual of interest is eroding the equity cushion; (2) whether the property is increasing or decreasing in value; (3) whether the debtor has offered any other means of adequate protection; and (4) whether current economic conditions suggest a realistic prospect for a successful reorganization.[254]

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251 *See, e.g.*, *Nantucket Investors II v. Cal. Fed. Bank* (*In re Indian Palms Assocs. Ltd.*), 61 F.3d 197, 210-11 (3d Cir. 1995).

252 11 U.S.C. § 506(b) ("To the extent that an allowed secured claim is secured by property the value of which…is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim....").

253 *In re Swedeland Dev. Grp.,* 16 F.3d 552, 564 (3d Cir. 1994).

254 *In re Timber Prods. Inc.,* 125 B.R. 433, 433-34 (Bankr. W.D. Pa. 1990).

Of course, the size of the equity cushion is critically important in determining whether adequate protection is present. As one court has noted, an equity cushion of 20 percent or more has "almost uniformly" been deemed to constitute adequate protection, whereas an equity cushion of less than 11 percent has "almost as uniformly" been deemed to be inadequate.[255] In short, a court will deny a priming lien if the only proposed adequate protection is an equity cushion with insufficient value.[256] An equity cushion may not be able to provide adequate protection for the duration of the case. As noted above, Bankruptcy Code § 506(c) entitles oversecured creditors to post-petition interest. Once an equity cushion is eaten away by the accrual of post-petition interest, the debtor must provide a new form of adequate protection.[257]

Whatever the form of adequate protection provided under § 361(3), it must have actual, cognizable value. Merely speculative value will not suffice. For example, the expectation that the debtor's property will increase in value has been held to be insufficient for adequate-protection purposes. Thus, in *In re YL West 87th Holdings I LLC*, the bankruptcy court explained that a priming lien would be denied where the only proposed form of adequate protection was a potential increase in the value of the debtor's property. This result was because (1) even assuming the projected increase in value, the subject property would be worth less than the sum of the DIP loan and existing lienholder's claim, and (2) even if projected increase was larger, it was too speculative.[258]

Similarly, proposed adequate protection that is dependent on the happening of uncertain future events has been found to be inadequate.[259] It is

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255 *Suntrust Bank. v. Den-Mark Constr. Inc.,* 406 B.R. 683, 700 n.24 (E.D.N.C. 2009); *see also* "Recent Developments in Adequate Protection under Section 361," *Norton's Annual Survey of Bankruptcy Law* at 636-38 (2011 ed.) (summarizing cases evaluating sufficiency of equity cushions).

256 *In re Strug-Division LLC,* 380 B.R. 505, 515 (Bankr. N.D. Ill. 2008) (refusing to grant priming lien under § 364(d) where equity cushion was decreasing daily and proposed use of cash collateral was not likely to generate cash in excess of lenders' claims); *In re Stoney Creek Techs. LLC,* 364 B.R. 882, 892 (Bankr. E.D. Pa. 2007) (denying grant of priming lien under § 364(d) "even assuming a substantial equity cushion" based on court's conclusion that the debtor could not operate at a profit).

257 *Shaw Indus. Inc. v. First Nat'l Bank of PA* (*In re Shaw Indus. Inc.*), 300 B.R. 861, 865-66 (Bankr. W.D. Pa. 2003) ("Where an equity cushion is insufficient in size or likely to erode, it cannot, standing alone, constitute adequate protection.").

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

259 *See In re Morgan & Co.,* No. 08-05066-8-ATS, 2008 WL 4287870, at *2 (Bankr. E.D.N.C. Sept. 16, 2008) (denying approval of priming liens where adequate protection depended on the completion of construction projects that were uncertain and explaining unfairness

therefore important to establish an evidentiary record of the value in the debtor's proposed adequate protection. As one court has explained, "[a] finding of adequate protection should be premised on facts, or on projections grounded on a firm evidentiary basis. Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects."

Where a debtor is unable to provide adequate protection to an existing lienholder, there is no "emergency" exception that allows for the granting of a priming lien. For example, in *In re Fontainebleau Las Vegas Holdings LLC*, the district court reviewed the bankruptcy court's approval of priming liens without granting replacement liens or cash payments to existing lienholders.[260] In the proceedings before the bankruptcy court, the debtor's expert testified that the debtor's business would fail absent the granting of priming liens.[261] The bankruptcy court approved the priming liens based on its conclusion that the lienholders would benefit from the DIP loan since it would enable the debtor to continue operating.[262] In reversing the bankruptcy court, the district court explained that such a benefit did nothing to compensate the lienholders for the decline in value of their interest in collateral as required by § 364(d).[263] Thus, arguing that the debtor's survival depends on the granting of priming liens is insufficient to get around the bedrock bankruptcy requirement of adequate protection.

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of shifting risk of noncompletion to secured creditor); *In re Eagle Creek Subdivision LLC,* Nos. 08-04292-8-JRL et al., 2008 WL 2761302, at *3 (Bankr. E.D.N.C. July 10, 2008) (denying priming liens where proposed adequate protection depended on contracts of uncertain viability).

260 *In re Fontainebleau Las Vegas Holdings LLC,* 434 B.R. 716, 750-51 (S.D. Fla. 2010).

261 *Id.* at 750.

262 *Id.* at 751.

263 *Id.* at 751-54; *see also In re Barbara K. Enters. Inc.,* No. 08-11474 (MG), 2008 WL 2439649, at *13 (Bankr. S.D.N.Y. June 16, 2008) ("The financing proposal would prime Level 10's valid liens on certain post-petition assets, and no adequate protection is offered to compensate Level 10 for the corresponding diminution of its interest. Accordingly, approval of the DIP facility proposed by Debtor must be denied.").

IV. When Adequate Protection Fails

The nature of a court's adequate-protection analysis is inherently forward-looking—that is, courts make their adequate-protection determinations prospectively, based on the evidence available at the time. As such, there can be no assurance that the adequate protection approved by the court will actually preserve the value of a secured creditor's interest in property. For example, the value of property securing an undersecured creditor's replacement lien might depreciate at a faster rate than the property securing the creditor's original lien. In other words, the "adequate protection" approved by the court may prove to be inadequate.

Section 507(b) of the Bankruptcy Code is the primary means of protecting secured creditors from the failure of adequate protection. Under § 507(b):

> If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a[n administrative expense] claim allowable under subsection (a)(2) of this section arising from…the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

Thus, to the extent that adequate protection proves to be inadequate, § 507(b) provides a secured creditor with a "super-priority" claim to the extent of the diminution of its interests in the debtor's property occasioned by a priming lien. A prior grant of adequate protection is therefore a prerequisite to a claim under § 507(b).[264]

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264 *In re Gateway Access Solutions Inc.,* 368 B.R. 428, 434 (Bankr. M.D. Pa. 2007) (refusing to grant § 507(b) claim to parties who were not entitled to adequate protection and observing that "[i]t is evident from the first sentence of § 507(b) that a prerequisite to super priority status is a prior entitlement to adequate protection").

Moreover, in order to qualify for § 507(b) super-priority, a party must show that its claim for the diminution in value of its interest qualifies for payment as an administrative expense (*i.e.,* that its claim resulted from a benefit conferred upon the debtor).[265] In the priming-lien context, this should not be a difficult burden because the debtor will have benefited from the ability to prime the creditor's lien in order to obtain DIP financing. It should finally be noted that although § 507(b) claims are considered "super-priority" claims, they are junior to claims granted under § 364(c)(1) as incentives for DIP financing.[266]

265 11 U.S.C. § 507(b) (stating that § 507(b) super-priority status requires creditor to hold a claim allowable as an administrative expense under Bankruptcy Code §§ 507(a)(2) and 503(b)).

266 Bankruptcy Code § 364(c) expressly states that such claims have "priority over any or all administrative expenses of the kind specified in section 503(b)." 11 U.S.C. § 364(c)(1).