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# "Cram Down" in Bankruptcy: Is a Secured Creditor Entitled to Replacement Value, Foreclosure Value, or the Average of the Two?

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# Case at a Glance

An advantage of a Chapter 13 bankruptcy filing is that the debtor can retain any asset the debtor chooses, including assets that have been used as collateral. The Bankruptcy Code requires the debtor's plan to provide for paying a secured creditor the *value* of the creditor's claim against the asset. In this case, the Supreme Court decides whether the secured creditor's claim is measured by the collateral's foreclosure value, its replacement value, or the average of the two.

# "Cram Down" in Bankruptcy: Is a Secured Creditor Entitled to Replacement Value, Foreclosure Value, or the Average of the Two?

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## ISSUE

When a bankrupt debtor under Chapter 13 proposes to retain an asset used as collateral, what is the proper method of valuing the collateral under Section 506(a) of the Bankruptcy Code?

## FACTS

On March 30, 1989, Elray Rash purchased a Kenworth commercial tractor truck from Janoe Truck Sales and Service, Inc. ("Janoe"), of San Antonio, Texas. The cash price of the truck was $73,700. Rash made a down payment and agreed to pay the remaining balance plus interest pursuant to an installment loan contract.

Janoe retained a security interest in the truck to ensure payment of the unpaid balance, which it subsequently assigned, along with its other rights under the sales agreement, to Associates Commercial Corporation ("Associates" or "ACC"). From the date of purchase, Elray Rash has continued to own and operate the truck as part of his freight hauling business which is the primary source of income for him and his family.

On March 18, 1992, Rash and his wife Jean filed a joint petition and plan under Chapter 13 of the Bankruptcy Code. 11 U.S.C. §§ 1301-1330 (1994). The Rashes' petition valued Associates' secured claim in the Kenworth truck at $28,500, its wholesale value at the time.

The Rashes' plan provided that they would keep the truck and that Associates' secured claim would be dealt with under the "cram down" option found in Section 1325(a)(5)(B) of the Bankruptcy Code, so called because the bankrupt debtor can force a creditor to accept a plan. 11 U.S.C. § 1325(a)(5)(B). Pursuant to that option, ACC would retain its security interest in the truck and receive payments over the life of the plan equal to the present value of its allowed secured claim. However, ACC and the Rashes disagreed about the value of ACC's claim.

*ASSOCIATES COMMERCIAL CORPORATION V. ELRAY RASH AND JEAN E. RASH*
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On January 20, 1993, after a hearing which included expert testimony on behalf of Associates and the Rashes, the bankruptcy court entered an order fixing the amount of ACC's allowed secured claim in the truck at its wholesale price of $31,875. 149 B.R. 430 (Bankr. E.D. Tex. 1993). The bankruptcy court determined that the value of the truck was equal to the amount that ACC would realize if it exercised its right under the security agreement to repossess and sell the truck, i.e., the truck's foreclosure value.

ACC appealed the bankruptcy court's order to the United States District Court for the Eastern District of Texas which affirmed in an unreported decision, holding that a secured creditor such as ACC is protected from loss under a Chapter 13 plan because the creditor receives the amount it would realize if it repossessed and sold the collateral in a commercially reasonable manner. ACC appealed the district court's decision to the Fifth Circuit.

A three-judge panel reversed and held that the appropriate measure of the truck's value was its replacement value, not its foreclosure value. 31 F.3d 325 (5th Cir. 1994), *modified,* 62 F.3d 685 (5th Cir. 1995). However, the Fifth Circuit decided to consider the case *in banc.* (Refer to Glossary for the definition of *in banc.*)

The *in banc* Fifth Circuit, by a vote of nine to six, affirmed the bankruptcy and district courts, holding that ACC's allowed secured claim was limited to the foreclosure value of the truck. The *in banc* majority reasoned that ultimately it is the creditor's interest that is being valued under Section 506(a) of the Bankruptcy Code, 11 U.S.C. § 506(a), and that interest is simply a security interest which is the right to repossess and sell the collateral. Therefore, valuation of collateral should start with what the creditor would realize by exercising that right. 90 F.3d 1036 (5th Cir. 1996).

The Fifth Circuit's use of foreclosure value as the measure of a secured creditor's allowed claim represents one of three approaches to valuing such claims. A second approach uses the replacement value of the secured property and has been adopted in the First, Eighth, and Ninth Circuits. For example, in *Taffi v. United States,* 96 F.3d 1190 (9th Cir. 1996), the Ninth Circuit held that when a Chapter 11 or Chapter 13 debtor intends to retain property subject to a security interest, the purpose of the valuation under Section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral; instead, the purpose is to determine the fair market value of the property the debtor chooses to retain and use. *See also Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav.,* 50 F.3d 72 (1st Cir. 1995); *Metrobank v. Trimble,* 50 F.3d 530 (8th Cir. 1995).

Yet a third approach comes from the Seventh Circuit's recent decision in *In re Hoskins,* 102 F.3d 311 (7th Cir. 1996). In that case, the Seventh Circuit held that collateral should not be valued from either the creditor's point of view, i.e., the replacement value of the property, or the bankrupt debtor's point of view, i.e., the foreclosure value of the property, but should be valued as an average of the two.

The Supreme Court granted ACC's petition for a writ of certiorari to resolve this conflict. 117 S. Ct. 758 (1997).

## Case Analysis

Section 1325(a) of the Bankruptcy Code sets forth six prerequisites to a bankruptcy court's confirmation, i.e., approval, of a Chapter 13 reorganization plan. One prerequisite concerns the plan's treatment of secured claims that are allowed by the bankruptcy court. Essentially, there are three ways of treating an allowed secured claim. First, the holder of an allowed secured claim may accept the plan's treatment of the claim as proposed by the debtor. If the secured creditor accepts the plan's treatment, nothing more is required. Second, the debtor may surrender the collateral securing an allowed claim to the creditor. Neither of these approaches is involved in this case.

The third approach to an allowed secured claim, and the one at issue here, permits the debtor to cram down, or force acceptance of, a plan notwithstanding objection by the secured creditor. The creditor retains its security interest and the debtor agrees to distribute to the creditor, over the life of the plan, property (usually, cash payments) with a present value that is not less than the amount of the creditor's allowed secured claim.

The cram down provision, as explained, is triggered whenever a creditor does not accept a plan, and the debtor does not want to surrender the collateral that secures the debt. Since this option requires a distribution to the creditor of property with a present value not less than the amount of the creditor's allowed secured claim, it is necessary for the bankruptcy court to determine the amount of the claim before confirming the plan.

*(Continued on Page 426)*

Section 506(a) prescribes the method for valuing an allowed secured claim. In relevant part, Section 506(a) provides that "an allowed claim of a creditor secured by a lien on property in which the [debtor's] estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . [and] shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . ."

Associates maintains that the plain meaning of Section 506(a) entitles it to the replacement value of the truck as the amount of its allowed secured claim. Associates asserts that Section 506(a) contains two sentences that specify how the amount of an allowed secured claim is determined.

The first sentence establishes that the amount of a secured claim is equal to "the value of such creditor's interest in the estate's interest in such property." The second sentence specifies that such value is determined in light of 1) the purpose of the valuation and 2) the proposed disposition or use of the property.

The first sentence of Section 506(a), argues ACC, provides only that the amount of the allowed claim is the value of the collateral; it says nothing about how to determine that value. In other words, ACC maintains that the first sentence addresses only what is to be valued but does not address the method of valuation.

ACC argues that the second sentence of Section 506(a) dictates how to determine value: in light of the purpose of valuation and in light of the proposed disposition or use of the property. ACC asserts that the provision clearly distinguishes between a proposed disposition and a proposed use of property for valuation purposes. A proposed disposition, for example, would occur when the property is to be surrendered to the creditor under Section 1325(a)(5)(C). As a result, the value of the allowed secured claim would be measured by the value of the property to the creditor. In this case, however, ACC asserts that there has been no disposition because the Rashes elected to keep the truck for use in Elray's business. This, in ACC's opinion, is use of the collateral by the debtor, and the only way to read Section 506(a) coherently is to value the truck in accordance with the debtor's proposed use, and the value of the truck in the Rashes' hands is the cost of replacing the truck, i.e., its current retail value. ACC believes that the Bankruptcy Code does not allow the Rashes to *use* the collateral property while paying only its *disposition* value.

The Rashes' argument that the measure of an allowed secured claim is the foreclosure value of the collateral, like ACC's counterargument, also is grounded in the language of Section 506(a). The Rashes assert that the first sentence of the provision directs the bankruptcy court to value the creditor's interest in collateral in light of the bankrupt debtor's interest in the property. They assert that the logical starting point for this valuation is, first, to value the creditor's interest which is in the nature of a security interest that gives the creditor the right to repossess and sell the collateral and nothing more.

The valuation, therefore, should start with what the creditor would realize by exercising that right. Under the Rashes' analysis, the first sentence of Section 506(a) calls for a valuation of collateral that preserves the extent to which a creditor is secured under state law by establishing that a creditor's claim is a secured claim to the extent of the value of its security interest. The value of a security interest, argue the Rashes, is that it may ripen into a foreclosure sale.

The Rashes then turn to the second sentence of Section 506(a) which, as noted above, directs the bankruptcy court to determine value in light of two factors: the purpose of such valuation and the proposed disposition or use of the collateral. The Rashes analyze each factor separately.

The Rashes acknowledge that the meaning of the "purpose of the valuation" is not obvious from the words themselves or from the remaining text of Section 506(a). They assert, however, that the purpose is to determine the amount of the distribution that a creditor such as Associates must receive under a plan in order to satisfy the cram down option under Section 1325(a)(5)(B). The Rashes conclude that since the purpose of valuation is to protect the value that the secured claimant would receive if it repossessed the collateral and disposed of it, it is appropriate to use the foreclosure value of the property and not its replacement value.

As to the proposed disposition or use of the collateral, the Rashes reject the argument that because the collateral is being retained and used by a bankrupt debtor, its value must necessarily be measured by its worth to the debtor. They contend that when the collateral is in the hands of the debtor in a Chapter 13 case, it is worth something to both the debtor and the creditor. The collateral has worth to the debtor because the debtor has an ownership or a possessory interest in it; the collateral has worth to the creditor because the creditor has a secu-

rity interest in it. Thus, in the Rashes' view, the "proposed disposition or use" language in Section 506(a) merely directs the court to value the collateral in light of the fact that the debtor has retained possession, which says nothing about whether worth to the debtor or worth to the creditor is the appropriate measure of value.

The Rashes assert further that the phrase "in light of" suggests that the court need only consider the proposed disposition or use of collateral and does not dictate that such disposition or use necessarily affects value. In fact, the Rashes assert that when a debtor retains collateral and uses it for its usual and intended purpose, such retention and use should not ordinarily affect value.

The Rashes contend, in sum, that Section 506(a) merely reaffirms the extent to which a creditor is secured under state law by suggesting that valuation starts with what the creditor could realize by repossession and sale of the collateral. This interpretation is not contradicted by the second sentence of Section 506(a), provided the bankruptcy court at least considers the two statutorily prescribed factors that may affect the value of the creditor's security interest in collateral.

## Significance

In 1995, over 286,000 Chapter 13 cases were filed; in 1994, almost 250,000 cases were filed. Undoubtedly, in most of these cases, the bankrupt debtors owned cars, trucks, appliances, and other assets that served as collateral because they were purchased on secured credit. Indeed, a principal reason for debtors to file a plan under Chapter 13 rather than to liquidate under Chapter 7 is that they wish to retain some or all of their property. Not infrequently, however, the debtor and secured party cannot come to agreement on the value of collateral and a cram down is elected by the debtor.

One essential part of the cram down process is to determine the value of the collateral. Thus, the difference between valuing the collateral in terms of foreclosure value, replacement value, or an average of these values will have an immediate and a substantial economic impact on debtors and creditors in a vast number of Chapter 13 cases. This means that debtors and creditors alike will be watching as the Supreme Court provides an answer to the valuation question.

## Attorneys of the Parties

**For Associates Commercial Corporation** (Carter Phillips; Sidley & Austin; (202) 736-8000).

**For Elray Rash and Jean E. Rash** (John J. Durkay; Mehaffy & Weber; (409) 835-5011).

## Amicus Briefs

**In support of Associates Commercial Corporation**

Joint brief of NationsBank, N.A., NationsBank, N.A. (South), NationsBank of Texas, N.A., Bank of America Texas, N.A., Bank of America National Trust and Savings Association, BANC ONE CORPORATION, and Chase Manhattan Bank USA, N.A. (Counsel of Record: John H. Culver III; Kennedy Covington Lobdell & Hickman; (704) 331-7400);

The United States (Counsel of Record: Walter Dellinger, Acting Solicitor General; Department of Justice; (202) 514-2217);

Washington Legal Foundation (Counsel of Record: David R. Kuney; David, Hagner, Kuney & Davison; (202) 467-6900).