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Adequate Protection Payments and the Surrender of Cash Collateral in Chapter 11 Reorganization

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ADEQUATE PROTECTION PAYMENTS AND
THE SURRENDER OF CASH COLLATERAL
IN CHAPTER 11 REORGANIZATION

David Gray Carlson*

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[Bijurcation [Entzweigung] is the source of the need for philosophy.

Hegel1

The Bankruptcy Code2 is deeply confused about the metaphysics

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of the undersecured creditor. In general, it wants to stop the clock on creditor claims. Creditor claims are allowed as of the day of the bankruptcy petition; they may not grow over time. Thus, postpetition interest is forbidden, because this would admit that time exists. But, inconsistently, postpetition interest is allowed to oversecured creditors—though only to the extent of the equity cushion. Thus, time is not abolished for oversecured creditors. Yet every oversecured creditor is implicitly an undersecured creditor, and perhaps vice versa.

That is to say, once an equity cushion disappears, the oversecured creditor becomes an undersecured or at least barely secured creditor. Therefore, if oversecured creditors live in a dynamic universe where time exists, the time of that universe will inevitably abolish itself.

Likewise, undersecured creditors live partly in time and partly out of time. When an undersecured party is entitled to postpetition proceeds, the secured claim of an undersecured creditor may grow over time, unless the secured claim somehow is capped at the value of the collateral at some designated time.

It is no accident, then, that when the Supreme Court condescends to pronounce some law in the field of debtor-creditor relations, it often chooses to address the rights and status of the undersecured creditor. On no bankruptcy subject since the Bankruptcy Code was

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4 11 U.S.C. § 502(b) (“the court . . . shall determine the amount of such claim . . . as of the date of the filing of the petition”).


6 But see 11 U.S.C. § 726(a)(5) (if a debtor surplus exists after all unsecured creditors are paid, the unsecured creditors are entitled to interest on their claims).


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, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

Id.

8 This is controversial. While some courts support this view, others believe that the secured party may insist that the equity cushion be preserved for its benefit. Still others insist that the equity cushion may be taken away from the secured party at any time prior to the final distribution or confirmation of the plan, even if interest has accrued against a then-existing cushion. See David Gray Carlson, Postpetition Interest Under the Bankruptcy Code, 43 U. MIAMI L. REV. 577, 646-50 (1989).


11 For example, the Supreme Court has declared that a mortgagee’s right to postpetition rent must be decided by state law. Butner v. United States, 440 U.S. 48 (1979). Ironically, it did so in the context of upholding a decision that denied postpetition rent for failure to meet a federal rule of procedure. See David Gray Carlson, Philosophy in Bankruptcy, 85 Mich. L. Rev. 1341, 1377-78 n.117 (1987). The Supreme Court also made clear that undersecured
promulgated has the Supreme Court spoken more often and with less clarity.

Most bankruptcy practitioners would identify two Supreme Court opinions in particular as the most mystifying. The first is *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*,12 where Justice Antonin Scalia ruled that undersecured creditors may not obtain postpetition interest as part of their right to adequate protection of their secured claims. As a result, bankruptcy delay reduces the value of an undersecured claim. This opinion denies that time exists.

The second opinion is *Dewsnup v. Timm*,13 where Justice Harry Blackmun ruled that debtors could not freeze undersecured creditors at the value of the collateral at some specified time. Rather, the secured claim must be allowed to grow. This opinion admits that time exists and, accordingly, it draws a withering dissent from Justice Scalia.14

Both opinions self-consciously address the question whether a secured claim can grow over time—through the accrual of interest on the claim itself or through the appreciating value of collateral. Yet a secured claim can also shrink—a subject in which virtually no scholarly attention has been invested. The shrinking secured claim is a routine phenomenon in chapter 11, where bankruptcy courts often insist that a debtor pay an undersecured creditor under the guise of its obligation to provide "adequate protection" of a secured claim.15 Or judges often insist that the debtor surrender "cash collateral" that the secured creditor already owns. What effect do these payments have on an undersecured claim? Do they reduce the secured portion of the claim, or the unsecured deficit? Or should they be deemed to do


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14 Id. at 779-88 (Scalia, J., dissenting).
neither—in which case they are payments of interest compensation? These are the questions I will address in this Article.

I will proceed as follows. First, I set forth some of the basic principles that govern undersecured creditors. Second, I consider the legal meaning of an adequate protection payment, which I will define as the payment of unencumbered dollars that the debtor owns free and clear of the undersecured creditor's security interest. These payments should be viewed as reducing the secured claim and the total claim of an undersecured creditor but not the unsecured deficit claim of that creditor. Third, I wish to describe the surrender of already encumbered dollars as tantamount to the abandonment of collateral. As such, these surrenders reduce the secured claim and the total claim as well, but they do so in a way that differs from that of adequate protection payments. When cash collateral is surrendered, the collateral necessarily shrinks because the cash has been removed from the collateral pool. If a court then writes down the secured claim again, it has double-charged the secured party. In contrast, an adequate protection payment does not reduce the pool of collateral available, because the dollars paid are, by definition, unencumbered dollars. These are important distinctions that are sometimes overlooked in judicial opinions.

Finally, I wish to consider the effect of cash collateral surrenders on chapter 11 cram down. Several cases approve of setting off post-confirmation payments of cram down interest against preconfirmation surrenders of cash collateral. I wish to identify the circumstances under which such setoffs are permissible, and which such setoffs constitute an illegal invasion of the secured claim.

I. SOME BASIC PRINCIPLES

A. Appreciation of Collateral

The Bankruptcy Code's bicameral instinct is to take the total claim of an undersecured creditor and divide it into two parts: one fully secured and one fully unsecured. This is accomplished under the authority of section 506(a), which provides:

An allowed claim of a creditor secured by a lien on property in which the 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 is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such dispo-
ADEQUATE PROTECTION PAYMENTS

The effect of section 506(a) can be illustrated as follows: suppose the secured party (SP) has a total claim of $100 and collateral worth only $80. According to section 506(a), SP’s $100 claim is subdivided into an $80 secured claim and a $20 unsecured claim.

Once this valuation occurs, the secured party is entitled to adequate protection of the $80 secured claim. Adequate protection implies that, if the collateral depreciates in value over time, the secured party is entitled to some form of compensation.

But what if the collateral increases in value—either through market fluctuation or investment? For example, suppose SP’s collateral increases in value from $80 to $95. Who owns the $15 in appreciation value? This question was the matter at hand in the landmark case of Dewsnup v. Timm.

Until 1992, many thought that a bankruptcy trustee owned the $15 in appreciation value. That is, SP’s secured claim was forever fixed at $80, thereby depriving SP of appreciation value and awarding it instead to the general creditors.

This was clearly the case if a reorganization plan had been confirmed. In chapter 11, a debtor-in-possession can cram down a secured creditor by giving the creditor a lien “to the extent of the allowed amount of such claims”; and securing “deferred cash payment totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.” According to this provision, SP can be crammed down for $80—the value of the collateral. If, later, the collateral increases in value to $95 after confirmation of the plan, the gain belongs to the reorganized debtor. Meanwhile, SP can attempt to escape this treatment by making the section 1111(b)(2) election.

Before confirmation—and prior to Dewsnup v. Timm—it was less clear that a trustee could grab the $15 appreciation value. Section 506(a) arguably implied that SP was limited to an $80 secured claim.

17 See id. § 363(e).
20 Id. § 1129(b)(2)(A)(i)(II).
21 The meaning and value of this election is famously obscure and beyond the scope of this Article, which concentrates on preconfirmation effects on the secured claim. Suffice it to say that the election repeals bifurcation in the chapter 11 plan. For a discussion of the § 1111(b) election, see David Gray Carlson, Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral, 6 BANKR. DEV. J. 253, 279-303 (1989).
If the collateral increased in value to $95, the appreciation value became an equity cushion, which perhaps might trigger SP’s right to postpetition interest under section 506(b). But, putting aside the accrual of interest, such an equity cushion would belong to the trustee. On such a view, valuations would be considered final.

A contrary interpretation of section 506(a) was possible as well. If the valuation on which the bifurcation of an undersecured claim was not final—if a court could constantly revisit the question and set new values on appreciating collateral—then SP would not be limited to $80. Rather, the new valuation would set the secured claim at $95 and the unsecured claim at $5. A reorganization plan would then be confirmed on the basis of awarding all preconfirmation appreciation value to SP.

Prior to 1992, section 506(d) seemed relevant to the meaning of section 506(a). Section 506(d) mysteriously provides:

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such a lien is void, unless—

(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

(2) such claim is not an allowed secured claim due only to the failure of an entity to file a proof of such claim under section 501 of this title.

Continuing the hypothetical numbers employed previously, the usual interpretation of section 506(d) was that SP’s security interest for the $80 secured claim was valid, but the security interest was “void” insofar as the $20 unsecured claim was concerned. Indeed, this much

22 Attempts to use § 506(a) to separate an oversecured party from her equity cushion (and hence a right to postpetition interest under § 506(b)) have been emphatically rejected. Abbott Bank-Thedford v. Hanna (In re Hanna), 912 F.2d 945, 949 (8th Cir. 1990) (Magill, J.) (“In short, § 506(a) cannot be read as extinguishing an oversecured creditor’s equity cushion.”).

23 It is sometimes asserted that a “petition day” rule enhances the debtor’s “fresh start” by reserving postpetition appreciation for the debtor. See Donahue v. Parker (In re Donahue), 110 B.R. 41, 45 (Bankr. D. Kan. 1990) (Franklin, J.); Brace v. State Farm Mut. Ins. Co., 33 B.R. 91, 93 (Bankr. S.D. Ohio 1983) (Kerr, J.); but see Fitzgerald v. Davis (In re Fitzgerald), 729 F.2d 306, 308 (4th Cir. 1984) (per curiam) (low valuation on bankruptcy day should be redone nunc pro tunc, given unexpectedly large sale price obtained later).


could even be inferred from section 506(a) standing alone, if it is assumed that valuations are final and cannot be revised. That is, if the $20 claim is indeed declared unsecured, no appreciation value accruing later could be applied to this unsecured $20 claim.

A line of cases refused to read section 506(d) in this manner. These rogue cases held that only claims not allowed under section 502 may be avoided under section 506(d). This view had been roundly criticized for rendering section 506(d) into "mere surplusage," in that we do not need section 506(d) to tell us that a lien is dead if it secures a claim disallowed under section 502(b). As Professor Margaret Howard pointed out, "[t]he problem with this reading . . . is the jump from a clearly correct proposition—that a lien is void if it secures a claim that is not allowable in bankruptcy—to the conclusion that a lien is void only if it secures a claim that is not allowable in bankruptcy." Therefore, it was quite widely agreed that a court might bifurcate an undersecured claim in a final way, such that no further growth in the collateral would reduce the size of the secured party's unsecured deficit claim. Yet, nevertheless, these rogue cases took precisely Justice Blackmun's position in Dewsnup v. Timm.

_Dewsnup v. Timm_ arose in the context of a struggle by debtors (as opposed to trustees) to exploit section 506(d). When there is no equity in the collateral, a trustee might abandon it to the debtor and any surviving secured creditors. To revert to the previous example, if SP's total claim is $100 and the collateral is worth only $80, the trustee should abandon the collateral (unless it is useful in a reorganization). Once the trustee has abandoned the collateral, the automatic stay no longer applies to restrain SP. Suppose SP moves to foreclose her security interest, and, at the auction, a buyer bids $95. Does SP take the full $95 (because her claim is $100) or only $80 (the

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29 Margaret Howard, _Stripping Down Liens: Section 506(d) and the Theory of Bankruptcy_, 65 AM. BANKR. L.J. 373, 379 (1991) (footnotes omitted).

30 See 11 U.S.C. § 554(a) ("After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.").

31 See 11 U.S.C. § 362(d)(2) (stay should be lifted unless _either_ debtor equity exists or the collateral is necessary for a successful rehabilitation).

amount of her allowed secured claim prior to the bankruptcy)? If the latter answer is correct, the debtor emerges with $15 in post abandonment appreciation value.

Courts were split on this question. Many courts thought that the debtor was entitled to the appreciation value because section 506(d) capped SP’s security interest at $80. Others found various reasons to deny the debtor any benefit from section 506(d).

The leading case following this theory is Gaglia v. First Fed. Sav. & Loan Ass’n, 889 F.2d 1304 (3d Cir. 1989) (Hutchinson, J.). For a defense of this position, see Joann Henderson, The Gaglia-Lowry Brief: A Quantum Leap from Strip Down to Chapter 7 Cram Down, 8 BANKR. DEV. J. 131 (1991); Margaret Howard, Dewsnupping the Bankruptcy Code, 1 J. BANKR. L. & PRAC. 513, 516-17 (1992).

There is a long line of cases that deny the debtor the power to use § 506(d) for a fresh start. See, e.g., Larson v. Alliance Bank (In re Larson), 99 B.R. 1 (Bankr. D. Alaska 1989) (Ross, J.) (collecting cases). These cases have relied upon a diverse set of reasons to deny fresh start benefits to a debtor claiming overencumbered collateral. The arguments include: (1) it is bad policy to encourage debtors to use chapter 7 in lieu of chapter 13; (2) benefiting the debtor eliminates the redemption provisions in § 722 from any utility; and (3) once property is abandoned, it is no longer part of the estate and it is too late for an avoidance power to affect that property. Each of these rationales has weaknesses. For a discussion, see Tracey Springer, Note, An Individual Debtor’s Right to Avoid Liens Under Section 506(d) of the Bankruptcy Code, 12 CARDOZO L. REV. 263, 269-73 (1990).

The clear (if surprising) answer should have been that neither SP nor the debtor should have obtained the $15. This follows because SP’s avoided lien of $15 was never really avoided, in spite of the misleading language of § 506(d). Rather, it was “preserved” under Bankruptcy Code § 551, which provides that “any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.” 11 U.S.C. § 551; see In re Mammoser, 115 B.R. 758, 760 (Bankr. W.D.N.Y. 1990) (McGuire, J.); In re Mahener, 34 B.R. 308, 310 (Bankr. W.D.N.Y. 1983) (Hayes, J.); Springer, supra, at 263-64.

Preservation of an avoided lien for the benefit of a bankrupt estate is a standard feature of the trustee’s avoidance powers. The basic premise is that if a trustee avoids a lien, and a second lien creditor exists, avoidance should not provide the second lien creditor with a windfall promotion. Tennessee Mach. Co. v. Appalachian Energy Indus., Inc. (In re Appalachian Energy Indus., Inc.), 25 B.R. 515 (Bankr. M.D. Tenn. 1982) (Lundin, J.). In order to ensure that only the general creditors benefit from lien avoidance by the trustee, § 551 of the Bankruptcy Code preserves the lien for the benefit of the estate, so that it can be asserted on behalf of the estate, thereby keeping the second lien creditor in her place. See generally John C. McCoid, II, Preservation of Avoided Transfers and Liens, 77 VA. L. REV. 1091, 1101 (1991). If § 551 is given its effect, then the trustee obtains the appreciation value. This view received a tentative endorsement in Justice Scalia’s dissenting opinion in Dewsnup v. Timm, 112 S. Ct. 773, 775 n.1 (1992).

This view that the trustee retains the avoided lien when she abandons the valueless equity also implies that, in cases where the trustee renounces all rights to the collateral, the preserved lien is abandoned as well as the valueless equity. See H.R. REP. No. 595, 95th Cong., 1st Sess. 91 (1977) (“A preserved lien may be abandoned by the trustee under ... § 554 if the preservation does not benefit the estate.”). But this preserved lien is not abandoned back to the debtor. Rather, it must be abandoned to its prior owner—the undersecured party. In our example, SP—not the debtor—is the recipient of the avoided lien for $15. See Mammoser, 115 B.R. at 760. Hence, as a logical matter, it would appear that a debtor could never benefit from § 506(d), only the trustee could. If the trustee elects to abandon the void-but-preserved lien, the property right would revert back to the undersecured creditor who previously owned it. See Mary Josephine Newborn, Undersecured Creditors in Bankruptcy: Dewsnup, Nobelman,
The Supreme Court in *Dewsnup v. Timm* \(^{35}\) granted certiorari to resolve the puzzle of whether a debtor could cap a secured party's security interest at an appraised amount in bankruptcy and thereby expropriate for herself all appreciation value. In *Dewsnup*, Justice Harry Blackmun stunned the bankruptcy bar by choosing to read section 506(d) in a most unorthodox manner.\(^{36}\) According to Blackmun, section 506(d) simply does not apply to undersecured claims at all. Rather, it simply makes the point that, if the secured party's claim is not allowed under section 502 of the Bankruptcy Code, any lien securing that claim is also void.\(^{37}\) This was a position that only a few judges took; the vast weight of authority scorned this view and held that section 506(d) did indeed apply to undersecured creditors.\(^{38}\)

The meaning of *Dewsnup v. Timm* is apparently that all appreciation growth in the collateral belongs to the secured party—at least until the collateral is sold or a plan is confirmed.\(^{39}\) Or, to say the same thing in different words, *Dewsnup v. Timm* requires that bifurcations of undersecured claims are never final.

**B. Proceeds**

Another way secured claims can grow over time is by the accrual of proceeds, in cases where the underlying collateral retains its original value. According to Bankruptcy Code section 552,

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

> (b) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the


\(^{35}\) 112 S. Ct. 773, 776 (1992) (Blackmun, J).


\(^{37}\) *Dewsnup*, 112 S. Ct. at 778.

\(^{38}\) See *supra* text accompanying notes 27-29.

\(^{39}\) Newborn, *supra* note 34, at 583.
security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable non-bankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. 40

Where a security interest in inventory exists, the right to proceeds under section 552(b) does not necessarily increase the size of the secured claim, because, for every dollar of postpetition proceeds obtained, the secured creditor gives up an item of inventory. 41 But in a real estate case, where the mortgagee has a valid security interest in rents, the secured claim routinely grows in size, so long as the building is properly maintained. Indeed, the value of the building is nothing but the present value of future rental income. As time passes and cash collateral accrues, the secured creditor will own not only the original building but the accumulating rents as well.

*Dewsnup* v. *Timm* was important for secured creditors whose cash collateral constituted an improvement in position over time. Prior to *Dewsnup*, when section 506(d) was thought to disencumber the unsecured deficit portion of the undersecured claim, it was open for trustees to argue that, following bifurcation, the unsecured claim was completely independent from and indifferent to the accrual of additional cash collateral. 42 To be sure, the secured creditor would still own postpetition proceeds of prepetition collateral. These proceeds, however, could not be applied against the separate unsecured claim of the undersecured creditor. Rather, they would form an equity cushion for the secured portion of the total claim. This equity cushion would have allowed the undersecured creditor to obtain postpetition interest and collection expenses under section 506(b)—provided the trustee abstained from spending the debtor equity so that interest

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41 Inventory sold in the ordinary course of business is free and clear of security interests created by the debtor. U.C.C. § 9-307(1) (1992). The trustee exploits this power to sell free and clear under 11 U.S.C. § 363(f)(1) ("The trustee may sell . . . free and clear of any interest . . . only if (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest . . . ").
could accrue against it.\footnote{See infra text accompanying notes 101-02 for a discussion of whether a trustee has the duty to preserve debtor equity in anticipation that interest will accrue in the future.}

Thanks to Dewsnup v. Timm, however, it is probably impossible to argue that bifurcations are final. As a result, accruing cash collateral cannot count as pure equity cushion. Rather, it must instead secure the previously unsecured deficit. Or, to say the same thing in different words, accruing cash collateral means that the unsecured portion of the total claim is shrinking and the secured portion is growing. This effect necessarily implies that the undersecured creditor is not receiving interest compensation from the accruing cash collateral.\footnote{In re Bloomingdale Partners, 160 B.R. 93, 96-97 (Bankr. N.D. Ill. 1993) (Barliant, J.).}

There is one remaining theory, however, whereby a debtor-in-possession might still deprive a secured creditor of the accrual of cash collateral. Section 552(b) may guarantee postpetition proceeds to the undersecured creditor, but that subsection also provides an exception: "to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."\footnote{11 U.S.C. § 552(b).} It is therefore open for a debtor-in-possession to argue that any improvement of position over time is inequitable. This even gets some support from the legislative history, which states: "The provision allows the court to consider the equities in each case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party."\footnote{124 CONG. REC. 32,400 (1978).} This remark does not quite say that improvements in position are inequitable. Rather, it says that improvements related to expenditures by the trustee are inequitable. Nevertheless, the debtor-in-possession always makes some expenditures to assure that postpetition cash flows are maintained. Therefore, it is not impossible that a court could use this remark to justify disencumbering an income stream from a security interest, to the extent that it allows the secured creditor to improve her position over time.\footnote{According to Judge Donal D. Sullivan: "The purpose behind the ‘equities of the case’ rule . . . is, in a proper case, to enable those who contribute to the production of proceeds during chapter 11 to share jointly with pre-petition creditors secured by proceeds." United States v. Van Vactor, Francis & Martin (In re Crouch), 51 B.R. 331, 332 (Bankr. D. Or. 1985). In applying this aphorism, Judge Arthur Spector has opined that the secured party is entitled to only the percentage of cash proceeds that represents the contribution of collateral to the production of the proceeds. In re Delbridge, 61 B.R. 484, 490-91 (Bankr. E.D. Mich. 1986).}

But it will be a brave judge indeed who does
this in the teeth of *Dewsnup v. Timm*, which is premised on the moral principle that undersecured creditors deserve any appreciation value in the collateral.\(^{48}\)

**C. Undersecured Creditors and Interest Compensation**

Bankruptcy Code section 506(b) gives oversecured creditors a right to postpetition interest—but only to the extent of the equity

What the secured party contributes, according to Spector, is the depreciation of the existing collateral. *Id.* at 491. What the debtor-in-possession contributes is maintenance expense of the capital, plus labor needed to bring the proceeds into existence.

In *Delbridge*, the collateral was cows, and the proceeds were milk produced, which milk was sold to a dairy cooperative. At stake was ownership of the checks issued by the cooperative in exchange for the milk. Spector suggested the following formula:

\[
CC = \frac{DP}{D + E + L}
\]

where \(CC\) = cash collateral, \(D\) = average depreciation per cow, \(E\) = average direct expenses maintaining the cow, \(L\) = average labor per cow, and \(P\) = average cash proceeds per cow. *Id.* at 490. Judge Spector describes this formula as follows:

*The lender is entitled to the same percentage of the proceeds of the post-petition milk as its capital contribution to the production of the milk bears to the total of the capital and direct operating expenses incurred in producing the milk. Because the parties are in a direct mathematical relationship, the rule should be easy to apply. Very simply, the larger is the lender's capital contribution to the venture, the larger its share of the proceeds ought to be. Conversely, if the farmer's input in the venture is great, the "equities of the case" compel that his share of the proceeds likewise be great.*

*Id.* at 491 (citing *In re Crouch*, 51 B.R. 331, 332 (Bankr. D. Or. 1985)).

At least one problem with this formula is that the secured party is independently entitled to adequate protection for any depreciation \((D)\) that eats into the secured claim itself. If the secured party receives adequate protection for this depreciation, then the secured party is contributing *nothing* to the cash flow. On Spector's formula, the secured party therefore receives zero proceeds. On the other hand, if proceeds are conceived as a replacement of adequate protection, it should be recognized that the ratio of \(D\) over a numerator larger than \(D\) guarantees that the secured party never recovers \(D\) out of the proceeds \((P)\). Therefore, Spector's formula effectively denies or at least reduces the secured party's right to adequate protection.

Also, if the above formula is applied in light of an equity cushion, then \(D\) can again be said to equal zero, because depreciation does not harm the secured party so long as an equity cushion is present. Such a conclusion means that the secured party's share of postpetition proceeds is always zero. Judge Spector, however, applied his formula to a case involving a debtor equity, and found that \(D\) had a positive value, thereby winning for the secured party a 20% share of the cash proceeds. *Id.* at 492.

Finally, in some cases, as in a typical real estate case, the collateral *never* depreciates, even as cash collateral accrues. When a building is well maintained and the real estate market is stable, the secured party will obtain zero rent, according to Judge Spector's formula.

Therefore, Judge Spector's formula is highly corrosive to the secured party's rights under Bankruptcy Code § 552(b).

\(^{48}\) Newborn, supra note 34, at 597 ("[T]he majority's only tenable position in *Dewsnup* and *Nobelman* is based on the notion that lien avoidance deprives the undersecured creditor of its pre-bankruptcy bargain.").
cushion the secured creditor enjoys. Undersecured creditors are conspicuously left out.

In the 1980s, the theory developed that an undersecured creditor deserved postpetition interest after all—as part of her right to adequate protection. The theory was that a secured claim drawing no interest is worth less than a secured claim that does. For example, if $SP$ claims $100 and the collateral is worth only $80, $SP$ is entitled to be protected for $80, and this can only occur if $SP$ obtains interest compensation. Suppose that the parties expect a bankruptcy proceeding to take a year before dividends are distributed, and the market rate of interest is 10%. If $SP$ is otherwise protected for $80 but obtains no interest compensation for a year, then the value of $SP$’s claim immediately falls to $72.72. $SP$ is therefore underprotected.

The argument that undersecured creditors deserve interest compensation was a severe threat to chapter 11. Many debtors-in-possession could not have provided adequate protection to undersecured creditors if that concept included interest compensation. It was therefore a matter of great relief to the debtor’s bar that this threat was eliminated by the Supreme Court in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*

Today, undersecured creditors are not supposed to obtain postpetition interest. Yet many ambiguities remain. For example, ancient law under the Bankruptcy Act always held that undersecured creditors could obtain postpetition interest when they also claimed the postpetition income stream produced by the collateral. *Dewsnup v. Timm* endorses the interpretive idea that any pre-Code practice not specifically denounced in the legislative history or negated by the exact words of the Bankruptcy Code is presumed to be ratified by Congress. Therefore, it is still possible that undersecured creditors obtain postpetition interest whenever their collateral is growing. And, by implication, if what they receive is postpetition interest, it should also be true that (a) accruing collateral does not secure the previously unsecured defi-

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50 This number is calculated by dividing $80 by 1.1, to reflect a 10% discount rate.


53 Dewsnup v. Timm, 112 S. Ct. 773, 779 (1992) (“[T]his Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.”). Ironically, Professor Mary Josephine Newborn demonstrates that Congress did indeed intend to change pre-Code practice in the treatment of undersecured creditors and that Congress indicated such intention in the legislative history. Newborn, supra note 34, at 573-76.
cit, (b) bifurcations are therefore final as soon as made, and (c) the secured party is entitled only to postpetition interest (presumably on the entire prepetition claim), and the bankruptcy trustee may have the rest. In this sense, Dewsnup is self-contradictory.

Whether cash collateral should be allocated to postpetition interest or to the unsecured deficit was raised in the Timbers case itself, and it would pay us to consider the exact procedural and financial posture of that case. In its earlier incarnation as Republic Bank Houston v. Bear Creek Ministorage, Inc. (In re Bear Creek Ministorage, Inc.), the mortgagee had a security interest on rents. Judge Wesley Steen had approved a cash collateral order that gave the secured party net rents—rents left over after maintenance expenses of the collateral were covered. Additionally, the secured party moved to lift the automatic stay pursuant to section 362(d)(1) of the Bankruptcy Code because the secured party was not receiving adequate protection for its remaining secured claim. To be more precise, the secured party insisted that adequate protection of the secured claim meant a right to postpetition interest on its secured claim. Since the secured party was taking away the accruing net rents, the secured claim was not growing. Therefore, the secured party wanted interest on this relatively stable secured claim.

Judge Steen ruled that adequate protection included the right to postpetition interest—a holding the Supreme Court would eventually reverse in Timbers—but, in response to this holding, the debtor insisted that the net rents the secured party was actually receiving be credited against the secured party's apparent right to receive postpetition interest as part of adequate protection.

Judge Steen was clearly skeptical of this claim. He pointed out that the rents were themselves collateral to secure the undersecured claim and implied that adequate protection payments had to be from unencumbered dollars. Nevertheless, he evaded the issue and refused to rule on whether the cash collateral could be credited against

55 Presumably, cash collateral could be used to cover maintenance expenses under the authority of § 506(c) and also § 552(b)'s equity exception. See David Gray Carlson, Secured Creditors and Expenses of Bankruptcy Administration, 70 N.C. L. REV. 417, 439-40, 484-90 (1992).
56 Bear Creek Ministorage, 49 B.R. at 456.
57 Possibly the collateral was appreciating because the market for real estate was improving, id., but this is different from growth stemming from the accrual of rents.
58 Id. at 460.
Yet, in spite of this sidestep, the question remains—what was the meaning of those rents that the secured party in Bear Creek Mini-storage was receiving? If the secured party's total claim was reduced one dollar for every net rent dollar received, then the net rents did not constitute postpetition interest. On the other hand, if the total claim of the undersecured party was unaffected, then these net rents did constitute postpetition interest payments.

On appeal, Justice Scalia was not perfectly clear on his view of the meaning of accruing cash collateral. One of his arguments against postpetition interest is that it too closely resembles rent:

Section 552(b) . . . makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors. Under petitioner's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under § 362.®

This statement indicates that secured parties can improve their position through rent, but it does not really indicate whether the secured claim remains frozen and the new cash collateral creates an equity cushion for the secured claim, or whether the rent increases the secured claim and decreases the unsecured claim.

Nevertheless, we will assume that the meaning of Timbers—at least when read contrapuntally with Dewsnup v. Timm—is that an undersecured creditor cannot have any postpetition interest. Any improvement of position goes to reduce the unsecured deficit claim and, simultaneously, to increase the secured claim. Only after so much cash collateral accrues that the unsecured deficit has disappeared may the secured creditor claim postpetition interest under section 506(b).

D. Summary

These are the principles we need to fathom the main question of this Article—what is the effect of postpetition payments to undersecured creditors? The operative principles are that (1) bifurcation of the undersecured claim into its component parts is never final before sale of the collateral, confirmation of the plan, or distribution of liquidation proceeds, (2) pending bifurcation, the undersecured creditor is entitled to all growth in the collateral, whether it results from pure

59 Id.
market improvement or the accrual of postpetition cash proceeds from the prepetition collateral, and (3) the undersecured creditor is not entitled to postpetition interest. Together these principles imply that growth of collateral must render the unsecured deficit smaller and the allowed secured claim larger as time passes.

II. ADEQUATE PROTECTION PAYMENTS

If depreciation infects the collateral of the secured creditor, Bankruptcy Code section 361 suggests, *inter alia*, that the secured creditor be awarded cash in compensation.²¹ Let us reserve the term "adequate protection payment" to mean the payment of unencumbered dollars to the secured creditor to counteract the effect of depreciation. Under this definition, surrender of cash collateral is strictly distinguished as something else entirely. A secured creditor already owns the cash collateral, but obtains title to adequate protection payments only at the time the payment is made.

What ought to be the meaning of these adequate protection payments, as we have narrowly defined them? Suppose a secured creditor is undersecured, so that bifurcation is necessary under Bankruptcy Code section 506(a). The undersecured creditor now owns two entirely separate claims—one secured and one unsecured. The two together constitute the total allowed claim of this creditor.

Adequate protection payments should reduce the secured claim and the total claim as well.²² The unsecured deficit claim, however, should be unaffected by the adequate protection payments, so long as any part of the secured claim remains outstanding. Once the secured claim is extinguished, the adequate protection payments ought to cease. The debtor-in-possession may be authorized to protect secured claims, but is not authorized to pay unsecured creditors prior to the confirmation of a plan or prior to a chapter 7 distribution.

For example, suppose an undersecured creditor, after a section 506(a) valuation, has a $100 claim subdivided into an $80 secured

²¹ According to § 361(1), adequate protection may be provided by requiring the trustee to make a cash payment or periodic cash payments to [the secured creditor], to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property.

ADEQUATE PROTECTION PAYMENTS

claim and a $20 unsecured claim, and suppose that the secured creditor receives an $8 adequate protection payment pursuant to section 361(1). After the payment, the secured creditor would have a $20 unsecured claim—the same as before—and only a $72 secured claim. The adequate protection payments, then, should reduce the secured claim as well as the total claim. This is shown in Figure One.

If, contrary to these principles, these payments are applied against the unsecured deficit claim of the secured creditor (without reducing the secured claim), then the secured creditor is getting a bonus—a secured claim according to the original valuation plus an additional payment on top of that. Thus, a secured creditor whose unsecured deficit was reduced from $20 to $12 but who still had the right to $80 in collateral is getting too much. Of course, if the collateral has depreciated, the above example presumes that the trustee has been obliged to find substitute collateral to supplement the collateral, so that the secured claim still equals $80. This is shown in Figure Two.

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Accord In re Spacek, 112 B.R. 162 (Bankr. W.D. Tex. 1990) (Monroe, J.) (holding that the adequate protection payments made while the case was pending must be applied against the secured portion of indebtedness).

Thus, § 361(2) provides that adequate protection may be achieved by “providing to [the secured creditor] an additional or replacement lien,” in case of depreciation or other depreciation. 11 U.S.C. § 361(2).
Such a holding constitutes double compensation for the depreciation. First, the secured creditor receives cash. Second, the secured creditor receives additional collateral to cover the depreciation. The secured creditor should have one or the other, but not both, of these modes of adequate protection.

The proper allocation of an adequate protection payment to the secured claim (and total claim) but not to the unsecured claim should be compared to voidable preference doctrine, where precisely the opposite allocations are made. When an undersecured creditor obtains unencumbered prepetition dollars from the debtor, courts will assume that these dollars have reduced the unsecured deficit claim. This allocation assures that the payment allows the secured creditor to receive more from the payment than it would have received from a hypothetical liquidation of the bankrupt estate—one of the classic elements of a voidable preference.\(^66\) If the dollars had been allocated to the secured portion of the claim, then this element cannot be met, because the dollars received before bankruptcy reduce dollar for dollar the bankruptcy dividend the undersecured creditor would receive in the hypothetical liquidation.\(^67\)

\(^66\) According to § 547(b)(5), the trustee may avoid a preference only if it enables such creditor to receive more than such creditor would receive if—
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

\(^67\) Early in the life of the Bankruptcy Code, a secured party tried to argue as follows: an undersecured creditor, by definition, has not one but two claims—one that is perfectly secured and one that is perfectly unsecured. When the debtor pays the secured party with unencumbered dollars, it is open to the secured party to allocate the payment to the secured claim. If this assumption is adopted, the secured party does not run afoul of the hypothetical liquidation test. This argument was disallowed in Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981). There, Judge William J. Jameson ruled that the payment of unencumbered dollars to
The difference between the allocation of adequate protection payments and the allocation of prepetition payments is that, prior to the petition, only one single undersecured claim exists. When the debtor pays this claim in part, the payment reduces the total claim but leaves the collateral intact. A debtor cannot force the secured creditor to apply the unencumbered dollars to reduce the amount of collateral available. After the petition, the undersecured claim becomes two entirely separate and divorced claims. Of these, only the secured claim is entitled to adequate protection. Accordingly, the adequate protection payments reduce the secured claim, not the unsecured deficit.

A. Cash Payments in Light of an Equity Cushion

Even though the continued existence of an equity cushion is not even mentioned as a mode of adequate protection in section 361, it is probably the most popular form of it. Some courts have suggested that when debtor equity exists, a court must not also award cash payments for depreciation as a means of adequate protection. That is, debtor equity as a mode of adequate protection preempts cash payments or perhaps any other form of adequate protection mentioned in section 361.

the secured party must first be allocated to the unsecured deficit. Id. at 511. On this assumption, an undersecured party has always received a voidable preference if the debtor is insolvent, because the hypothetical liquidation test always condemns the payment. The reason Judge Jameson insisted on this assumption is that it conforms to the natural assumption any undersecured party would have made prior to the bankruptcy petition. No undersecured creditor willingly gives up collateral if she does not have to. Therefore, the undersecured party could not, through revisionist history, redescribe its belief of the significance of the prepetition payment.

The Barash decision, however, seems based on the probable intent of the secured party prior to bankruptcy. If so, it remains open for a secured party to make a record that, indeed, just before bankruptcy, the secured party did intend to release collateral in exchange for payment. When this occurs, the hypothetical liquidation test cannot be met. Craig H. Averch & Michael J. Collins, Avoidance of Foreclosure Sales as Preferential Transfers: Another Serious Threat to Secured Creditors?, 24 TECH L. REV. 985, 1004 (1993). Furthermore, a release of collateral constitutes "new value," as that word is defined in § 547(a)(2). Hence, a release of value in exchange for payment would constitute a contemporaneous exchange of value, not a transfer on antecedent debt at all. This constitutes a second reason why such a transaction is not a voidable preference. But these ideas depend upon the intent of an undersecured party prior to bankruptcy to release collateral, something most undersecured creditors are loathe to do. Vern Countryman, The Concept of a Voidable Preference in Bankruptcy, 38 VAND. L. REV. 713, 744 (1985).


A rule against cash payments whenever debtor equity exists is useful in one regard. If principal is paid down, or if extra collateral is contributed, the equity cushion increases and, with it, the secured party’s entitlement to postpetition interest under section 506(b). This development would violate the premise, now endorsed by the Supreme Court, that the equity cushion is the maximum amount of postpetition interest a secured party can have. From this it follows that any attempt to create or expand the cushion through adequate protection payments or the like should not be permitted to enrich the secured party in the guise of increased postpetition interest.

A similar concern arises if the court authorizes current payment of postpetition interest under section 506(b). If the interest is paid currently, it fails to accrue against the equity cushion. If interest compensation is allowed to extend beyond the equity cushion, then the bankruptcy court has violated the premise that the equity cushion is the limit of the postpetition interest entitlement.

Some courts allow for payments in the face of an equity cushion. In RCA Corp. v. Video East, Inc. (In re Video East, Inc.), the debtor alleged that the collateral was not deteriorating in value. Nevertheless, because the secured party had received no payment under the security agreement in twenty-four months, the automatic stay was lifted. Significantly, Judge Emil Goldhaber emphasized that payments under the security agreement must be made. These payments, of course, are not precisely the same as adequate protection payments, which should arguably match the amount of depreciation.

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70 United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372 (1988) (Scalia, J.) ("§ 506(a) permits postpetition interest to be paid only out of the 'security cushion'.")

71 To the extent the secured party received cash in Laymon, Judge Clark ordered that the payments be recharacterized as payment of postpetition interest. Laymon, 117 B.R. at 865. This would not entirely solve the problem of the expanding cushion. If interest is paid in cash, then the cushion is preserved so that postpetition interest can continue to be collected indefinitely. Even under Judge Clark’s rule, a means is needed to prevent the secured party from getting interest beyond the amount implied in the equity cushion at the start of the bankruptcy proceeding. For the suggestion that the trustee should buy increments of the secured claim and never pay the interest obligation, see David Gray Carlson, Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys’ Fees, and Collection Expenses, 7 BANKR. DEV. J. 381, 397-407 (1990).

72 See Carlson, supra note 71, at 389-94.

73 E.g., Grundy Nat’l Bank v. Frank (In re Frank), 103 B.R. 771, 774-75 (W.D. Va. 1989) (Williams, J.) (upholding adequate protection order that permitted the complete retirement of the secured claim, thereby obviously outstripping depreciation—and allowing the payment of interest to an undersecured creditor to boot).


75 Id. at 181-82.

76 Id.
expense. And, in his opinion, Goldhaber expressly stated that he was not lifting the automatic stay for lack of adequate protection, but rather for "cause."\textsuperscript{77} Hence, it appears that Goldhaber viewed his ruling as not one pertaining to classic adequate protection.\textsuperscript{78} Rather, he simply required that secured parties be paid, from time to time.

**III. CASH COLLATERAL COMPARED**

Adequate protection payments entail the transfer of unencumbered dollars and must always be distinguished from the surrender of cash collateral. Cash collateral already belongs to the secured party. Properly viewed, payment of encumbered dollars is tantamount to abandonment of overencumbered collateral. If a bankruptcy court treats cash collateral as an adequate protection payment, it has ruthlessly disencumbered it and has avoided a perfected security interest.

Suppose a trustee proposes to compensate a secured party for depreciation by paying over cash collateral. The surrender of cash collateral, by definition, reduces the secured claim, just as abandonment of any collateral would. Meanwhile, the secured party remains entirely uncompensated for any depreciation, unless something else is done. In our example, suppose that, of the $80 in collateral, $65 is illiquid collateral that is depreciating, and $15 is cash collateral. The total claim is $100. The bankruptcy court determines that the illiquid collateral is expected to depreciate by $15, and, in attempting to protect the secured party, requires the surrender of the $15 in cash collateral. In fact, the secured party is not protected at all. The original collateral of $80 reduces itself to $65 when the cash collateral is surrendered and, on top of that, the $65 in illiquid collateral depreciates to $50. At the time a plan is confirmed, the secured party has an unsecured deficit claim of $35 and only $50 of illiquid collateral. Such a secured party has not been adequately protected. This is shown in Figure Three.

\textsuperscript{77} Id.

On the other hand, if a trustee gives over cash collateral and replaces that cash collateral with additional substitute collateral, the secured claim is now being protected. The additional collateral might compensate for depreciation, while surrender of the cash collateral serves to reduce the total claim of the creditor. For example, suppose a secured party claims a $65 illiquid asset and $15 in cash collateral. Depreciation of the illiquid asset is expected, so that the bankruptcy court orders the debtor to give $15 in extra collateral, resulting in a total secured claim of $95 (up from $80). The debtor also surrenders the cash collateral of $15, reducing the secured claim back to $80. The expected depreciation occurs, so that, at the time a plan is confirmed, the collateral is worth only $65. Of this, $15 represents the new collateral, and $50 represents the worth of the old depreciated illiquid asset. The secured party has been adequately protected, because the total claim was reduced from $100 to $85 (when the secured party received cash collateral). The unsecured deficit has remained constant at $20. This scheme is shown in Figure Four.
A. Increasing Cash Collateral

Slightly more confusing are the cases in which collateral is not depreciating, but cash proceeds are accumulating. Here we have a paradox. On the one hand, an income-producing asset is valued on the basis of future income. On the other hand, as time passes, the amount of collateral increases. For example, an asset may earn $8 a year. On the basis of this income going forward, the present value of the asset is deemed to be $80. One year later, the asset, having suffered no depreciation, is still worth $80—based on income going forward. Yet $8 of income has accumulated so that total collateral is now $88.

A valuation implies that the right to collect income is subsumed into the collateral itself. In *In re Landing Associates, Ltd.*, a debtor tried to exploit this economic factor by using it to argue that, once-income-producing property is valued, income is disencumbered from an undersecured party’s perfected security interest in the income. On this view, accrued income never belongs to the secured property; rather, the secured party has only the collateral, which always represents future income. Judge Leif Clark properly rejected this attempted introduction of a new avoidance power. Instead, Judge Clark contemplated that the undersecured party should become increasingly secured as new rental income accrued. This was justified because Clark specifically rejected the petition date as the relevant valuation rule. Rather, he chose to value the collateral as of the time the reorganization plan was confirmed.

If, instead of accumulating income, the bankruptcy court orders that the income be surrendered, the secured claim is reduced—from $88 back to $80. Now these payments cannot be payments of postpetition interest (thanks to at least one reading of *Timbers*). The payments must instead be payment on the total claim (which is reduced to $92). The payments also reduce the secured claim (provided that it is strictly understood that the secured claim had grown to $88 and is now being pared back to $80).

One case that conforms to this model is *In re Flagler-at-First Associates, Ltd.*, an opinion that is conceptually sound, though perhaps not a monument to expressive clarity. In *Flagler*, the debtor surrendered cash collateral to an undersecured party. Judge Jay Cristol
ruled that these surrenders should not reduce the secured claim, but what he meant was (using the above numbers) the secured claim was reduced from $88 back to $80. Cristol thought the collateral had been “declining in value,” but the decline in question was precisely the surrender of the $8. In Cristol’s view, the surrender of the $8 to the secured party was simply a form of depreciation, along the lines of rusty pipes or cracking foundations. While a confusing way of putting it, Judge Cristol was nevertheless correct in his result.

Simultaneously, it should also be true that the total claim of the undersecured party was reduced (from $100 to $92), and the unsecured deficit claim remains where it would have been if the cash collateral simply accumulated in the bankrupt estate. This additional consequence is at least not inconsistent with Judge Cristol’s opinion.

Meanwhile, what the debtor wanted in Flagler was to reduce the secured claim from $80 (where it stood at the beginning of the proceeding) to $72. Judge Cristol saw this for what it was—an avoidance of the security interest in the cash flow, so that cash actually surren-

83 Id. at 297.
84 Judge Cristol states:

The post-petition payments made by Flagler were not intended to protect [the secured party’s] interest in any noncash collateral. The post-petition payments only afforded [adequate] protection against the erosion of [the secured party’s] secured claim with respect to [the secured party’s] interest in the cash collateral derived from the Building.

Id. at 301. The meaning of this seems to be that the secured party may have received money, but it also lost the cash collateral by virtue of receiving the money. That is, using the sample numbers supplied in the text, accumulating cash collateral drives the secured claim up to $88 and the surrender of these proceeds brings it back down to $80.

86 Judge Cristol remarks:

In its reply memorandum Flagler asks a somewhat misleading, but otherwise valid, question: “If the Building and its rent are intended to collateralize [the secured party’s] secured claim, isn’t it the case that such payments from the collateral are intended to repay either interest on such claim, or reduce the principal balance of such claim? . . . [T]he answer to the question is yes, the post-petition payments are to be applied to principal, after taking into account that [the secured party’s] secured claim includes the excess rents generated and paid to [the secured party] during the Chapter 11.

Flagler, 114 B.R. at 301-02. Judge Joyce Bihary reads Flagler as meaning that the unsecured deficit is reduced. In re Oaks Partners, Ltd., 135 B.R. 440, 450 (Bankr. N.D. Ga. 1991). But just in case, she also remarked, “while the courts have politely discussed Flagler and have attempted to distinguish it, it is difficult to understand or apply and it has not been generally followed.” Id. at 451 (citing In re Reddington/Sunarrow Ltd. Partnership, 119 B.R. 809, 813 (Bankr. D.N.M. 1990) (McFeeley, J.)).
dered was unencumbered cash. If unencumbered cash had been paid—a genuine adequate protection payment—and if no security in­
interest in the cash flow existed, the secured claim would indeed be re­
duced from a static $80 to $72. This, Judge Cristol noted, would violate the secured party’s rights to proceeds under section 552(b).87

B. Pop-Up Equity Cushions

Cash collateral surrendered to the secured party should reduce the total claim and also prevent (to the extent of the surrender) the growth of the secured claim. On the hypothetical numbers illustrated in Figure Four, when $8 in cash collateral is surrendered, the total claim shrinks to $92 and the secured claim stays at $80; that is, it fails to grow to $88. It should follow that, if more time passes, the un­
secured deficit of $12 will entirely disappear as more and more cash collateral is surrendered. This occurred in several cases in which a debtor wished to cram down an undersecured party with a large un­
secured deficit claim at the start of the reorganization proceeding.88

The disappearance of the unsecured deficit claim is a happy event for a debtor wishing to cram down a plan in a single asset case. Typi­
cally, if any unsecured deficit exists in a single asset case, it is so large relative to other unsecured claims that the dominant secured creditor can assure that no class of impaired creditors votes yes on the plan. In such an event, the plan could not be confirmed because section 1129(a)(10) will not have been satisfied. According to section 1129(a) (10), at least one impaired class of creditors must vote yes on the plan.89 The debtor might have tried to put the unsecured deficit claim in a class separate from other general creditors, thereby gerrymand­
ing the classes to produce at least one yes vote. But a great many courts have prevented any such gerrymandering.90

In In re Oaks Partners,91 Judge Joyce Bihary treated the un­
secured deficit claim as satisfied by the surrender of comparable en­
cumbered dollars. Accordingly, the secured party had no deficit

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87 Flagler, 114 B.R. at 302. “What Flagler suggests is to simply cutoff [the secured party’s] rights under Section 552(b) and limit its secured claim as to the value of the Building without accounting for [the secured party’s] lien on the excess rents generated during the course of the Chapter 11.” Id.
claim and therefore could not vote against the plan. The remaining impaired creditors therefore cheerfully voted for the plan, satisfying section 1129(a)(10).\(^92\)

This result may sound strange, but it is quite correct. If the cash collateral had not been surrendered—if it had been accrued—the secured claim of the undersecured party would have increased and the unsecured claim would have decreased. Given enough time, the claim would become entirely secured and would even begin to obtain an equity cushion, thereby justifying postpetition interest under section 506(b).\(^93\) All Judge Joyce Bihary did in *Oaks Partners* was to replicate the situation if the cash collateral had been retained instead of paid out.\(^94\)

One feature of the holding in *Oaks Partners* pertains to the treat-

\(^92\) *Id.* at 465.  
\(^94\) *Oaks Partners*, 141 B.R. at 458. When sufficient cash exists to satisfy all creditors (and even when it does not), some dominant creditors argue that impairment of minor trade creditors and the like is unnecessary and in bad faith. *See* 11 U.S.C. § 1129(a)(3) (plan can be confirmed only if the plan "has been proposed in good faith"). If this argument prevails, a court might nullify the vote of an artificially impaired class of creditors, thereby assuring that the debtor-in-possession will run aground upon the shoals of § 1129(a)(10). In contrast, other courts have struck down plans on grounds of bad faith artificial impairment. *See*, e.g., *Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc.* (*In re Windsor on the River Assocs., Ltd.*), 7 F.3d 127 (8th Cir. 1993) (Arnold, J.); *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.*), 881 F.2d 1346, 1353 (5th Cir. 1989) (Garwood, J.); *Willows Convalescent Ctrs. Ltd. Partnership v. Unum Life Ins. Co. (In re Willows Convalescent Ctrs. Ltd. Partnership)*, 151 B.R. 220, 223 (D. Minn. 1991) (Alsop, J.); *In re Lettick Typographic, Inc.* v. *Bankr. D. Conn.* (Shiff, J.) ("In a transparent attempt to stage compliance with (a)(10), the debtor created an artificially impaired class by amending its Second Plan so that the otherwise unimpaired creditor is to be paid two weeks after the effective date of the Plan."); *In re Meadow Glen, Ltd.*, 87 B.R. 421, 427 (Bankr. W. D. Tex. 1988) (Ayers, J.); *Peter E. Meltzer, Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment*, 66 AM. BANKR. L.J. 281, 319-20 (1992) (artificial impairment should not be allowed because otherwise the veto of § 1129(a)(10) is trivial).

When a debtor-in-possession is solvent, it is possible to write a plan in which no class of general creditors is impaired. Thus, in *Windsor* Judge Morris Sheppard Arnold ruled an apparently solvent debtor could not impair the small trade creditors in order to win a yes vote from their class. *Windsor*, 7 F.3d at 132-33. The *Windsor* case therefore strongly suggests that when the unsecured deficit disappears because postpetition collateral has accumulated, any impairment of the remaining trade creditors is artificial, and their positive vote on the plan cannot count.

On the other hand, the trade creditors are, by hypothesis, voting in favor of their own impairment. As Judge Leif Clark has emphasized, if the impaired creditor is happy, why should some other creditor be allowed to complain of impairment? *In re Landing Assocs.* Ltd., 157 B.R. 791, 814 (Bankr. W. D. Tex. 1993); see also *In re Schoeneberg*, 156 B.R. 963, 968-69 (Bankr. W. D. Tex. 1993) (Monroe, J.).

On sham impairment generally, see Carlson, *supra* note 90, at 610.
ment of the surplus, once the total claim of the undersecured party had become entirely secured. Judge Bihary found that more cash collateral had been surrendered than was necessary to get rid of the unsecured deficit claim. The balance was an “overpayment” of the deficit—an amount the secured party had to return. And it was to be returned in the form of interest foregone after the plan was confirmed. That is, the debtor could offset the overpayment against its obligation to pay the secured party interest under the plan.

This setoff overlooks the fact that the overpayment constitutes debtor equity out of which the secured party might be paid postpetition interest under section 506(b). On this view the overpayment must also be added to the principal amount of the secured claim (the result if postpetition interest is accrued rather than paid out), not offset against postconfirmation cram down interest.

For example, in In re Bloomingdale Partners, Judge Ronald Barliant held that an undersecured creditor who later becomes oversecured as cash collateral accrues is entitled to the belated equity cushion as postpetition interest. And in In re Vermont Investment Ltd. Partnership, Judge Martin Teel refused to allow the debtor to characterize surrendered cash collateral as payment on principal. Rather, he insisted that the payments be deemed payment of postpeti-

95 Oaks Partners, 141 B.R. at 463.
96 Id.; see infra text accompanying notes 148-52 for a presentation of a mathematical model of the setoff.
98 Id. at 99-100. The procedural posture of the case was most unusual. The undersecured creditor regretted its decision to make the § 1111(b)(2) election. The election meant that the secured creditor would lose its unsecured deficit claim, and with it, its chance to vote the unsecured deficit against the plan. In re Bloomingdale Partners, 155 B.R. 961, 967 (Bankr. N.D. Ill. 1993) (Barliant, J.). Under a line of cases that require the unsecured deficit claim to be classified together with other unsecured claims, such an opportunity to vote the unsecured claim might guarantee the secured party the chance to veto the plan. According to Bankruptcy Code § 1129(a)(10), at least one class of impaired creditors must vote yes on the plan. If the dominant undersecured creditor can prevent this by outvoting the other unsecured creditors with its unsecured deficit claim, the undersecured creditor is in a position to veto the plan. See generally Carlson, supra note 90, at 571-82.

In moving for permission to undo the election with regard to a newly modified proposed plan, Judge Barliant informed the secured creditor that the election was moot. Over the life of the chapter 11 case, cash collateral had accumulated, so that the undersecured claim was now oversecured. Furthermore, the surplus cash collateral should be treated as postpetition interest. The secured creditor tried to argue that an unsecured deficit still existed because all cash collateral surrendered should be viewed as postpetition interest and none of it is decreasing the unsecured deficit. Judge Barliant refused to countenance this, In re Bloomingdale Partners, 160 B.R. at 96-97, but he did uphold a postpetition interest entitlement once the unsecured deficit was fully secured and an equity cushion rendered itself apparent. Id. at 99-100.
tional interest under section 506(b). Therefore, these two decisions contradict the result that Judge Bihary reached in *Oaks Partners*.

Whereas Judge Bihary refused to honor the right of an undersecured creditor to postpetition interest, once the accumulation of rent created an equity cushion late in the case, Judges Barliant and Teel did the opposite. They guaranteed to the initially undersecured creditor the right to postpetition interest once the undersecured creditor became oversecured.

Which approach is correct is a very close question. The following observation weighs heavily in favor of Judge Bihary’s approach, though. As cash collateral accrues and a debtor equity is created, the excess dollars are, after all, property of the estate. It is far from clear that the trustee has a duty to preserve the cushion. If the trustee spends it before interest accrues, then the secured party must do without her postpetition interest. To be sure, the security interest of the secured party continues to encumber postpetition proceeds. Accordingly, court permission or secured party consent is required. But

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100 *Id.* at 573. In *Vermont Investment*, the value of the collateral was and always remained $19.1 million. The undersecured party’s prepetition claim was as follows:

<table>
<thead>
<tr>
<th>Prepetition principal</th>
<th>$18.8 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepetition unpaid interest</td>
<td>$0.6 million</td>
</tr>
<tr>
<td>Total prepetition claim</td>
<td>$19.4 million</td>
</tr>
<tr>
<td>Unsecured deficit claim</td>
<td>$0.3 million</td>
</tr>
</tbody>
</table>

Meanwhile, postpetition rent accumulated. Of this, the debtor surrendered $1.4 million to the undersecured party. The secured party used $200,000 to pay senior taxes. This amounted to a § 506(c) expense validly charged to the secured party. Therefore, about $1.2 million in surrendered cash collateral had to be characterized as either the payment of the prepetition claim or of postpetition interest. *Id.* at 572-73.

The secured party itself characterized the surrender as first going toward the payment of $600,000 in postpetition interest—part of the allowed prepetition claim. *Id.* at 573. This was too generous a concession. By doing so, the secured party voluntarily waived its lien and consented to take an adequate protection payment. The undersecured party could have characterized only $300,000 as going toward the payment of the prepetition claim. If it had done so, the prepetition claim would have been precisely equal to the value of the collateral. In such a case, any future rent dollars that accumulated could be characterized as equity cushion, against which the now-oversecured party could have had postpetition interest.

In any case, the now-oversecured party was satisfied to apply $600,000 to the prepetition claim (the amount that corresponded to prepetition interest) and wished to establish the remaining $600,000 as payment of postpetition interest. Judge Teel agreed:

Because the rents received by the bank provided additional collateral, the rents—in equal amounts—both increased the bank’s allowed secured claim under 11 U.S.C. § 506(b) by virtue of post-petition interest accruals and, by payment, decreased the bank’s allowed secured claim. The rent payments never exceeded postpetition interest accruals on the bank’s claims. Hence the bank’s allowed secured claim plus senior tax liens continue to equal the value of the debtor’s building and there is no equity cushion for the bank’s lien.

*Id.* at 573.

101 As Teel emphasized. *Id.* at 573-74.
it is simultaneously true that the equity cushion belongs to the bankruptcy trustee. If the trustee obtains court permission to use cash collateral, the trustee may be able to remove and spend the cash collateral before any interest accrues against it. The idea that the trustee can use the equity cushion without preserving it for the creditor strongly supports this approach.

On the other hand, the debtor in *Oaks Partners* did not spend the cash surplus. It surrendered it to the secured party. At the time of the confirmation hearing, the now-oversecured party enjoyed an equity cushion in the building. Therefore, section 506(b) clearly applied to the benefit of the secured party. Yet if the debtor had characterized (or the court was willing to characterize) the transaction as follows, then the secured party properly loses the right to postpetition interest. According to this characterization, the debtor takes surplus cash collateral for its own purposes free and clear of the security interest as soon as the cash is available. This now unencumbered cash is used to pay down the secured claim, so that surplus cash collateral becomes a genuine adequate protection payment. Since a debtor has no duty to preserve an equity cushion for the benefit of future unaccrued interest, there is no reason why the transaction could not be characterized (or recharacterized *nunc pro tunc*) in this fashion.¹⁰²

C. *Surrenders of Cash Collateral with No Effect on the Size of the Prepetition Claim*

Two decisions have held that surrendered cash collateral consti-

¹⁰² If, in spite of what has just been said, a court decides that § 506(b) postpetition interest prevents the debtor-in-possession from dissipating the belated equity cushion, a second issue must be considered: Does interest accrue from the beginning of the bankruptcy case, or does it start to accrue only when the equity cushion first appears? The question becomes important in a case where net income accumulates at a rate faster than interest accrues.

If phantom interest starts to accrue at the beginning of the case (even though no equity cushion exists against which interest might accrue), then this phantom accrued interest soaks up all excess cash that comes into existence once the equity cushion reveals itself. If interest accrues only when there is an equity cushion, the difference between the interest rate and the income accrual rate belongs to the debtor.

The only case to address this issue is *In re Bloomingdale Partners*, 160 B.R. 93 (Bankr. N.D. Ill. 1993), where Judge Barliant ruled:

- Interest has been accruing on Hancock’s [initially undersecured] claim since the pendency of the case and will be allowed if and to the extent Hancock’s collateral exceeds its claim. Hancock’s collateral now exceeds its claim, and given the more than two years that have elapsed during this case, all the net rents that accrue are fully encumbered by Hancock’s interest allowance.

*Id.* at 100. For this position, Barliant could quote some dictum from a Supreme Court case which did not, incidentally, involve belated equity cushions. *See Rake v. Wade*, 113 S. Ct. 2187, 2191 (1993) (Thomas, J.) (§ 506(b) interest “accrues as part of the allowed claim from the petition date until the confirmation or effective date of the plan”).
tutes a reduction of neither the undersecured creditor’s total claim nor the creditor’s bifurcated secured claim. Rather, the surrenders had no effect on the claim at all, which means that the surrenders constituted the payment of postpetition interest to an undersecured creditor, in violation of *Timbers of Inwood Forest*.

In *In re Birdneck Apartment Associates, II, L.P.*, a dominant undersecured creditor sought to block confirmation because the debtor could not confirm a plan in light of section 1129(a)(10), which requires that at least one impaired class of creditors vote yes. As the largest secured creditor and the largest unsecured creditor, the dominant undersecured creditor claimed that, since it could cause all impaired classes to vote no, the plan could not be confirmed.\(^\text{104}\)

The debtor pointed out that the unsecured deficit claim of the undersecured creditor was only $300,000, yet the undersecured creditor had received $438,191.57 in cash collateral since the start of the chapter 11 proceeding. According to the debtor, the undersecured creditor was actually oversecured. As such, there was no unsecured deficit, and the remaining unsecured creditors were free to vote yes as a class.\(^\text{105}\)

Judge Douglas Tice refused to go along with this reasoning. He ruled instead that neither the secured nor the unsecured claim of the undersecured creditor was reduced by the surrender of cash collateral. Instead, the creditor was entitled to treat the cash collateral as interest payments. Judge Tice saw no impediment in *Timbers* to such a result:

> Debtor ignores the fact that [the undersecured creditor] has a continuing perfected postpetition security interest in rents, and that all revenues of the debtor constitute . . . cash collateral. The Supreme Court’s decision in [*Timbers*] prohibits payments to undersecured creditors only from “unencumbered” assets where there is no evidence of decline in collateral value. Debtor’s argument interprets *Timbers* too broadly and reads § 552(b) out of the Code.\(^\text{106}\)


\(^{104}\) Id. at 504. Apparently the debtor did not try to separately classify the trade creditors. If so, and if the trade creditors voted yes on the plan, the court would have been compelled to find that § 1129(a)(10) had been met. See supra text accompanying notes 89-90.

\(^{105}\) *Birdneck*, 156 B.R. at 504-05.

\(^{106}\) Id. at 505. See supra text accompanying notes 69-78 for a discussion as to whether *Timbers* really does bar adequate protection payments when the collateral is not depreciating in value. Judge Tice read *Vermont Investment* as a case in which surrenders of cash collateral did not reduce the principal amount of the debt. In fact, the secured party applied some of the cash received toward postpetition interest under § 506(b), and some toward the prepetition claim. See supra note 100.
In fact, the debtor entirely honored the security interest in rents—it simply thought that the rents should go to pay down the total claim of the secured party. Judge Tice, in contrast, granted an undersecured party postpetition interest in violation of *Timbers*.

A case that is apparently similar to *Birdneck* is *DeFranco v. Ralph D. Kaiser Co. (In re DeFranco)*, which inexplicably held that surrendered cash collateral does not extinguish any part of the prepetition claim. Rather, the surrenders were viewed as “compensation” for depreciation, separate and apart from the secured claim, which stays intact. In *DeFranco*, Judge Martin Teel thought that the compensatory nature of cash payments ruled out applying these payments against the principal amount of an undersecured creditor’s claim. As a result, the secured creditor obtained a windfall—the payments *plus* the entire secured claim later.

It is hard to tell whether *DeFranco* constitutes a case of surrendered cash collateral or one of a genuine adequate protection payment. In *DeFranco*, Judge Teel had disencumbered the income stream from the security interest claimed by the secured creditor. As a result, the dollars paid over at a time when they were thought to be cash collateral were later recharacterized as unencumbered dollars. The disencumbrance of the security interest on the cash flow came about this way: a different, senior undersecured creditor claimed real estate as collateral, but it stupidly forgot to encumber rents in the mortgage agreement. A junior mortgage was completely under water with regard to the real estate, but *did* have an otherwise valid security interest on rents. Judge Teel ruled that the debtor could bifurcate the junior mortgage into its secured and unsecured parts. Since the mortgage was entirely under water on the day of bankruptcy, the secured claim was zero and the unsecured claim was for the entire prepetition amount. The debtor could then use section 506(d) to avoid the mortgage for the unsecured portion, thereby disencumbering the rents. This theory—quite valid in its day—is now severely threatened by *Dewsnup v. Timm*, which holds that section 506(d) cannot be used to place a cap on the secured portion of an undersecured creditor’s total claim.

Yet, in spite of this lien avoidance, the secured creditor actually obtained better treatment than it would have received if its security interest in cash collateral had been validated. The surrender of cash

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108 Id. at 309.
109 Id. at 308-09.
collateral ought to reduce the total claim of the secured creditor. But in *DeFranco*, the total claim of the secured creditor (which was entirely unsecured, after the lien avoidance) was left intact.\(^{111}\)

The theory underlying the result in *DeFranco* is a mystery, but one interpretation that cannot be applied to it is that Judge Teel had bifurcated the undersecured claim, had recognized accruing cash collateral as an equity cushion, and was awarding the undersecured party postpetition interest on its secured claim under section 506(b). Since the secured claim was deemed to be zero, postpetition interest under section 506(b) must also be zero. Therefore, whatever the meaning of the payment actually received by the undersecured creditor, it could not have been postpetition interest under section 506(b).

Neither can it be said that Judge Teel was awarding postpetition interest as part of adequate protection—what *Timbers of Inwood Forest* now bars.\(^{112}\) Yet such interest compensation would also be based on the value of the collateral, which in this case was zero. Therefore, the only way to interpret the *DeFranco* decision is that Judge Teel simply gave postpetition interest to a creditor that was entirely unsecured.

A rule that characterizes surrender of cash collateral as payment of the total claim is not entirely satisfactory, because the parties can evade this rule by contract. Suppose that, instead of surrendering the cash collateral that accumulates, the debtor and the secured party agree that the debtor could use cash collateral. That is, the secured party consents to the disencumbrance of cash collateral, but, in exchange for this concession, the parties agree that the secured party is entitled to some substitute collateral plus genuine interest payments that do not affect the size of the secured party’s total allowed claim against the debtor. *Timbers of Inwood Forest* may prevent interest compensation to prepetition undersecured creditors, but it does not prevent interest compensation to undersecured postpetition lenders, or even to entirely unsecured postpetition lenders. In *Unsecured Creditors’ Committee v. Jones Truck Lines, Inc.* (In re Jones Truck

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\(^{111}\) *DeFranco*, 93 B.R. at 309. The numbers in *DeFranco* are confusing. Judge Teel refers to the secured creditor’s total claim as $300,000, which is under water. The secured creditor received adequate protection payments of $12,000, which does not reduce the prepetition claim. Yet the secured creditor is deemed to have an unsecured claim of only $3,659. The collateral as to which the junior secured party is under water was the only property the debtor still owned. It is possible that the difference between $300,000 in original prepetition claims and the remaining $3,659 claim may reflect that the debtor had abandoned other property to the secured party as to which it was senior. Perhaps this abandoned property was worth $296,341.

the secured party and the debtor agreed to such a plan, and the unsecured creditors objected, on the authority of *Timbers of Inwood Forest*. The secured party responded that, according to the cash collateral order, the use of cash collateral was really a postpetition loan, to which *Timbers* does not apply. Ruled Judge Morris Shepard Arnold: “The court believes that the bank's view of the arrangement is the correct one and accepts its characterization as realistic.”

The situation, then, may be expressed as follows. If the debtor surrenders cash collateral, any surrender ought to be considered a reduction of principal—in this respect, *Birdneck* is wrongly decided. On the other hand, if the debtor agrees to characterize the cash collateral as a postpetition loan to the debtor in exchange for the obligation to pay interest, the secured party is entitled to genuine interest payments, without any reduction of the secured party's total allowed claim.

**D. Sub Rosa Avoidance of Security Interests on Income Streams**

Many of the opinions previously discussed follow a theory that recognizes the secured party's property rights to an encumbered cash flow, but Judge Horace T. Ward, in *Confederation Life Insurance Co. v. Beau Rivage Ltd.*, obliterated the security interest and changed a surrender of cash collateral into what I have been calling an adequate protection payment.

*Beau Rivage*, the secured party received what the court called "adequate protection payments" in advance of the plan. In fact, these payments were surrenders of cash collateral. The debtor was permitted to offset these adequate protection payments against the first few payments on the debt instrument issued under cram down. Although this setoff may seem to resemble those in *Oaks Partners*, there is this key difference. In *Oaks Partners*, the surrendered cash collateral was used to eliminate the unsecured deficit claim. In *Beau Rivage*, these same payments were used to reduce the secured

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114 Id. at 613. Arnold at least hinted that, given the consent of the secured party and the debtor, the unsecured creditors may not even have standing to object to the cash collateral order, but surely this applies to the bare use of the cash collateral. If the bank receives postpetition interest as part of adequate protection, surely the unsecured creditors have standing to object, because the payment of interest—that is, payments that do not reduce the total allowed claim of the secured party—must come from unencumbered assets the unsecured creditors might otherwise get.
116 Id.
117 See supra notes 91-96 and accompanying text.
claim twice over. Using the hypothetical numbers employed earlier, Judge Ward approved a reduction of the secured claim from $88 to $80 (by virtue of the surrender of $8 in cash collateral) and a second reduction from $80 to $72 (by virtue of the setoff against the postconfirmation payments). In short, the secured party was double charged by the court. Or, to say the same thing, Judge Ward essentially disencumbered the rent stream and treated the cash collateral surrenders as adequate protection payments of unencumbered dollars.

Judge Ward conceded that the secured party had presented “a sophisticated and well-reasoned argument that the bankruptcy court’s analysis resulted in a ‘double credit’ ” for the debtor, but he felt compelled to reject it in deference to Timbers, which he read to mean that no “adequate protection payments” were allowed unless the value of the collateral was depreciating.118 Because, in Beau Rivage, collateral was increasing in value, adequate protection payments were inappropriate. According to Judge Ward:

In Timbers, the Court was concerned that an undersecured creditor not improve its position with respect to other creditors. If payments are made to an undersecured creditor, they must be allowed to reduce the allowed secured claim of the creditor. Otherwise the payments would be treated as interest payments or use value, in direct contravention of Timbers and § 506.119

This reference to improvement of position means that Beau Rivage is best read as a case in which the security interest on the income stream was avoided, turning the encumbered dollars into unencumbered dollars, and the surrender of cash collateral into genuine adequate protection payments. But avoidance is not how Judge Ward perceived the result he reached:

While the court agrees that [the secured party] has a perfected security interest in both the real property and the rents, the bankruptcy court was correct in its determination that the application of the rents to the property was a transfer of value. The value simply shifted from one form of collateral to another. There was no depletion.120

The reference to “transfer of value” is confusing, but what Ward seems to mean is that, while the secured party claimed real estate for collateral, its security interest was shifted to cash, and so the cash payment should reduce the amount of the secured claim. This overlooks the fact that the secured party was claiming both the real estate

118 Beau Rivage, 126 B.R. at 641.
119 Id. at 640 (citations omitted).
120 Id. at 641.
and the cash. If the cash substitutes for real estate, then Judge Ward must have disencumbered the cash in advance of the substitution.

Meanwhile, Judge Ward distinguished *In re Flagler-At-First Associates, Ltd.*,\(^{121}\) which honored the security interest in the income stream. According to Ward, *Flagler* depended on the presence of depreciable collateral. But since the collateral in *Beau Rivage* was increasing in value, *Flagler* should not apply. Here we see Judge Ward justifiably falling into confusion over the way Judge Cristol struggled to express himself in *Flagler*. It will be recalled that, in *Flagler*, Cristol wrote of depreciation, but what he really meant was that the surrender of the cash collateral itself eroded the secured party's collateral.\(^ {122}\) He did not mean to imply that the underlying nonliquid collateral was depreciating.\(^ {123}\)

Another *sub rosa* avoidance of a security interest in an income stream occurred in *In re Reddington/Sunarrow Ltd. Partnership*.\(^ {124}\) In *Reddington*, Judge Mark McFeeley held that valuations should occur on the day of the bankruptcy petition.\(^ {125}\) Now *timing* of valuations may seem like a benign, technical consideration, but hidden in the timing decision are important property implications.\(^ {126}\) For example, in *Reddington*, valuation on the day of bankruptcy, followed by strict bifurcation of the undersecured claim into its secured and unsecured parts,\(^ {127}\) implies that the undersecured creditor now owns two quite independent claims—one secured and one unsecured. The secured claim is defined by the value of the collateral, which in turn is derived by the presentation of future income. If the valuation is *final*, then this bifurcation essentially disencumbers the income stream.\(^ {128}\) That is to say, further accruing income does not reduce

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121 114 B.R. 297 (Bankr. S.D. Fla. 1990) (Cristol, J.); see supra text accompanying notes 82-87.
122 See supra note 84.
123 See Stein, supra note 81, at 20. For a case following *Beau Rivage* and disencumbering the rent stream, see *In re IPC Atlanta Ltd. Partnership*, 142 B.R. 547, 558-59 (Bankr. N.D. Ga. 1992) (Drake, J.).
125 Id. at 813.
126 These implications are covered in Carlson, supra note 10, at 114-15.
128 See *In re Vermont Inv. Ltd. Partnership*, 142 B.R. 571, 574-75 (Bankr. D.D.C. 1992) (Teel, J.) (reading *Reddington* in this manner). Ironically, Judge Teel may have unwittingly followed *Reddington* by accident. In the *Vermont* case, a secured creditor was undersecured when the case started, and sufficient cash collateral was handed over to render the secured party oversecured and hence, entitled to postpetition interest after a certain point. The secured party then suggested that the surrendered cash be applied first to prepetition interest, then other things, like real estate taxes (the accrual of which constituted a senior lien) and postpetition interest. Id. at 573.

The application of cash collateral to reduce the prepetition secured claim was precisely
the unsecured deficit. At best, the income stream further secures the separate secured claim, creating an equity cushion and hence the right to postpetition interest under section 506(b).

The Supreme Court’s opinion in *Dewsnup v. Timm*, however, is a formidable impediment to the view that valuations on the day of the bankruptcy petition are final. In this opinion, Justice Blackmun ruled that section 506(d) could not be used to place a cap on the amount of a secured portion of the undersecured claim, so that the debtor could reserve for herself all appreciation value thereafter. The implication is that new valuations can always occur, and appreciation value can always be recaptured by the secured party. Nevertheless, *Dewsnup* is a reading of the words in section 506(d). Bifurcation under section 506(a) is another matter that the Court did not directly address, though it is an aggressive judge indeed who will uphold the finality of a bankruptcy day valuation after *Dewsnup*.

Therefore, it is not clear that *Reddington* is still viable after *Dewsnup*. Nevertheless, *Reddington* is based on the premise that an undersecured party should not improve her position—a principle Judge McFeeley drew from that other Supreme Court pronouncement—*Timbers of Inwood Forest*. Hence, with reference to the hypothetical numbers discussed previously, Judge McFeeley found that the illiquid collateral, valued at $80, was not depreciating. During the bankruptcy, the debtor surrendered $8 in cash collateral—a sum that represented pure improvement of position by the secured party. In light of this surrender of essentially unencumbered dollars, Judge McFeeley reduced the secured party’s secured claim from $80 to $72 and the total claim from $100 to $92. The unsecured deficit claim of $20 remained constant.

Meanwhile, Judge McFeeley, like Judge Ward, also distinguished *Flagler* as a case involving depreciating collateral—a misreading of Judge Cristol’s uncrystalline opinion. Also, Judge McFeeley noted that the court had chosen confirmation day as the time of valuation. Such a choice of timing means that the income stream was not encumbered. As McFeeley thought that petition day was the choice what Judge McFeeley did and what Judge Teel criticized. This application constituted a disencumbrance of the cash collateral to the extent it reduced the prepetition claim.


130 Id. at 778.

131 Newborn, supra note 34, at 583.

132 E.g., *In re Bloominghamdale Partners*, 160 B.R. 93, 97 (Bankr. N.D. Ill. 1993) (Barliant, J.) (suggesting that *Reddington/Sunarrow* is overruled by *Dewsnup*).

that *Timbers* dictated, he found *Flagler* unpersuasive.\textsuperscript{134}

Another *sub rosa* avoidance decision is *In re Continental Airlines, Inc.*,\textsuperscript{135} where the collateral was depreciating.\textsuperscript{136} Judge Helen Balick ruled that because interest income was accruing, the debtor-in-possession was allowed to indulge in depreciation elsewhere, without compensating the secured party.\textsuperscript{137} Yet this interest income was cash collateral, so that the secured party never properly received anything in compensation for the depreciation. Or, *sub rosa*, Judge Balick disencumbered the cash collateral and then reassigned it to the secured party as adequate protection payments.

E. Cash Collateral Setoffs Against Cram Down Payments

Several cases have allowed the debtor to set off previously surrendered cash collateral against the first few payments of interest due under cram down debt instruments issued under the authority of Bankruptcy Code section 1129(b)(2)(A)(i)(II). These cases resemble negative amortization cases, in that no interest need be paid at first. But the resemblance is misleading. A true negative amortization results in the growth of the principal amount due and owing, which is then paid back later.\textsuperscript{138} The growth occurs because unpaid interest is added to unpaid principal.

These setoff cases are not necessarily negative amortization cases. Sometimes the cram down interest is never allowed to accrue. Rather, the cram down interest obligation of the debtor is simply set off against cash collateral received by the secured party prior to con-

\begin{itemize}
    \item \textsuperscript{134} *Id.* In *Reddington*, the secured party moved to lift the automatic stay on the grounds that no plan could ever be confirmed. The debtor conceded that confirmation depended upon this disencumbrance of the income stream. Judge McFeeley seemed to emphasize "the context of automatic stay litigation," *Id.* at 812, but, as the issue was one of law, i.e., the state of the security interest on cash flow, it would appear logical that McFeeley's holding is just as valid at a confirmation hearing as it is with regard to the motion to lift the stay. See *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154, 162 (3d Cir. 1993) (Alito, J.) (holding that legal unconfirmability of a plan is per se reason to lift the stay under § 362(d)(2), where a creditor is undersecured).
    \item \textsuperscript{135} 134 B.R. 536, 542-43 (Bankr. D. Del. 1991) (Balick, J.).
    \item \textsuperscript{136} The collateral was a reversionary interest in property leased to a Continental subsidiary, for less than market rent. If the secured party had been allowed to take the premises, it could have expelled the tenant and rerented the space at a higher market rate. While the lease endured, the secured party suffered a loss for which it should have been compensated. *Id.* at 543-44.
    \item \textsuperscript{137} *Id.* at 544.
\end{itemize}
firmation. That is, interest on the cram down note disappears and does not augment the principal amount due under the cram down note.

To illustrate the difference between setoffs that are false negative amortization plans and genuine negative amortization, it will be useful to demonstrate a nonamortization cram down, against which the various setoff plans might be compared.

Assume an undersecured creditor claims $100 in total, against only $80 of collateral. The unencumbered asset earns $8 a year, and the secured party's lien encumbers this income. For three years, such income ($24) has been surrendered to the secured party. These surrenders have reduced the total claim to $76, while the underlying collateral remains at $80. The secured party, once undersecured, has become oversecured. This is shown in Figure Five.

Under section 1129(b)(2)(A)(i), a debtor-in-possession might acceptably cram down a secured party's secured claim of $76 by issuing the secured party a note payable in five years, with the market rate of interest (say, 10%) due at the end of every year. By definition, such a debt instrument has a present value of $76 (rounded off), but more formally:

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139 Recall that the value of collateral is simply the present value of income going forward; if no depreciation has occurred, the income-producing collateral remains at $80 in perpetuity.
In this formula, \( A = \$76 \), the principal amount of the secured claim, \( r = \) the market rate of interest (0.1), \( t = \) the year in which payment is due, \(^{141}\) and \( n = \) the number of years before the principal is due (5). The first ratio represents the present value of \$76 to be received five years hence and the second ratio represents the present value of an income stream of \$7.60 per year for five years.

Even this plan can be criticized because it implicitly eliminates the secured party’s right to postpetition interest.\(^ {142}\) Recall that the collateral was worth \$80 and the secured claim had fallen to \$76 (after the total claim of \$100 had been reduced by \$24 to account for the surrenders of cash collateral). If the cash collateral had never been surrendered and had instead been allowed to accrue, then the secured creditor, initially under water, would have developed an equity cushion in the third year of the proceeding. This is shown in Figure Seven.

\(^{140}\) The collateral is worth \$80, but the remaining prepetition claim is only \$76, because \$24 of cash collateral has reduced the prepetition claim of \$100. Therefore, the secured claim is only \$76.

\(^{141}\) Payment on principal is due in five years, so that, in the first ratio, \( t = 5 \). Payment of interest is due at the end of five years in the second ratio, so that \( t \) has a range of one to five.

\(^{142}\) On the other hand, the debtor has had the benefit of \$24 in early distributions which could profitably be reinvested. This reinvestment income might properly count in mitigation of any fault in the cram down provisions of the plan.
Nothing in section 506(b) conditions postpetition interest on the existence of an equity cushion at the commencement of the case.\textsuperscript{143} Nevertheless, surplus cash belongs to the bankrupt estate and can be used (with court permission)\textsuperscript{144} for the benefit of the estate. One use of these funds is to make adequate protection payments—including the adequate protection of the very creditor that used to own the cash collateral. If a court is willing to characterize the payment of surplus cash in this way, then the secured creditor has no right to postpetition interest.\textsuperscript{145}

The plan just presented resembles one that Judge Margaret Murphy confirmed in \textit{In re Club Associates}.\textsuperscript{146} Judge Murphy also ruled that the principal amount of the secured claim should be $76—not $80. This amounted to a denial of postpetition interest under section 506(b). Judge Murphy justified this reduced amount on the ground that “[i]f a creditor’s claim is not oversecured . . . accrual of interest stops on the date the petition is filed.”\textsuperscript{147} This limitation on section 506(b) is not expressly stated in that provision, but can nevertheless be supported by the observation that a trustee has no obligation to maintain a cash surplus for the benefit of a secured party’s unaccrued interest. This is not to say that the trustee may invade the collateral needed to secure the creditor’s claim. But the pure surplus is property of the estate and should, under court supervision, be available to the trustee.

The debtor in \textit{In re Oaks Partners, Ltd.},\textsuperscript{148} proposed something

\textsuperscript{143} \textit{See In re} Vermont Inv. Ltd. Partnership, 142 B.R. 571 (Bankr. D.D.C. 1992) (Teel, J);
\textsuperscript{144} \textit{See} 11 U.S.C. § 363(c)(2).
\textsuperscript{145} \textit{See supra} text accompanying notes 91-102.
\textsuperscript{146} 107 B.R. 385 (Bankr. N.D. Ga. 1989) (Murphy, J).
\textsuperscript{147} \textit{Id.} at 391 n.6.
different from just a write-down of the secured claim that occurred in *Club Associates*. The *Oaks Partners* debtor wanted the secured party's total claim to be reduced to $80 by application of $20 of the cash collateral to the total debt. It then wanted the secured party to return the "overpayment" of $4. The debtor's plan did not require the secured party to transfer cash. Instead, the extra $4 would be paid by setoff of interest due under the debt instruments issued to the secured party under cram down.

The cram down rights issued to the secured party therefore can be expressed as follows:

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149 *Id.* at 457. This return may have violated the secured party's right to postpetition interest under § 506(b). In addition, the secured party was a wraparound mortgagee, meaning that it was surety for a senior mortgagee. To the extent senior interest (if left unpaid) swelled the size of a senior encumbrance on the collateral, the secured party was entitled to adequate protection—that is, compensation in the form of unencumbered dollars for the amount of senior interest actually paid. Senior accruing interest is routinely held to be one of the things against which a junior mortgagee is entitled to be protected. See Carlson, *supra* note 8, at 650-53; see also *Ridgemont Apartment Assocs.*, Ltd. v. *Atlanta English Village*, Ltd., 110 B.R. 77, 82-83 (N.D. Ga.) (Vining, J.), aff'd mem., 890 F.2d 1166 (11th Cir. 1989).

Judge Bihary ruled against the secured party on this last point because the senior mortgagee was nonrecourse. See also *In re Club Assocs.*, 107 B.R. 385, 396 (Bankr. N.D. Ga. 1989) (Murphy, J.), aff'd, 956 F.2d 1065 (11th Cir. 1992). Lack of recourse, however, is irrelevant if senior interest would nevertheless accrue if left unpaid. In fact, the wraparound junior mortgagee should be considered subrogated to the senior mortgagee. The junior mortgagee therefore remains entitled to protection from itself as subrogee to an encroaching senior mortgage. Stephen A. Weiss, *Note, Suretyship as Adequate Protection in Bankruptcy: The Status of Undersecured Third Party Guaranties Under Section 361 of the Bankruptcy Code*, 12 Cardozo L. Rev. 285 (1990).

150 *Cf.* *Fairfax Sav. v. Sherwood Square Assocs.* (*In re Sherwood Square Assocs.*), 87 B.R. 388, 394 (Bankr. D. Md. 1988) (Derby, J.). In *Sherwood Square*, the debtor paid postpetition interest to an undersecured party as part of adequate protection. Before confirmation, the Supreme Court, in *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, Ltd., 484 U.S. 365 (1988) (Scalia, J.), ruled that postpetition interest was not part of adequate protection. Judge Stephen Derby effectively applied *Timbers* retroactively and ordered the return of these payments. *Sherwood Square*, 87 B.R. at 394. But the return was to be in the form of offsets against obligations to pay the secured party under the plan. This transformed the plan into one entailing false negative amortization. And, like in *Oaks Partners*, the secured party was entitled to return what it owed over time, without having to pay interest—a fiscal advantage to the secured party. *Id.*
$PV = \frac{A}{(1 + r)^t} + \frac{rA - C}{1 + r} + \sum_{i=2}^{n} \frac{rA}{(1 + r)^i}$

$PV = \frac{80}{(1.1)^5} + \frac{4}{1.1} + \sum_{i=2}^{5} \frac{8}{(1.1)^i}$

$PV = $49.60 + 3.636 + 23.048 = $76,284

**Figure Eight: The Cram Down in Oaks Partners**

Here, $A = $80, $r = 0.1$, $C =$ the total cash collateral surrendered between the bankruptcy petition and confirmation of the plan, $n = 5$, and $t =$ the year in which a payment is to be made. The first ratio is the present value of $80 to be received in five years, the second ratio is the present value of $4 of interest due at the end of the first year, and the third ratio is the present value of $8 a year starting in the second year and running through the fifth year.

Like Club Associates, the Oaks Partners decision denied the secured party postpetition interest, when $4 of equity cushion was created by the surrender of cash collateral beyond the amount of the unsecured deficit. If the secured party had been awarded postpetition interest, the debtor would have been entitled to $80 (the amount of the secured claim). As evidenced by these numbers, the secured party received only $76,284.152

Another case in which a setoff was approved in principle is *In re*...
Montgomery Court Apartments of Ingham County, Ltd. In this case, the debtor had surrendered $8 of cash collateral, so the remaining total claim was $92 and the collateral remained at $80. The debtor then proposed to set the entire $8 off against cram down obligations, but, in compensation, also proposed to raise the secured claim from $80 to $88, thereby establishing the status quo as if the cash collateral had never been surrendered and had been allowed to accrue. The present value of the cram down instrument in Montgomery Court was as follows:

\[ PV = \frac{A + C}{(1 + r)^t} + \frac{rA - C}{1 + r} + \sum_{i=2}^{n} \frac{rA}{(1 + r)^i} \]

\[ PV = \frac{88}{(1.1)^5} + \frac{.80}{(1.1)} + \sum_{i=2}^{5} \frac{8.80}{(1.1)^i} \]

\[ PV = \$54.56 + 0.7272 + 25.3528 = \$80.64 \]

Figure Nine: The Cram Down in Montgomery Court

The first ratio is the present value of $88 to be received in five years. The second ratio is the present value of $0.80 of interest due at the end of the first year (that is, $8.80 in cram down interest minus the $8 setoff), and the third ratio is the present value of $8.80 a year starting two years hence and running through the fifth year.

The cram down rules require that the debtor receive a present value of $80 (the value of the collateral that existed at the time of confirmation). As can be seen, on these numbers the secured party gets over $80.

Although this plan is described as a give-back of cash collateral, it is actually a true negative amortization plan. The negative amortization ($8) equated with the amount of cash collateral received, but this was pure coincidence. In negative amortization plans, other amounts could have been chosen, if the concept is to be allowed at all. No principle connects the amount of negative amortization

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154 Id. at 339.
155 Once again, this figure represents the value of distributions under the plan. The secured creditor has also received the investment income from the early distribution of the $8 in cash collateral. See supra note 142.
156 In Montgomery Court, the secured party claimed that it could not be forced to forego cram down interest because the cash collateral had been received as part of its adequate protec-
with the amount of cash collateral surrendered above the amount of
the unsecured deficit claim.

Though she found other reasons to reject the plan, Judge Sellers, in Montgomery Court, seemed to approve of this negative amortization plan in principle:

Although [the secured party] appeared to object to such addition, that treatment is favorable to it. Therefore, the Court believes that the objection is more properly to the application of the amount added to satisfy the initial payments required under the Plan rather than to the addition to the allowed secured claim. Such addition is permissible, although it may not be the only appropriate treatment of such postpetition payments.

In conclusion, the Court finds permissible [the debtor's] proposals to ... add to the appraised value for rents paid to [the secured party] postpetition. Thus, Montgomery Court appears to be a rare case in which negative amortization might have worked.

To summarize, in Club Associates, the secured claim was written down to $76 by the amount of cash collateral surrendered. This produced a secured claim that was less than the value of the collateral. Yet no provision was made for the accrual of postpetition interest. In Oaks Partners, the secured claim was also written down to $76. The $4 in surrendered cash collateral beyond the $20 unsecured deficit was treated as a mistake that had to be corrected. The secured party, however, was permitted to return the mistaken payments in the form of an offset against postconfirmation cram down interest. Because the secured party was not required to return the overpayment immediately, the secured party in Oaks Partners made out slightly better ($76,284) than the secured party in Club Associates (who obtained only $76). Both cases essentially denied to their respective secured parties their rights to receive postpetition interest under section 506(b) out of an equity cushion. In Montgomery Court, however, the secured party forfeited nothing. The amount of cash collateral received became the measure of negative amortization, but this measure was pure coincidence.

tion. Judge Sellers disagreed, stating that the collateral had not declined in value and therefore the payments could not be viewed as compensating for depreciation. Montgomery Court, 141 B.R. at 340. A better response would have been that the equation of negative amortization with cash collateral payments is purely coincidence, so that characterization of those payments is irrelevant.

157 Judge Sellers found that the plan violated the absolute priority rule, because the old owners' new capital was insufficient to trigger the new value exception. Id. at 345-46.

158 Id. at 339.
A different sort of setoff case is *In re IPC Atlanta Ltd. Partnership.* Retreating once again to the artificial numbers employed previously, the secured party in *IPC* had received $8 of cash collateral, and the collateral was valued at $80. Judge Homer Drake ruled that the cash collateral surrendered could be credited against the first few cram down obligations of the debtor, so that we had this situation:

\[
PV = \frac{A}{(1 + r)^t} + \frac{rA - C}{(1 + r)} + \sum_{i=2}^{n} \frac{rA}{(1 + r)^i}
\]

\[
PV = \frac{80}{(1.1)^20} + \frac{0}{1.1} + \sum_{i=2}^{5} \frac{8}{(1.1)^i}
\]

\[
PV = $49.60 + 0 + 23.048 = $72.648
\]

**Figure Ten: The Cram Down in IPC**

In *IPC*, the secured party should have received $80 (the value of the collateral), but received only $72,648. This occurred because the setoff wiped out the first year of cram down interest. Now if Judge Drake had simply declared the security interest on the income stream to be void, then the $8 the secured party received would be an adequate protection payment that would reduce the secured claim to $72 (and the total claim to $92). By allowing the setoff, however, the deduction of the $8 was taken out of cram down interest—a form of recoupment that was slightly more financially advantageous for the secured party. Nevertheless, it is fair to read the *IPC* decision as one in which the income stream was disencumbered from the secured party's lien—a decision, incidentally, in line with the governing appellate opinion in the Northern District of Georgia, but one that cannot be reconciled very well with *Dewsnup v. Timm.*

**Conclusion**

By way of concluding, I have tried to illustrate a few mutually exclusive ideas which should be kept as separate as possible when it becomes necessary to determine the meaning of adequate protection payments or a surrender of cash collateral.

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160 Id. at 559.
First, the phrase "adequate protection payment" should signify the transfer of previously unencumbered assets from the debtor to the creditor in satisfaction of debt. The surrender of cash collateral may be a payment, in the sense of extinguishing antecedent debt, but cash collateral is different from the adequate protection payments, because the secured party already owns the cash collateral. Surrender of cash collateral is more precisely analyzed as the abandonment of overencumbered property—something the trustee should do whenever overencumbered collateral is not necessary for an effective reorganization. The only difference between surrendering an encumbered dollar and an encumbered piece of equipment is that the former, being already liquid, need not be liquidated in a sale. The latter must be sold pursuant to the rules of the Uniform Commercial Code.

Second, "payment," in the strict sense of the word, reduces the debtor's estate, but surrender of cash collateral does not, as cash collateral has already been transferred to the secured creditor. This distinction implies that genuine payment can constitute a mode of adequate protection of the secured party, but surrender of cash collateral can never constitute adequate protection. If the two are confounded, then the security interest on the cash collateral is effectively avoided. If cash collateral is changed into an "adequate protection payment," the secured party has effectively forfeited its security interest. Or, to say the same thing in different words, the secured creditor is made to pay for her own adequate protection—precisely what the Bankruptcy Code guards against.

These are hard distinctions indeed to keep straight, yet attending to their integrity would increase the clarity of analysis in one of the most difficult areas in bankruptcy (or any other) law—the meaning and application of adequate protection payments and surrender of cash collateral.

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162 These are the words of 11 U.S.C. § 362(d)(2), which articulate the policy of abandonment in bankruptcy. Abandonment per se is governed by 11 U.S.C. § 554.