EVIDENCE NECESSARY TO PROVE ADEQUATE PROTECTION
by
Timothy M. Lupinacci¹
Bill D. Bensinger²
Baker Donelson Bearman Caldwell & Berkowitz, P.C.
Birmingham, Alabama
tlupinacci@bakerdonelson.com

I. Introduction

Adequate protection is a fundamental protection for creditors in bankruptcy. It is therefore one of the most frequently litigated issues in bankruptcy. The Bankruptcy Code references and requires the provision of adequate protection in several circumstances including stay relief, use of a secured creditor’s collateral and when the debtor proposes to prime a secured creditor’s lien on collateral with an additional lien. In order to protect their rights during these and other situations, it is important for secured creditors to understand the protections afforded their interest in collateral. Equally important, creditors must come to Court prepared to present sufficient evidence to secure adequate protection of its interests.

II. Adequate Protection Generally

The concept of adequate protection derives from the Fifth Amendment protection of property interests.³ In this respect, the United States Supreme Court has held that bankruptcy power is subject to the Fifth Amendment due process clause prohibiting the taking of private property without compensation despite a public purpose for the taking.⁴ Adequate protection, however, is more than a constitutional protection of creditor’s interest in property; §361 of the Bankruptcy Code, and the concept of adequate protection generally, is based as much on policy grounds as on constitutional grounds.⁵ As Congress explained

¹ Timothy M. Lupinacci is the managing shareholder of the Birmingham office of Baker, Donelson, Bearman, Caldwell & Berkowitz, PC. and is a member of the firm’s Bankruptcy and Restructure Practice Group. His practice focuses primarily on the representation of special servicers, banks, financial institutions and asset-based lenders in loan workouts and insolvency, with an emphasis on creative restructuring of problem loans in long-term care and seniors’ housing defaults, and all aspects of problem CMBS loans. Mr. Lupinacci received his B.A. degree, cum laude, from the University of Montevallo and his J.D. degree from Vanderbilt University.

² Bill D. Bensinger is an associate in the Birmingham, Alabama office of Baker, Donelson, Bearman, Caldwell & Berkowitz, PC and a member of the firm’s Bankruptcy and Creditor’s Rights Practice Group. His practice focuses primarily on the representation of secured creditors in loan workouts and bankruptcy. Mr. Bensinger received J.D. degree from Cumberland School of Law, Samford University and is a 2005 graduate of the LL.M. in Bankruptcy Program at the St. John’s University School of Law.


Error! Unknown document property name.
secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, §361 recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.

The basic purpose of adequate protection is to replace the protections afforded a secured creditor by a debtor’s possession of its collateral. Adequate protection payments are designed to compensate a holder of a secured claim for any decline in the value of its collateral post-petition and pre-confirmation. Because adequate protection is designed to compensate secured creditor, unsecured creditors do not have the right to adequate protection payments. Indeed there is no express statutory requirement that unsecured creditors be provided adequate protection as may be required under §§ 362, 363 or 364 of the Code.

A. When a Debtor is Required to Provide Adequate Protection

The Bankruptcy Code requires a debtor to provide adequate protection to a secured creditor in at least three circumstances: (1) when the automatic stay is in effect; (2) when the debtor uses, sells or leases a secured creditor’s collateral; and (3) when the debtor proposes to prime a secured creditor’s lien with an additional lien. In addition to these three circumstances that occur prior to confirmation of a debtor’s plan, the Bankruptcy Code requires a Chapter 13 debtor to adequately protect a secured creditor during the period of the Chapter 13 plan.

In many instances, a secured creditor must request that the bankruptcy court order the debtor to provide adequate protection of the secured creditor’s interest. While the stay provisions of §362 require that a secured creditor’s interest be adequately protected, most courts still require that the secured creditor actually request the relief or adequate protection prior to the court ordering it.

---

6 Id.


9 In re Southern Biotech, Inc., 37 B.R. 318, 324 (Bankr. M.D. Fla. 1983); see also In re Babcock and Wilcox Co., 250 F.3d 955, 961 n.12 (5th Cir. 2001); In re Dairy Mart Convenience Stores, Inc., 351 F.3d 86, 90-91 (2d Cir. 2003) (concluding that an unsecured creditor was ineligible to receive adequate protection under section 361 of the Bankruptcy Code; rather, the adequate protection provision of section 361 only protects secured creditors).

10 In re Sharon, 234 B.R. 676, 684 (6th Cir. B.A.P. 1999) (holding that continuation of the automatic stay may be conditioned by the bankruptcy court on the provision of adequate protection, but the procedural prerequisite is that the lien creditor must first “request” relief from the stay by motion to the bankruptcy court under Bankruptcy Rule 4001(a)); In re Coates, 180 B.R. 110 (Bankr.D.S.C.1995) (stating that adequate protection is only required when requested by a creditor who is entitled to receive it); In re Hinckley, 40 B.R. 679 (Bankr. D. Utah 1984).
Similarly, secured creditors must request adequate protection when a debtor intends to use, sell or lease the secured creditor’s non-cash collateral. Section 363(e) states that

On request of an entity that has an interest in property used, sold, or leased . . . the court . . . shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.11

Courts place the onus of requesting adequate protection on the secured creditor.12 The rules are different in the cash collateral context. The Bankruptcy Code provides that a debtor cannot use cash collateral unless it first provides the secured creditor with an interest in such cash collateral with adequate protection.13 This is because a debtor does not have the right to use cash collateral without either the consent of the secured creditor or by order of the court.14

Section 363’s requirement that a debtor provide adequate protection is extended to situations where a secured creditor has possession of estate property and is required to turnover the property pursuant to §542.15 The adequate protection requirement is incorporated into §542(a) by reference to §363.16 Section 542(a) authorizes the bankruptcy court to order the turnover of property of the estate, but only to the extent that the court orders adequate protection for those who have an interest in such property.17

A secured creditor does not have to request adequate protection when the debtor attempts to prime the secured creditor’s interest in collateral with another lien. Section 364(d)(1) states that

The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

12 Tidewater Finance Co. v. Henson, 272 B.R. 135, 140 (D. Md. 2001); In re Williams, 246 B.R. 591, 596 (8th Cir. B.A.P. 1999); In re Cason, 190 at 928.
15 Section 542(a) requires “an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property.” 11 U.S.C. §542(a).
16 In re Empire for Him, Inc., 1 F.3d 1156, 1160 (11th Cir. 1993).
17 Id.
(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.\(^{18}\)

Courts therefore require the debtor to provide adequate protection in all cases where a secured creditor’s interest will be primed by an additional lien.\(^{19}\)

**B. Forms of Adequate Protection**

The determination of how a debtor actually provides sufficient adequate protection continues to evolve. The Bankruptcy Code sets forth three non-exclusive examples of what may constitute adequate protection.\(^{20}\) Section 361 states:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by-

1. requiring the trustee to make a cash payment or periodic cash payments to such entity, 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;

2. providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

3. granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.\(^{21}\)

---


\(^{20}\) *In re Briggs Transp. Co.*, 780 F.2d 1339, 1344 (8th Cir. 1985) (holding that §361 is not an exclusive list of means of providing adequate protection); *In re Mellor*, 734 F.2d 1396, 1400 (9th Cir. 1984) (same); *In re Grant Broadcasting of Philadelphia, Inc.*, 75 B.R. 819, (E.D. Pa 1987) (same).

Periodic cash payments are the most common ways that a debtor provides adequate protection to its secured creditors. Adequate protection pursuant to § 361(1) requires the debtor to make a single or periodic cash payments to a secured creditor to the extent of depreciation of the value of the secured creditor’s interest in the collateral.

A debtor may also provide its secured creditor with adequate protection by granting additional or replacement liens in the debtor’s assets. The replacement lien scenario typically arises when the secured creditor has a pre-petition lien on accounts, inventory and other “soft collateral”. The commencement of a bankruptcy case cuts off a secured creditor’s interest in property acquired post-petition. Thus, the pre-petition secured creditor’s security interest in accounts and inventory will not extend to accounts and inventory generated post-petition. Bankruptcy courts, however, typically allow a debtor to provide adequate protection to a secured creditor by granting a security interest in the pre-petition collateral secured by the lien by granting a replacement lien in the post-petition generated assets.

The final illustrative means of adequate protection found in §361 is for the debtor to provide the secured creditor with the indubitable equivalent of its interest. The Bankruptcy Code does not define “indubitable equivalent”. A debtor cannot provide the indubitable equivalent by granting a secured creditor an administrative expense priority. Conversely, courts have consistently held that a debtor can provide the indubitable equivalent of a secured creditor’s interest by surrendering the collateral to the creditor. Within these parameters, the indubitable equivalent is limited only by the imagination of debtor’s counsel.

---

24 Soft collateral is collateral that the debtor uses or consumes in the operation of the debtor’s business.
30 In re Shriver, 33 B.R. 176, 183 (Bankr. N.D. Ohio 1983) (“The ‘indubitable equivalent’ standard of §361(3), if anything, is designed to broaden, not circumscribe the range of solutions available to debtors and creditors in accommodating their respective interests in the infinite number of variations possible in their dealings.”).
The examples of adequate protection in §361 are not exclusive of the means of protecting a secured creditor’s interests. Courts have long recognized that there are other means of providing secured creditors with adequate protection. One of the primary means is when the debtor has an equity cushion\(^{31}\) in the secured creditor’s collateral. Adequate protection exists if the value of a secured creditor’s collateral exceeds the value of its claim and the difference is either great enough to absorb interest accrual or the debtor is servicing the post-petition debt.\(^{32}\) Case law suggests that an equity cushion of 20% or more constitutes adequate protection; while a rapidly deteriorating equity cushion of less than 10% may be insufficient to constitute adequate protection.\(^{33}\)

Some courts have also found that a secured creditor is adequately protected if it has a lien on, or access to, assets outside of the bankruptcy estate. Similarly, a guarantee by a third party can be a form of adequate protection.\(^{34}\) In such cases, the key to whether a guaranty adequately protects the secured creditor is whether such a guarantee is secured by collateral.\(^{35}\) A federal guaranty, standing alone, may constitute adequate protection because the government is obligated to make payments to the secured creditor.\(^{36}\) Additionally, a secured creditor’s lien on property, some of which is owned by non-debtors, can afford the creditor adequate protection.\(^{37}\)

III. Proving Adequate Protection

A. The Burden of Proof

While the debtor always bears the burden of proving adequate protection, the secured creditor has significant burdens before the debtor must offer its proof. In many instances, the secured creditor must request adequate protection. The secured creditor’s burden, however, goes beyond simply making a request. When the Bankruptcy Code requires the secured creditor to

---

\(^{31}\) An equity cushion exists when the appraised value of the collateral is greater than the amount owed on the loans that the property secures. In re Nichols, 440 F.3d 850, 856 (6th Cir. 2006). An equity cushion should not be confused with equity in property. A debtor has equity in property when the value of the subject property is greater than the amount of debt encumbering it. Estate Const. Co. v. Miller & Smith Holding Co., Inc., 14 F.3d 213, 219 (4th Cir. 1994).

\(^{32}\) In re 1025 Associates, Inc., 106 B.R. 805, 810 (Bankr. D. Del. 1989); see also In re James River Associates, 148 B.R. 790, 796 (E.D. Va. 1992) (holding that if a debtor has equity in a property sufficient to shield the creditor from the declining value of the collateral then the creditor is adequately protected).

\(^{33}\) In re James River Associates, 148 B.R. at 796.


\(^{35}\) Matter of Belton Inns, Inc., 71 B.R. 811 (Bankr. S.D. Iowa 1987) (holding that a guarantee secured by collateral may qualify as adequate protection, but a guarantee not backed by collateral generally does not provide such protection).


request adequate protection, the secured creditor bears the initial burden of going forward in regards to certain issues, even if it does not bear the ultimate burden of persuasion. The issues for which the secured creditor must carry the initial burden depends on the applicable section of the Bankruptcy Code governing the requested relief. If the secured creditor fails to carry its initial burden, the court may dismiss the motion without requiring the debtor to offer any evidence.

1. Relief from Stay for Cause

Under Section 362(d)(1) of the Bankruptcy Code, the secured creditor must prove that cause exists for the requested relief. Generally, courts have held that the creditor has the burden of showing that “continuation of the stay [would] cause some affirmative harm to its interest in the [property].” To establish a prima facie case under §362(d)(1), a secured creditor should introduce evidence of (1) a debt owing from the debtor to the secured creditor; (2) a valid security interest that secures the debt; and (3) a decline in value of the property securing the debt, combined with the debtor’s failure to provide adequate protection of the secured creditor’s interest.

Without evidence of the amount of the debt, “the court is unable to find cause to lift the stay.” The burden of proving the debt is straightforward; a duly executed and filed proof of claim “shall constitute prima facie evidence of the validity and amount of the claim.” Supporting evidence, by affidavit or live testimony, can help establish the debt. To establish a perfected security interest, the secured creditor should file its perfection documentation with its claim. This should include updated title and/or UCC searches showing the priority and perfection of its interest in the applicable property.

Erosion of the secured creditor’s position may be shown through evidence of declining property values, the increasing amount of the secured debt through interest accruals or otherwise, the non-payment of taxes or other senior liens, failure to ensure the property, failure to maintain

---

39 Id.
40 In re Mazzeo, 167 F.3d 139, 142 (2nd Cir. 1999); In re Bogdanovich, 292 F.3d 104 (2d Cir. 2002); In re Brown, 311 B.R. 409 (E.D. Pa.2004).
41 Capital Communications Federal Credit Union v. Boodrow (In re Boodrow), 126 F.3d 43, 53 (2d Cir.1997)
the property, or other factors that may jeopardize the creditor’s present interest in the property. As described below, this evidence is proven through expert or other live testimony and typically includes testimony establishing the declining value of the property.

Once the secured creditor makes a prima facie showing of cause, the burden then shifts to the debtor to refute the existence of cause. When the secured creditor has moved for relief because of lack of adequate protection, the debtor can refute the existence of cause either by proving that the property is not decreasing in value or that the secured creditor is adequately protected. The debtor bears the burden of proof by a preponderance of the evidence that cause to modify the stay does not exist.

2. Adequate Protection for Debtor’s Use, Sale or Lease of Collateral

When a debtor seeks to use, sell or lease property that secures a creditor’s claim, the party bearing the burden or proof depends on the type of property at issue. When the debtor seeks to use, sell or lease non-cash collateral, the secured creditor requesting adequate protection on account of a debtor’s use, has the initial burden of going forward on certain issues. If the debtor seeks to use a secured creditor’s cash collateral, the debtor has the burden of proving adequate protection of the secured creditor’s interest in cash collateral.

The secured creditor asserting an interest in non-cash collateral, must prove the validity, priority, or extent of its interest. The secured creditor must demonstrate that adequate protection is required by showing a likelihood that the collateral will decrease in value on account of the debtors use, sale or lease of the collateral.

If the secured creditor carries its initial burden of going forward, the burden then shifts to the debtor. Likewise, if the debtor seeks to use cash collateral the debtor bears the entire burden of providing adequate protection. The courts have split as to the burden of proof that the debtor must carry under § 363(o)(1). Some bankruptcy courts have required clear and convincing evidence. Other courts have required proof by the preponderance of the evidence. The debtor

46 In re Anthem Communities/RBG, LLC, 267 B.R. at 871.
47 Mazzeo, 167 F.3d at 142.
52 Zink, 300 B.R. at 402-403.
54 In re O.P. Held, Inc., 74 B.R. 777 (Bankr. N.D.N.Y. 1987); In re Leavell, 56 B.R. 11 (Bankr. S.D. Ill. 1985); In re
must show that either that adequate protection is not needed or can be provided in a different manner.56

3. Adequate Protection of a Primed Creditor’s Interest

When a debtor seeks to prime a secured creditor’s lien under §364, the debtor has the burden of proving adequate protection of the secured creditor’s interest.57 A secured creditor that is going to have its interest primed is not required to request adequate protection of its interest. Whether protection is adequate depends directly on how effectively it compensates the secured creditor for loss of value caused by the superpriority lien given to secure the post-petition loan. In other words, the proposal should provide the pre-petition secured creditor with the same level of protection it would have had if there had not been post-petition superpriority financing.58 A debtor seeking to prime a secured creditor should present an evidentiary foundation of adequate protection premised on facts or projections.59

B. Evidence of Adequate Protection

In preparing to try adequate protection issues, the presentation of sufficient evidence is critical. When a party bears the ultimate evidentiary burden, it is important to present effective witnesses and documentary evidence to the bankruptcy court.60 In addition, courts generally consider affidavits submitted in support of motions, although there are limitations in relying solely upon affidavit.61 Courts can take judicial notice of a debtor’s bankruptcy schedules or other pleadings filed in a case when property value is at issue.62 Bankruptcy schedules qualify for use as an admission by a party-opponent under Federal Rule of Evidence 801(d)(2).63


56 Id.


58 In re Swedeland Development Group, Inc., 16 F.3d at 564; other cases have stated that the “important question” in determining the adequacy of protection under section 364(d)(1)(B) is whether the interest of the secured creditor whose lien is to be primed “is being unjustifiably jeopardized.” In re Plabell Rubber Products, Inc., 137 B.R. 897, 899 (Bankr. N.D. Ohio 1992), quoting from In re Aqua Associates, 123 B.R. 192, 196 (Bankr. E.D. Pa.1991).


62 Id.

63 Schedules are (a) intended by the debtor declarant as an assertion, (b) relevant to the question of value, and (c) being used against the party declarant. Applin, 108 B.R. at 258.
Appraisals are admissible as business records if they satisfy three basic requirements: (1) the appraisal is kept in the course of a regularly conducted business activity; (2) it is the movant’s regular business practice to make the record; and (3) the source of the information or the method or circumstances of preparation must not indicate lack of trustworthiness.\textsuperscript{64} The appraisal is admissible as evidence on a motion for relief from stay only if the opinion as to the value expressed therein is supported by live testimony, affidavit or deposition testimony of the appraiser. The movant must lay a proper evidentiary foundation for the appraiser’s expertise.\textsuperscript{65} In most cases, real estate appraisals generally lack the circumstantial guaranties of trustworthiness and therefore, an appropriate foundation to present a real estate appraisal in support of a motion.\textsuperscript{66} The most effective presentation of valuation testimony is through the use of a live expert witness.

The evidence sufficient to prove, or disprove, adequate protection varies by case. Set forth below is a list of cases involving a secured creditor’s attempt to prove the need for adequate protection of its interest in a debtor’s property. These cases affirm that a secured creditor must prove not only a diminution in value, but that the diminution continues during the bankruptcy case.

- Secured creditor showed a decline in the value of the collateral over the two years prior to the petition date, but did not carry their burden of showing that such a decline continued post-petition. The secured creditor proved that the collateral, a heard of cattle, had a value of $89,800.00 two years prior to the petition date and a value of $54,000.00 as of the petition date. The secured creditor, however, failed to show that the depreciation would continue post-petition.\textsuperscript{67}

- In support of motion, secured creditor may prove declining property values, increase in amount of the secured debt through interest accruals or otherwise, non-payment of taxes or other senior liens, failure to insure the property, failure to maintain the property, or other factors that may jeopardize the creditor's present position. It may be necessary to show a combination of these factors and/or to show that the circumstances as a whole are sufficient to jeopardize the creditor's interest in the property.\textsuperscript{68}

- In determining the amount of adequate protection a creditor is entitled to receive on its secured claim, absent more reliable evidence, the average rate of decline in

\textsuperscript{64} \textit{In re Applin}, 108 B.R. at 258 (citing Fed. R. Evid.803(6)).

\textsuperscript{65} Id. at 261.

\textsuperscript{66} Id.

\textsuperscript{67} \textit{Zink v. Vanmiddlesworth}, 300 B.R. at 402-403.

\textsuperscript{68} \textit{In re Anthem Communities/RBG, LLC}, 267 B.R. at 871.
the Blue Book value of the particular automobile over a three (3) month period immediately preceding the date of the request for adequate protection should be used.\(^69\)

- If a secured creditor’s collateral consists of rents, evidence that the stream of rents is declining, and that the renewal rents are not providing constant value is evidence of lack of adequate protection.\(^70\)

- To prove a decline in value, the movant must complete two steps. First, it must establish value at a beginning point, which is the benchmark. Second, it must show a decrease in that value. The secured creditor can show this by a comparison with a second value at the end of the protected period, by a previous decline from an earlier date (i.e. filing date, which is expected to continue), or by a straight-line depreciation.\(^71\)

- With certain collateral, such as stock, courts may take a long term view of the collateral to determine if it is deprecating. The court found that the secured creditor’s collateral of publicly traded stock was not declining despite evidence that the stock price had gone from $13 1/8 on the petition date of June 17, to a price of $10 1/4 on August 24. On cross-examination, the secured creditor’s expert testified that the decline was temporary and expected the stock price to climb.\(^72\)

- Secured creditor can prove diminution in value by showing that similar property is decreasing in value. The secured creditor’s collateral consisted of farm land. The secured creditor showed through expert witness testimony that farm land values in the same geographic area as the collateral had declined by at least twenty-four percent in the twelve-month period immediately preceding the filing of the petition in bankruptcy.\(^73\)

IV. Conclusion

Secured creditors are entitled to protection of their interests in the debtor’s property. There is a natural tension between providing the secured creditors with every aspect of their bargained-for rights and the bankruptcy policy of allowing a debtor to reorganize. This tension often leads to litigation over the extent that secured creditors will be protected and the court will allow the debtor to continue its operations. Both secured creditors and debtors have their

\(^{69}\) *In re Cook*, 205 B.R. 437, 440-441 (Bankr. N.D. Fla. 1997).

\(^{70}\) *In re Wreclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997).

\(^{71}\) *In re Cason*, 190 B.R. at 928.

\(^{72}\) *In re Johnson*, 90 B.R. 973, 976 (Bankr. D. Minn. 1988).

respective burdens of proof. A failure by either party to carry its burden can have dire consequences for that party’s interest.