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The Saga of Income from Income-Producing Collateral Treatment in Bankruptcy for Undersecured Creditors

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THE SAGA OF INCOME FROM INCOME-PRODUCING COLLATERAL TREATMENT IN BANKRUPTCY FOR UNDERSECURED CREDITORS

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ABSTRACT

Who gets the income from income-producing collateral during bankruptcy—the debtor or the undersecured creditor? Throughout the history of bankruptcy law in America, this question has not had a bright-line answer. It is one of those indelible questions whose answer lies even to this day within the equitable power of courts of equity. In 2014, the First Circuit looked at this question and adopted the Fifth Circuit’s “flexible approach.”

With the flexible approach growing in popularity, the lower courts’ tendency to adopt rigid valuation methodologies should fade. Instead of taking positions on either the addition method or the subtraction method, bankruptcy courts should exercise their congressionally-mandated equitable powers to develop standards based on non-exclusive factor tests. Over time, the factors used and weights assigned to each will hopefully begin to provide a measure of clarity to this heavily facts-and-circumstances-dependent area of the law.
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I. Introduction

The legal issues regarding income-producing collateral treatment for undersecured creditors in bankruptcy often devolve into fact-specific valuation issues. The Fifth Circuit’s opinion in *Matter of T-H New Orleans* and the First Circuit’s decision in *In re SW Boston Hotel Venture* endorsing the Fifth Circuit’s “flexible approach” reflect this emphasis on employing valuation principles rather than legal tests. The approach is flexible and must be flexible because valuation in bankruptcy “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 disposition or use or on a plan affecting such creditor’s interest.”

As one commentator pointed out, “the values derived by bankruptcy courts are not objective or even subjective facts. Rather, they are *subjunctive* facts—facts that can be assessed only contingently in the context of a hypothetical universe which can never be.” For this reason, the Bankruptcy Code, in general, should not be interpreted by analogizing to what would happen in a hypothetical world where no bankruptcy occurred. Throughout the lengthy history of income-producing collateral treatment for undersecured creditors in bankruptcy, bright-line rules have been difficult to establish and even more difficult to apply. The contours of the “flexible approach” remain in flux. Still, some principles should be established. First, the separate-and-distinct-item-of-collateral theory should be clearly and permanently laid to rest. Second, to the

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1 11 U.S.C.A. § 506(a)(1) (Allowed claims of secured creditors in bankruptcy are “a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property.” Consequently undersecured creditor’s claims in bankruptcy are bifurcated into two parts, the secured portion and the unsecured portion).
3 *Prudential Ins. Co. of Am. v. SW Boston Hotel Venture, LLC (In re SW Boston Hotel Venture, LLC)*, 748 F.3d 393, 405 (1st Cir. 2014) (endorsing the “flexible approach”).
4 *Id.*
extent that the analysis in *Timbers of Inwood Forest* conflicts with *Dewsnup v. Timm*, the *Timbers* analytical framework should be used.

**II. The History of Income-Producing Collateral Treatment**

Historically, post-petition interest has not been allowed to undersecured creditors. Under the Bankruptcy Act of 1898, however, an exception was created for when the underlying collateral produced income. Later, that exception was subjected to the equitable discretion of the court. Today, we still struggle with the contours of that equitable discretion.

**A. From The 1898 Act to Sexton v. Dreyfus**

Under the Bankruptcy Act of 1898 (The Nelson Act), courts largely adopted the English practice regarding postpetition interest entitlement. As a general rule, postpetition interest was not available. The Supreme Court endorsed the first exception to this rule in *Coder v. Arts*. Under the exception, when proceeds of the collateral’s sale were sufficient, “the mortgagee was entitled to interest on his mortgage debt.” In other words, creditors who turned out to be oversecured at the collateral’s sale could collect postpetition interest.

The second exception allowed the income from income-producing collateral to be applied toward post-petition interest. Justice Learned Hand first examined an inconsistency caused by this exception in *In re Kessler & Co*. Judge Hand looked at the situation from an economic perspective, pointing out that outside of bankruptcy, creditors would be entitled to seize their

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9 Id.
10 O'Toole, *supra* note 6, at 251.
collateral and liquidate it. Inside bankruptcy, however, liquidation is postponed. If the purpose behind the income-producing exception to the general rule is to compensate undersecured creditors for the “loss involved in waiting till [their return] is realized,” then the undersecured creditor without income-producing collateral should also be compensated for the delay, or neither party should be compensated for the delay. Judge Hand decided that both parties should be compensated. Judge Hand did not discuss whether the income-producing collateral exception should be abolished or simply not adopted in the United States.

Judge Hand’s opinion was appealed to the Supreme Court where Justice Holmes reversed Judge Hand and gave a reason for the inconsistency that justified the inconsistency’s existence. Justice Holmes said that when collateral is income-producing, the bankrupt estate should not benefit from the income during the bankruptcy proceeding. Therefore, the inconsistency is rational.

Both Hand’s and Holmes’s opinions discussed English bankruptcy law. In the end, Holmes wholeheartedly adopted the English practice. The rules, then, were as follows. When the proceeds of the collateral’s sale were sufficient, the creditor was oversecured and could collect interest. When the proceeds did not cover the principal, the creditor could not submit a deficiency claim for the interest, only the uncovered principal. When, however, the collateral

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12 Id. at 754.  
13 Id.  
14 Id.  
15 Id.  
17 Id.  
18 Id.; Also see David Gray Carlson, Postpetition Interest under the Bankruptcy Code, 43 U. MIAMI L. REV. 577, 592 (1989).  
19 Kessler, 171 F.751; Sexton, 219 U.S. 339.  
20 Sexton, 219 U.S. at 344–45 (“The [English] rule is not unreasonable when closely considered.”)
produced income, the “creditor could apply that income to postpetition interest, and prove for any deficiency in principal after the sale proceeds were exhausted.”  

B. From Sexton to Vanston to Timbers

The Sexton rules for postpetition interest entitlement were generally but not rigidly followed. A few decades later in Vanston, the Supreme Court “subjected the Coder and Sexton exceptions to the equitable discretion of the bankruptcy court.” While Vanston had unique facts involving interest on interest, the “lower courts did not hesitate to invoke the Vanston rule in reorganizations.” The willingness to use Vanston discretion was exemplified in this language, “this Court is of the opinion that the legal principle announced in the Vanston case cannot be limited only to the factual situation where interest upon interest is involved. Rather the Court there spoke of the duty of the bankruptcy court to determine how and what claims shall be allowed under equitable principles.”

C. The Impact of the Advent of Adequate Protection on the Sexton and Vanston Rules

Traditionally, courts required an equity cushion to avoid the lifting of the stay. Consequently, undersecured creditors could get the stay lifted, seize income-producing property and obtain the income for themselves. As one commentator points out, these creditors essentially did receive post-petition interest because they were able to obtain the income from the income-producing property. Although it was not in the form of interest, it effectively replaced the

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21 O'Toole, supra note __, at 254.
23 O'Toole, supra note __, at 255.
24 Id.
26 Carlson, supra note __, at 593–94.
27 Id. at 594.
interest. Courts did not always, however, insist on an equity cushion’s presence if the collateral could be adequately protected by other means.

In *Yale Express*, for example, the debtor, Yale Express, bought trucks on credit from Freuhauft and used the trucks for transportation. The trucks were essential to the operation of the business. When Freuhauft’s attempt to reclaim the trucks failed for reasons not relevant to this article, Freuhauf demanded rental payments for the use value of the trucks, in essence, periodic cash payments based on use value. The trucks certainly played a large role in the production of profits to the debtor because the court found that a successful reorganization could not be achieved without the trucks. The *Yale Express* court affirmed the lower court’s denial of Freuhauft’s claim for rental value payments on the grounds that the lower court properly exercised its equitable discretion over whether or not to grant the rental payments. The Second Circuit noted that granting this right to one creditor would mean that the right would have to be granted to all creditors, which would destroy the strong possibility of reorganization. The Second Circuit also noted that (a) Freuhauft’s damages as a result of not having access to its collateral would entitle Freuhauf to equitable consideration in the reorganization plan, and (b) the Chapter X trustee had offered to fix the value of the security interest so that Freuhauf’s position would not be affected by depreciation of the trucks. In this case, the Second Circuit endorsed the idea that an administrative priority alone could adequately protect a creditor. Later, the case of *In re Bermec* endorsed the idea that a trustee should use periodic cash payments to

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28 *Id.*
29 *Id.* at 597 n. 65 (listing example cases).
30 *Freuhauft Corp. v. Yale Express Sys., Inc.* (In re Yale Express Sys., Inc.), 384 F.2d 990 (2d Cir. 1967).
31 *Id.* at 991.
32 *Id.*
33 *Id.*
34 *Id.*
35 *Id.* at 992.
36 *Id.*
37 *Id.*
compensate the secured creditor for depreciation or diminution in value of the creditor’s collateral.

The *Sexton* and *Coder* rules were weakened when subjected to *Vanston* discretion. The impact of the emerging doctrine of adequate protection in cases like *Yale Express* and *Bermec* threatened to weaken the rules further by allowing courts even more flexibility to alter rights.

**D. The Impact of the Bankruptcy Code of 1978**

The Bankruptcy Code of 1978 (The Code) revolutionized bankruptcy law when it replaced the old Bankruptcy Act of 1898 (The Act). Up until the Bankruptcy Code, all changes to bankruptcy law had been mere modifications of the Act. The Code, however, totally replaced the Act. Though the Code drew from the Act in some ways, it largely presented a clean slate on which courts would have to write. With respect, however, to income-producing collateral treatment for undersecured creditors, the Code largely adopted existing law. Section 506(b) codifies the *Coder* exception. For the *Sexton* exception, however, the Code seemingly codified the equitable discretion of *Vanston*. According to the Senate Report, Section 506 “codifies current law.”

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39 DAVID A. SKEEL, JR., DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 131 (“The touchstone of the current era of American bankruptcy was the 1978 Bankruptcy Code . . . .” and “It is no overstatement to say that the 1978 Code has had a transformative effect on bankruptcy as we know it . . . .”).

40 *Id.* at 5 (explaining that the first age of bankruptcy law began with the 1898 act, the second age began with New Deal modifications to the 1898 act, and the third age began with the 1978 code).

41 S. Rep. 95-989, 1978 U.S.C.C.A.N. 5787, 5788 (“The Major Purpose of this bill is the modernization of the bankruptcy laws. The substantive law of bankruptcy and the current bankruptcy system were designed in 1898, and underwent the last significant overhaul in 1938, nearly 40 years ago. Since that time there have been vast changes in the law of debtor-creditor relations, including the widespread adoption of the Uniform Commercial Code in the early 1960’s and the vast spread of consumer credit.”).

42 O’Toole, *supra* note _, at 266.

43 *Id.*


E. United Savings v. Timbers of Inwood Forest (1988)

In Timbers of Inwood Forest, the Supreme Court addressed the treatment of income from income-producing collateral for undersecured creditors in bankruptcy after enactment of the modern 1978 Code.\(^\text{46}\) In Timbers, the debtor owned an apartment complex.\(^\text{47}\) At a hearing on relief from the automatic stay, the mortgage holder argued that “absent the automatic stay, it would foreclose on and sell the property and reinvest the proceeds at the market rate” and that its interest to be adequately protected was “the present value of the proceeds.”\(^\text{48}\) Consequently, the creditor demanded and received payments to be made from the rental receipts subject to the cash collateral order.\(^\text{49}\)

i. The Initial Panel Appeal

On appeal, the Fifth Circuit vacated the bankruptcy court’s order and held, essentially, that undersecured creditors were not entitled to compensation for the delay caused by the automatic stay.\(^\text{50}\) Among other reasons, the court said that it would be inequitable and inconsistent for oversecured creditors’ rights to post-petition interest to be contingent on an eroding equity cushion while undersecured creditors could get virtually the same post-petition interest entitlement in the form of “lost opportunity costs” except that the entitlement would be perpetual and not contingent at all.\(^\text{51}\) Also, allowing “adequate protection of foreclosure rights” would create a need to perform complex valuations of “foreclosure rights” that would involve


\(^{47}\) Id. at 368.

\(^{48}\) In re Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380, 1383 (5th Cir. 1986) on reh’g, 808 F.2d 363 (5th Cir. 1987) aff’d sub nom. United Sav. Ass’n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988).

\(^{49}\) Id.

\(^{50}\) Id. at 1416.

\(^{51}\) Id. at 1413–15; Also see O’Toole, supra note _, at 255.
highly conjectural assumptions and that would overlap and conflict with valuation of the underlying collateral.52

ii. The En Banc Rehearing

Later, likely because the initial holding exacerbated a developing circuit split, the Fifth Circuit agreed to rehear the case en banc.53 After rehearing, Judge Randall wrote the en banc opinion reinstating her earlier panel opinion over a vigorous four-judge dissent penned by Judge Edith Jones.54 The dissent contended that, in bankruptcy, property rights (like secured interests) are “created and defined by state law” and “unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”55 The dissent took the position that the interest to be adequately protected was defined by state foreclosure law.56 Because state law governed, as it generally does, the property interests to be adequately protected, the value to be protected depended on the contours of the state’s law. Consequently, undersecured creditors must be entitled to “lost opportunity costs” like the loss or delay of “foreclosure rights” to the extent that state law would not cause the loss.57 The dissent believed that the “expansive phrase ‘the value of an entity’s interest in such property’ [found in § 361 of the Bankruptcy Code] demonstrate[d] a ‘general intention to protect a broad range of secured creditor’s interests.”58

The dissent saw this broad range of interests as including both the value of the collateral itself

52 In re Timbers of Inwood Forest Assocs., 793 F.2d at 1404, 1416.
53 In re Timbers of Inwood Forest Assocs., 802 F.2d 777 (5th Cir. 1986).
56 Id.
57 See generally id. at 376–77 (making generally such argument).
58 Id. at 377 (citing In re Am. Mariner Indus., 734 F.2d 426, 430 (9th Cir. 1984)).
and the value of the ability to use the collateral, or in other words, the “time-value of the secured creditor’s rights.”

The dissent seemingly failed to consider that income-producing collateral like an apartment complex can be and is often valued using a discounted cash flow method where the forecasted rents are the primary determinant of the underlying collateral’s value. Consequently, the “use value” or the “time-value” is likely already a component of the property’s value. Use value does not necessarily need to be separately arrived at and then added to the underlying property value, which must be based on a different valuation method like “liquidation” or “exchange” value. Also, to give the creditor her exact non-bankruptcy “lost opportunity cost” value would mean awarding her a dollar-for-dollar increase in the secured portion of the bifurcared claim for each dollar of post-petition income minus the costs of generating that income. Also, those income-generation costs would be based on sundry assumptions about the methods of generating the income and how successful those methods would become. Replacing “lost opportunity costs” with entitlement to a dollar-for-dollar increase in the secured portion of the claim for every dollar of income generated would, in many cases, award the undersecured creditor greater rights than she enjoyed outside of bankruptcy, not equal rights. On the other hand, valuation in bankruptcy is done with myriad methods on a notoriously case-by-case basis. As one commentator pointed out, “it is impossible to say as an objective matter whether valuation standards must adhere to ‘liquidation’ versus ‘going concern’ value, or between ‘use’ or ‘exchange’ value, or whether valuations should be ex ante or ex post transaction costs.”

59 Id. ("the secured creditor is not so much deprived of a particular piece of property as he is deprived of the use of that property to obtain a certain amount of money at a certain time").

60 This valuation idea is known in some circles as the “rents are subsumed in the land” hypothesis. For more information, see R. Wilson Freyermuth, The Circus Continues-Security Interests in Rents, Congress, the Bankruptcy Courts, and the "Rents Are Subsumed in the Land" Hypothesis, 6 J. Bankr. L. & Prac. 115, 121 (1997).

61 Carlson, supra note __, at 64.
The *Timbers* dissent would have held that undersecured creditors were entitled to adequate protection of their lost opportunity costs, but what is a lost opportunity cost and how does one place a value on it? Lost opportunity cost valuation would depend on the contours of state foreclosure law. As one commentator has said in the personal property context, “Using state law transaction costs to define value is consistent with imagining what would have happened had no bankruptcy occurred, but this approach denies the reality of the bankruptcy proceeding itself where the trustee’s sales expense is sure to be higher than article 9’s cheap self-help remedies.”62 Estimated state law sales expenses are just one of the many assumptions that “imagining what would have happened had no bankruptcy occurred” would entail. The *Timbers* dissent seemingly viewed “what would have happened had no bankruptcy occurred” as the cardinal bankruptcy valuation principle. The majority in the Fifth Circuit *en banc Timbers* opinion, meanwhile, viewed valuation more flexibly. See Part IV(G)(ii) of this Article for more on this point.

While the *Timbers* dissent’s “what would have happened had no bankruptcy occurred” guiding valuation principle likely sounded better in theory than in practice, the *Timbers* dissent did make a compelling public policy argument for the position. Allowing “lost opportunity costs,” whatever they are, would produce a “social gain” by “render[ing] bankruptcy more expeditious” and “facilitating the transfer of assets from nonproductive to productive ventures” primarily by driving hopeless yet starry-eyed debtors into liquidation before they have an opportunity to consume what little going-concern surplus they have, suffer piecemeal foreclosures, and even potentially siphon off cash and assets illegally.63 The dissent seemed to identify a real problem, citing empirical reports claiming that over 90% of Chapter 11 cases

62 *Id.* at 104.
63 *In re Timbers of Inwood Forest Assocs.*, 808 F.2d at 383.
ended in liquidation or a reorganization plan that called for asset liquidation. According to the dissent:

“The objective candidate for a successful Chapter 11 reorganization is not hard to describe: it has some cash and a decent cash flow, encumbered or not; it has at least some lines of business that are profitable or nearly so; it has good management; and it is not facing a disastrous economic forecast in all of its markets.”

In other words, a viable reorganization candidate should have the unencumbered resources necessary to finance its own reorganization. Otherwise, the reorganization will likely delay the inevitable and will certainly increase the cost of capital. The *Timbers* dissent viewed the *Timbers* single-asset real estate debtor as not only starry-eyed, but also as a potential bad faith filer. The dissent cited another Judge Jones opinion that described the quintessential bad faith filer as follows:

Several, but not all, of the following conditions usually exist. The debtor has one asset, such as a tract of undeveloped or developed real property. The secured creditors' liens encumber this tract. There are generally no employees except for the principals, little or no cash flow, and no available sources of income to sustain a plan of reorganization or to make adequate protection payments pursuant to 11 U.S.C. §§ 361, 362(d)(1), 363(e), or 364(d)(1). Typically, there are only a few, if any, unsecured creditors whose claims are relatively small. The property has usually been posted for foreclosure because of arrearages on the debt and the debtor has been unsuccessful in defending actions against the foreclosure in state court. Alternatively, the debtor and one creditor may have proceeded to a stand-still in state court litigation, and the debtor has lost or has been required to post a bond which it cannot afford. Bankruptcy offers the only possibility of forestalling loss of the property. There are sometimes allegations of wrongdoing by the debtor or its principals. The “new debtor syndrome,” in which a

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64 *Id.* at 382.
65 *Id.* at 383.
one-asset entity has been created or revitalized on the eve of foreclosure to isolate the insolvent property and its creditors, exemplifies, although it does not uniquely categorize, bad faith cases.66

The dissent described *Timbers* as one of a “horde of hopeless bankruptcy cases in which the national reorganization policy is irrelevant.” 67 The dissent went on to point out that “Timbers has no full-time employees and no business except the rental of one unit of apartments” and that the unsecured debts were small, the mortgage holder was the only secured creditor, and, given those facts, there seemed to be nothing to reorganize.68

The Supreme Court affirmed the *en banc* opinion without dissent. While the Court did not weigh the pros and cons of the *Timbers* dissent’s public policy argument based on efficiency and capital formation considerations, the Court did address the Code’s treatment of “hopeless” cases where the “national reorganization policy” was indeed “irrelevant.” The Supreme Court said that undersecured creditors should not “face inordinate and extortionate delay if they are denied compensation for interest lost during the stay” because the debtor, after a lift-stay motion, must prove that an “effective reorganization . . . is in prospect.”69 This means, “as many lower courts . . . have properly said” that there must be “a reasonable possibility of a successful reorganization within a reasonable time.”70 So, regardless of whether the single-asset apartment complex debtor in *Timbers* was one of the “hoard of hopeless cases” referred to by the *Timbers* dissent, the Code’s remedy for hopelessness is not an entitlement to “lost opportunity costs” in the form of post-petition interest for undersecured creditors. Instead, the remedy consists of the imposition on the debtor of a burden to prove that the reorganization is not hopeless and has

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67 *Timbers*, 808 F.2d at 383.
68 Id.
70 Id. (citing Judge Randall’s *en banc* panel decision in the 5th Circuit).
reasonable prospects for success. Although a “lost opportunity cost” remedy might align with appropriate bankruptcy policy, the Code does not authorize the grant of lost opportunity costs to creditors.

iii. The Supreme Court Resolution that Answered Some Questions While Giving Birth to a Slew of New Ones

What rights did undersecured creditors have before the Bankruptcy Code of 1978 revolutionized bankruptcy law? Would depriving undersecured creditors of their right to post-petition interest constitute a dramatic departure from pre-Code practice? The Supreme Court in *Timbers* found that it was “far from clear” that undersecured creditors had an absolute right to post-petition interest before the advent of the Bankruptcy Code and that the authority on the subject was “at best divided.”71 Under pre-Code practice, the lack of an equity cushion was a reason to lift the stay.72 Consequently, undersecured creditors could, commonly, get the stay lifted, foreclose, and begin collecting cash proceeds or reinvest the sale proceeds, “thereby obtaining a kind of post-petition interest through investment.”73 As Judge Scalia pointed out in *Timbers*, however, some pre-Code cases neither allowed the undersecured creditor to foreclose nor granted post-petition interest to her.74 According to one commentator, under pre-Code practice, “Usually [undersecured creditors] received [post-petition interest] in one form or another, but sometimes [like in *Yale Express*75] they did not.”76 In cases like *In re Bermec*, where there was a “reasonable possibility of success[ful] reorganization” and the creditor was offered

71 *Id.* at 380–82.
73 *Id.*
74 *Timbers*, 484 U.S. at 380; *In re Yale Exp. Sys., Inc.*, 384 F.2d 990 (2d Cir. 1967).
75 In re Yale Exp. Sys., Inc., 384 F.2d 990 (2d Cir. 1967).
76 Carlson, *supra* note __, at 597.
payment to cover his “economic depreciation . . . so as to preserve [his] status quo,” the debtor was allowed to continue with his reorganization over the objection of his secured creditors.\(^77\)

Creativity in protecting secured creditors through means other than equity cushions developed in cases like *In re Bermec*\(^78\) and *In re Franklin Garden Apartments*.\(^79\) According to the Supreme Court in *Timbers*, the Bankruptcy Code exchanged the equity cushion requirement, if there ever was one, for the concept of adequate protection, which is more malleable and encompasses equity cushions as well as other methods of protection.

In *Timbers*, the Supreme Court readdressed obliquely the *Sexton v. Dreyfus* rules regarding post-petition interest entitlement under the Bankruptcy Act of 1898. These rules were not modified by the Chandler Act in 1938,\(^80\) and the *Timbers* Court seemed to hold that the 1978 Code did not modify them either.\(^81\) Under the new Code, undersecured creditors fall “within the general rule disallowing postpetition interest.”\(^82\) The Court went on to say that “Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors.”\(^83\) The Court then went on to cite *Vanston* (the case notorious for subjugating the *Sexton* and *Coder* exceptions to the bankruptcy court’s

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\(^{77}\) *In re Bermec Corp.*, 445 F.2d 367, 369 (2d Cir. 1971).

\(^{78}\) *Id.* (creditor protected by Chapter X trustee's payment of compensation for “economic depreciation”).

\(^{79}\) *In re Franklin Garden Apartments*, 124 F.2d 451, 452 (2d Cir. 1941) (If a plan was proposed that left the creditor in a better position, then lien-encumbered rental income could be used to pay reorganization proceeding expenses. Also, the trustee could prevent the mortgagee from remaining in possession of the apartments and rents. Thus, as long as the creditor’s status quo was preserved, the debtor could use the income. The presence of the income could serve as a protection, which would stave off foreclosure.).

\(^{80}\) See *In re Macomb Trailer Coach, Inc.*, 200 F.2d 611, 613 (6th Cir. 1952) (citing the *Sexton* and *Vanston* rules as still “settled law” under the 1938 Act); Also see Lillian E. Kraemer & Robert E. Goldenberg, *The Accrual & Payment of Interest*, CA46 ALI-ABA 433, 446 (American Law Institute Sept. 28, 1995).

\(^{81}\) *Timbers*, 484 U.S. at 373.

\(^{82}\) *Id.*

\(^{83}\) *Id.*
equitable discretion). The Court unfortunately, however, neither mentioned the *Sexton* and *Coder* exceptions nor discussed whether the 1978 Code codified them in addition to the general rule. It is likely that all of the pre-Code rules were meant to be codified subject to *Vanston* discretion and that this is what was contemplated in Section 552 of the Code when it excepts post-petition “proceeds, products, offspring, or profits” from the general cut-off of after-acquired property clauses on the petition date except to “any extent that the court . . . based on the equities of the case, orders otherwise.”

The Court’s failure to clearly address this issue, however, led to widespread divergences of opinion in the lower courts.

Whether or not undersecured creditors whose collateral produces income can use the old *Sexton* exception to apply encumbered post-petition income towards post-petition interest is still unclear after all these years since *Timbers* was decided in 1988. One reason that the issue has not been resolved since *Timbers* is that the open question over the *Sexton* exception became overshadowed by a larger dispute. After *Timbers*, one line of cases, the “addition cases” held that the creditor does not just (as in the *Sexton* exception) receive interest out of post-petition income, but rather he receives the income in full without a corresponding reduction of the secured portion of his claim. Another line of cases, the “subtraction cases,” held that post-petition income

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84 See Section II.B. of this article; Also see Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946).
paid to the creditor had to be subtracted from the secured portion of the creditor’s claim.\textsuperscript{88} So, the former line of cases would give the undersecured creditor more rights than the \textit{Sexton} exception (because the creditor would get the full amount of post-petition income rather than the amount needed to cover interest) while the latter line of cases would remove the \textit{Sexton} exception altogether. The choice became one between two extremes.

The failure of the current cases on income-producing collateral treatment for undersecured creditors to consider the impact of the \textit{Sexton} exception is disappointing. As one commentator has pointed out, “by understanding that the encumbered net rents can be used to pay interest on the secured portion of an undersecured creditor’s claim, most, if not all, of the confusion can be eliminated.”\textsuperscript{89} According to the same commentator, the statutory approach to recognizing the \textit{Sexton} exception would be to follow the addition method, rather than the subtraction method, but only to the extent that the income covers post-petition interest.\textsuperscript{90} This approach would preserve the \textit{Sexton} exception and complete the codification of pre-Code law on the subject.

\textit{Timbers}’ failure to tackle the \textit{Sexton} exception head on gave rise to confusion in the lower courts. This confusion was only exacerbated by the 1992 Supreme Court case, \textit{Dewsnup v. Timm}.\textsuperscript{91}


\textit{Dewsnup v. Timm}, a widely criticized opinion\textsuperscript{92} that, by its’ own terms, was limited to the facts of the case, contradicted \textit{Timbers} in a way that exacerbated the divide caused by \textit{Timbers}.

\textsuperscript{88} See \textit{In re Kalian}, 169 B.R. 503, 505 (Bankr. D.R.I. 1994) (explaining why the “addition method” is wrong); \textit{Also see} Lillian E. Kraemer & Robert E. Goldenberg, \textit{The Accrual & Payment of Interest}, CA46 ALI-ABA 433, 446 (American Law Institute Sept. 28, 1995) (discussing both approaches).


\textsuperscript{90} \textit{Id}.

Justice Scalia, who wrote *Timbers*, dissented vigorously in *Dewsnup*, at one point predicting that “Having taken this case to resolve uncertainty regarding one provision, we end by spawning confusion regarding scores of others.”  

In *Dewsnup*, a Chapter 7 debtor wanted to void the security interest of the holder of a mortgage on two parcels of Utah farmland to the extent that they exceeded the farmland’s judicially determined value. The creditor would then have a bifurcated claim secured for the judicial value and unsecured for the rest. The creditor balked at this and raised sundry arguments, some of which the Supreme Court accepted. After surmising that (1) freezing the creditor’s secured interest at the judicially determined valuation would unfairly deprive the creditor of the “benefit of any increase in the value of the property by the time of the foreclosure sale,” (2) the mortgagee bargained for his lien to remain with the property until foreclosure, and (3) the pre-Code practice that liens pass through bankruptcy unaffected should be continued for various reasons, the Court held that a “strip-down” in Chapter 7 in order to give effect to Section 506(a) bifurcation is not allowed. The result of *Dewsnup* is that, after liquidation, secured creditors’ liens survive the discharge. The secured creditor may proceed against the collateral. The debt, however, which is covered by the discharge, does not need to be repaid. The *Dewsnup* Court explained that the bankruptcy discharge extinguishes only *in personam* actions against the debtor, but leaves *in rem* actions unaffected.

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92 In re Talbert, 344 F.3d 555, 561 (6th Cir. 2003) (“the Court's opinion has not escaped scholarly criticism, see Cunningham, 246 B.R. at 246 (compiling law review articles that have criticized the *Dewsnup* decision”).
93 Id. at 436.
94 See 11 U.S.C.A. § 506(a), 506(d) (laying out the concept of claim bifurcation).
95 *Dewsnup*, 502 U.S. at 417–18.
97 *Dewsnup*, 502 U.S. at 418 n.4 (the 1898 Act stated that “liens . . . shall not be affected by this Act” and when the Chandler Act removed this language, the alteration had no substantive effect).
Dewsnup was expressly limited to the facts in front of the Court.\textsuperscript{98} The Dewsnup Court all but admitted that it had selected an inferior method of statutory interpretation because it felt that the plain meaning result was not “plausible,” that the 1978 Code was not written on a “clean slate,” and that the approach that it decided on just happened to be “generally the better of the several approaches.”\textsuperscript{99} Given the large amount of equivocation in Justice Blackmun’s opinion, Dewsnup should only be relied on with a high degree of hesitation.

Still, if Dewsnup stood for the proposition that the Code continued practices under the Act even if some violence must be applied to the Code’s language to do so, then a fortiori it would seem that the Sexton rule regarding post-petition interest and undersecured creditors should be continued.

Dewsnup’s exacerbation of the post-Timbers confusion surrounding post-petition income treatment for undersecured creditors was probably unanticipated. Dewsnup was, of course, a Chapter 7 liquidation case with a holding that was equivocal at best. Still, Dewsnup was seen by some courts as having conclusively resolved the question of when to value the underlying collateral for bifurcation purposes.\textsuperscript{100} A raucous debate had broken out in the bankruptcy courts over whether the secured portion of the undersecured creditor’s bifurcated claim should be valued as of the petition date or as of the confirmation date. The petition date courts refused to allow undersecured creditors to increase their claim due to post-petition income, while the confirmation date courts allowed the increase. Dewsnup’s authors likely had no idea that their opinion, which was meant to be limited to liquidation under Chapter 7 and the other facts of the

\textsuperscript{98} Id. at 416–17 (“We therefore focus on the case before us and allow other facts to await their legal resolution on another day”).

\textsuperscript{99} Id. at 417.

\textsuperscript{100} In re Bloomingdale Partners, 160 B.R. 93, 97 (Bankr. N.D. Ill. 1993) (“Therefore, the debate over valuation timing has been decided by Dewsnup in favor of the effective date of confirmation.”).
particular case before the Court, would have such a profound impact on the debate over post-petition income treatment for undersecured creditors.

III. The Post Timbers and Dewsnup Divide

*Timbers* had said that after bifurcation, the proportion of the undersecured creditor’s bifurcated claim that was secured was not supposed to increase due to the use value that the creditor lost as the case dragged on.101 *Timbers* also pointed out that the “value of such creditor’s interest” in Section 506(a) was synonymous with “the value of the collateral.”102 Some courts interpreted these statements to mean that the bifurcated value is fixed as of the petition date.103 Courts then took *Timbers* a step further to say that, under *Timbers*, the allowed secured claim is “strictly limited to the value of the property securing the debt” determined as of the petition date.104 From this, it became “the rule of *Timbers* that undersecured creditors are not entitled to improve their position relative to other creditors during the pendency of the bankruptcy.”105 This “rule” came to be known as the “single-valuation” approach106 to valuing an undersecured creditor’s claim. The subtraction cases, implemented the single valuation approach. The “rule” however, potentially took stray language from *Timbers* farther than that language was meant to

101 *Timbers*, 484 U.S. at 372.
102 *Id.* (citing to relevant legislative history).
104 *Id.*
106 The following cases may or may not use the term “single valuation,” (the approach later came to be known by the term) but they all apply the *Timbers* analysis in an expansive, aphoristic way that reaches a single valuation result. These cases are also known as the “subtraction” cases because they hold that post-petition rents paid over to the creditor during the bankruptcy must be subtracted from the secured portion of the creditor’s claim: Confederation Life Ins. Co. v. Beau Rivage Ltd., 126 B.R. 632, 640–41 (N.D. Ga. 1991); In re Kalian, 169 B.R. 503, 505 (Bankr. D.R.I. 1994); In re Oaks Partners, Ltd., 135 B.R. 440, 450 (Bankr. N.D. Ga. 1991); In re Reddington/Sunarrow Ltd. P’ship, 119 B.R. 809, 813 (Bankr. D.N.M. 1990).
go. Consequently, many courts (namely, the addition cases discussed *supra*) rejected the single valuation rule.\textsuperscript{107}

*In re Reddington/Sunarrow* seems to be the seminal case for the single valuation approach.\textsuperscript{108} Numerous courts adopted the approach, likely because of its consistency with *Timbers*.\textsuperscript{109} A critic has attacked this approach saying that “If the valuation is final, then this bifurcation essentially disencumbers the income stream [*i.e.*, the post-petition rental income].”\textsuperscript{110} Whether the income stream is encumbered to begin with is another issue.\textsuperscript{111}

This alternative to the *Reddington/Sunarrow* approach became known as the “return-of-collateral” approach.\textsuperscript{112} Courts adhering to this approach typically say that the “single valuation” approach “interprets *Timbers* too broadly and reads § 552(b) out of the code.”\textsuperscript{113} The reasoning goes something like this. Under § 552(b) rents are treated as additional collateral. Treating them as pre-payments of the secured portion of the undersecured creditor’s claim eviscerates the purpose of § 552(b). Instead, the rents must be treated as additional collateral and must increase the secured creditor’s claim. One court went as far as to say that “Not counting [the undersecured


\textsuperscript{108} Reddington/Sunarrow Ltd. P’ship, 119 B.R. at 813.

\textsuperscript{109} In re Trenton Ridge Investors, LLC, 461 B.R. 440, 481 (Bankr. S.D. Ohio 2011) (“the Court believes that the most reasonable interpretation of the orders is that PNC could apply the net rents it received in a manner consistent with the Bankruptcy Code [*i.e.*, in these cases, to principal or real estate taxes, not to interest]”); In re Reddington/Sunarrow Ltd. P’ship, 119 B.R. 809, 813 (Bankr. D.N.M. 1990) (“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.”); Matter of IPC Atlanta Ltd. P’ship, 142 B.R. 547, 558 (Bankr. N.D. Ga. 1992); Confederation Life Ins. Co. v. Beau Rivage Ltd., 126 B.R. 632, 639 (N.D. Ga. 1991); In re Oaks Partners, Ltd., 135 B.R. 440, 451 (Bankr. N.D. Ga. 1991); Matter of IPC Atlanta Ltd. P’ship, 142 B.R. 547, 558 (Bankr. N.D. Ga. 1992); Confederation Life Ins. Co. v. Beau Rivage Ltd., 126 B.R. 632, 639 (N.D. Ga. 1991); In re Oaks Partners, Ltd., 135 B.R. 440, 451 (Bankr. N.D. Ga. 1991);


\textsuperscript{111} See *In re Addison Properties*, 185 B.R. at 774 (Saying that under *Timbers*, §552(b) only ensures that rents are made available to satisfy the secured claim, not that rents must increase the secured claim or that rents are to be valued separately and added to the secured claim value).

\textsuperscript{112} Averch, Berryman, & Collins, *supra* note __, at 703–04.

creditor’s] security interest in rents would render § 552(b) a ‘practical nullity and theoretical absurdity.’” Also, courts taking this approach often quote *Timbers*, saying,

Section 552(b) therefore makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfy the claim of the secured creditor ahead of the claims of unsecured creditors.115

From this quote, the courts extract the idea that *Timbers* mandates that post-petition rents must increase the creditor’s secured claim. As one court pointed out, however, “Timbers says no such thing. Rather, without commenting on how a secured creditor’s claim is valued, *Timbers* simply states that Section 552(b) results in proceeds or rents being made available to satisfy that claim.”116

The return-of-collateral approach garnered almost as much support as the “single valuation” approach.117 The two approaches were diametrically opposed, however, since one favored the creditor while the other favored the debtor.

Under the return-of-collateral approach, the secured portion of the undersecured creditor’s claim is not reduced at all during bankruptcy.118 Any payments made either reduce the creditor’s overall claim, but not the secured portion of the claim, or are treated as if they were held in escrow by the creditor until confirmation at which point the court reevaluates the

116 *Addison Properties*, 185 B.R. at 774.
118 *Addison Properties*, 185 B.R. at 777.
situation. Courts have analogized the way that the income is treated to the way that appreciation would be treated.

In a commendably thorough 1995 case, *In re Addison Properties*, the bankruptcy court analyzed current case law on encumbered post-petition income treatment for undersecured creditors and attempted to strike a compromise between the extremes. The court did not address the effect of the *Sexton* exception on post-petition income treatment, but instead, analyzed the addition and subtraction cases in terms of the way that they valued the undersecured creditor’s interest. Then, the court announced a taxonomy for the different methods. “Single valuation” represented the subtraction method. “Continuous valuation” represented the addition method. Finally, the court announced its’ own middle-of-the-road method called “dual valuation.” *Addison Properties* talked not about post-petition interest entitlement as a matter of right under the law, but rather about the best and most practical way to value the secured creditor’s interest. *Addison Properties*’ dual valuation approach would grant post-petition interest to undersecured creditors, but only to the extent that their claim on the petition date, plus cash proceeds generated during bankruptcy, minus administrative expenses exceeded the total prepetition claim amount. The following table illustrates the various approaches as summarized by the *Addison Properties* court:

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119 *Id.*
120 *Id.*
121 *Id.* at 766.
<table>
<thead>
<tr>
<th>Valuation Approach</th>
<th>Bifurcation Method</th>
<th>Dates Used for Valuation</th>
<th>Brief Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Valuation</td>
<td>Subtraction method</td>
<td>Undersecured creditor’s secured interest valued as of the petition date</td>
<td>The property is valued as of the petition date. The claim is bifurcated. That bifurcation remains fixed throughout the proceedings. Post-petition income paid to the undersecured creditor reduces the secured portion of his claim.</td>
</tr>
<tr>
<td>Continuous Valuation</td>
<td>Addition method, a.k.a., the return-of-capital approach</td>
<td>Undersecured Creditor’s secured interest valued as of the confirmation date</td>
<td>The claim is still bifurcated as of the petition date, but the secured portion of the claim increases every time income is generated.</td>
</tr>
<tr>
<td>Dual Valuation</td>
<td>Addition method, a.k.a., the return of capital approach</td>
<td>Undersecured creditor’s secured interest valued as of the petition date solely for adequate protection purposes and as of the confirmation date for all other purposes</td>
<td>Under this method, the debtor only has to provide adequate protection on the initial bifurcated amount, but at confirmation, the creditor’s secured claim will be valued by adding the income generated during the bankruptcy to the value of the underlying collateral.</td>
</tr>
</tbody>
</table>

To confuse matters further, the “addition method” was also known in other circles as the “return of capital” approach. The method was called the “return of capital approach” because the courts employing it generally saw post-petition income as a “separate and distinct item of collateral, apart from the underlying real estate which also secures the creditor’s claims and which generates such rents.” In one case, the court said that under state law, the undersecured creditor owned the rents generated post-petition and, consequently, the rents constituted a property interest that was “quite apart from any consideration of the value of the [underlying] Property.” Comparing non-bankruptcy law to bankruptcy law in order to interpret rights in

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123 In re Vermont, 142 B.R. at 574.
124 In re Union Meeting Partners, 178 B.R. at 677.
bankruptcy is problematic for several reasons. These reasons are explored in Part IV(A)(ii) of this Article.


The court determined that while the formulaic approach developed in *Addison Properties* may be the best formula that rigid adherence to formula conflicts with the Code’s grant of equitable discretion to the bankruptcy court.

The flexible approach to valuation was recently adopted in *In re SW Boston Hotel Venture*, making it the law in the Fifth and First Circuits. At a minimum, this means that bankruptcy courts must do more than state the approach adopted (single valuation, dual valuation, continuous valuation, etcetera). Instead, the court should look at the facts and balance the equities. Further judicial development in this area of the law could come in the form of crafting and adoption of a non-exclusive factor test to analyze. Promulgation of such tests in judicial opinions could allow bankruptcy courts across the country to compare notes and work toward consensus that will help future litigants, courts, and legislators because adoption of a particular valuation method, in light of the “flexible approach,” will likely need to come from Congress.

*Matter of T-H New Orleans* did not address the *Sexton* exception and the divide between the addition and subtraction cases because “that issue was not raised on appeal.” Instead,
Matter of T-H New Orleans and In re SW Boston Hotel Venture continued the modern trend of addressing income-producing collateral treatment for undersecured creditors not by examining the extent to which the Code continued pre-Code practice regarding post-petition interest entitlement, but instead, by disposing of the issues solely with a discussion of valuation methodology.

Dewsnup was seen by some courts as a tacit adoption of the “return-of-capital” approach.129 Dewsnup, however, did not actually address the issue and any inference drawn from Dewsnup that mandates adoption of the “return-of-capital” approach is equivocal at best.130 Furthermore, Dewsnup’s author explicitly warned against drawing exactly the sort of inference drawn by courts adopting the return-of-capital approach when he said, “Hypothetical applications . . . advanced at oral argument illustrate the difficulty of interpreting the statute in a single opinion that would apply to all possible fact situations. We therefore focus upon the case before us and allow other facts to await their legal resolution on another day.”131 For better or worse, Dewsnup seemed to turn the momentum among bankruptcy courts in favor of the “return-of-capital” approach;132 however, in the wake of Dewsnup, the “single valuation” approach remained strong.133

A. In re Scopac

As discussed above, the “return of capital approach” garnered its name because the courts employing it generally saw post-petition income for undersecured creditors as a “separate and

130 See Addison Properties, 185 B.R. at 774 (explaining the core holding of Dewsnup and giving a detailed explanation for why the Dewsnup holding could not reasonably be expanded to address post-petition rent treatment).  
131 Dewsnup, 502 U.S. at 417.  
132 Averch, Berryman, & Collins, 48 U. Miami L. Rev. at 703 n. 87 (stating that in the mid-1990s, the “recent trend” was the “return of collateral” approach.) (also, citing to various cases, most of which relied heavily on Dewsnup).  
distinct item of collateral, apart from the underlying real estate which also secures the creditor’s claims and which generates such rents.”134 This idea, the separate-and-distinct-item-of-collateral theory, persevered, showing up most recently in the case of In re Scopac.135 In re Scopac is an interesting case because it is authored by Judge Edith H. Jones, the same judge who penned the vigorous Timbers of Inwood Forest dissent in the Fifth Circuit’s en banc review of the case.136 Furthermore, Judge Jones has special credibility and authority in the area of bankruptcy law and policy due to her work on the commission tasked by Congress in the mid-1990s with conducting “an exhaustive review of the nation’s bankruptcy laws.”137

Scopac dealt with a company that grew, harvested, and processed redwood timber.138 The Fifth Circuit interpreted the cash collateral order in the case as bestowing two protections on the undersecured creditors: (1) protection against diminution in the value of the cash collateral existing at the date of filing, and (2) the grant of a continuing lien on the proceeds of the prepetition collateral.139 Consequently, once Scopac sold timber, the proceeds became cash collateral. Because the proceeds became cash collateral, the cash collateral order (as interpreted by the Fifth Circuit) granted those proceeds to the secured creditor.140 Consequently, the creditors were guaranteed to receive the petition date value of the cash collateral and were also guaranteed to receive gross revenues from timber sales from that point on. Essentially, the Fifth Circuit interpreted the cash collateral orders as mandating application of the separate-and-distinct-item-of-collateral theory.

134 In re Vermont, 142 B.R. at 574.
135 In re Scopac, 624 F.3d 274, 284 (5th Cir. 2010) opinion modified on other grounds, 649 F.3d 320 (5th Cir. 2011).
136 Id.; Timbers of Inwood Forest, 808 F.2d 363.
137 SKEEL, supra note __, at 197–98.
138 In re Pac. Lumber Co., 584 F.3d 229, 236 (5th Cir. 2009) (affirming, in large part, the plan confirmation order in the case).
139 Scopac, 624 F.3d at 278.
140 Id.
The main message in *Scopac* seems to be the emphasis of a familiar aphorism, “the debtor cannot make secured creditors pay for the reorganization.”¹⁴¹ The message, however, runs counter to what the Supreme Court said in *Timbers of Inwood Forest*.¹⁴² No amount of stray language from *Dewsnup* can change *Timbers* to revive the unwieldy platitude that “the debtor cannot make secured creditors pay for the reorganization.”¹⁴³ Under the holding of *In re Stembridge*, Scopac’s undersecured creditors were, unarguably, protected from any downside once the bankruptcy case was filed because the creditors were entitled to have their security interest valued as of the filing date and then protected against any subsequent declines in value by adequate protection measures.¹⁴⁴ The flexible approach allows for a later valuation date than the *Stembridge* date (the petition date) for purposes of Section 506(b) interest if an undersecured creditor moves for a secured status redetermination.¹⁴⁵

The *Scopac* decision held that the bankruptcy court committed “clear error”¹⁴⁶ apparently by either (a) misinterpreting its own cash collateral order, or (b) by failing to apply the separate-and-distinct-item-of-collateral theory. Assuming that the bankruptcy court could read its own orders, the Scopac decision abrogated the bankruptcy court’s equitable discretion. The case, then, should have either been remanded for a Section 552 “equities of the case” decision or the bankruptcy court’s determination should have been upheld because the bankruptcy court’s Section 552 decision would have been implied in the bankruptcy court’s resolution of the case.¹⁴⁷

¹⁴¹ In re Franklin Garden Apartments, 124 F.2d 451, 452 (2d Cir. 1941).
¹⁴² *Timbers of Inwood Forest*, 484 U.S. at 373, 379–80 (1988) (the Bankruptcy Code consciously allocates reorganization benefits and losses between undersecured and unsecured creditors, *i.e.*, as between undersecured and unsecured creditors, undersecured creditors do not always or even generally win) (furthermore, generalizations such as “[s]ecured creditors should not be deprived of the benefit of their bargain” cannot overcome textual indication to the contrary impacting rights of undersecured creditors).
¹⁴³ *Addison Properties*, 185 B.R. at 774.
¹⁴⁴ In re *Stembridge*, 394 F.3d 383, 387 (5th Cir. 2004).
¹⁴⁶ *Scopac*, 624 F.3d at 285 (“This was clear error.”).
i. The Separate-and-Distinct-Item-of-Collateral Theory is Incompatible with the Flexible Approach and Conflicts With the Discretion Granted to the Bankruptcy Court by Section 552 of the Bankruptcy Code

Courts applying the “flexible approach” should not use the separate-and-distinct-item-of-collateral theory. The theory’s application inevitably results in continuous valuation in contravention of the flexible approach. In the Fifth and First Circuits, bankruptcy courts must follow the “flexible approach,”148 which means that they cannot apply continuous valuation exclusively without considering the equities of the case.

Continuous valuation can, depending on the circumstances, give the secured creditor “greater protection than it would have had, through foreclosure, in the absence of a bankruptcy.”149 As discussed in the next section of this Article, no analogy of a bankruptcy case to what would have happened “in the absence of a bankruptcy” works perfectly and the analogy rarely even works well. These what-would-have-happened-without-a-bankruptcy analogies rarely provide valuable insight. Instead, the focus of the inquiry should rest on whether the approach employed would result in a windfall to the debtor or to the creditor. If single valuation would result in a windfall to the debtor or if continuous valuation would result in a windfall to the creditor, then a middle-of-the-road approach should apply. Theories like the separate-and-distinct-item-of-collateral theory cannot resolve disputes over what result the “equities of the case”150 demand.

Unfortunately, the flexible approach, in giving effect to the Bankruptcy Code’s mandate to consider the “equities of the case,”151 creates a striking lack of clarity. Rather than clear rules

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149 Addison Properties, 185 B.R. at 783.
151 Id.
governing who owns what item of collateral, the analysis descends into factual litigation over valuation methodology. Valuation is a quintessential factual, as opposed to legal, inquiry and under the Bankruptcy Code is to be done “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 disposition or use or on a plan affecting such creditor’s interest.” In bankruptcy, the undersecured creditor owns a bifurcared Section 506 claim as defined by the Bankruptcy Code, rather than a right to compel the application of the value of the collateral to payment of the debt, which is traditionally the ultimate right that security interests are thought to convey.

The myriad of contractual arrangements that have cropped up in recent years have, to some extent, blurred the traditional lines between debtor and creditor. If a creditor takes sufficient control of a debtor, then it can be treated as the debtor’s principal, and held responsible for the debtor’s actions. The layperson understanding of what it means to be a debtor likely contemplates one whose business management expertise is put to use to employ diverse resources in a profitable way. Furthermore, secured creditors have an interest in discrete items of resources used, but employ little or no managerial expertise in creating profits. Creditors are compensated through fixed rights that are readily calculable like interest. Finally, the benefits of

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152 Bankruptcy Code § 506(a)(1).
154 Douglas G. Baird & Robert K. Rasmussen, Antibankruptcy, 119 Yale L.J. 648, 651 (due to financial innovation, the interested parties in a large reorganization no longer “bargain[] with each other against a backdrop of well-developed norms” because “[d]ozens of contrarily changing stakeholders occupy every tranche, each pursuing its own agenda” and these stakeholders often “hold a basket of both long and short positions in multiple tranches and complicated hedges involving other businesses”).
155 Restatement (Second) of Agency § 14O (1958) (“A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business.”); Jeremy W. Dickens, Equitable Subordination and Analogous Theories of Lender Liability: Toward A New Model of ''Control'', 65 TEX. L. REV. 801, 802 (1987).
skilled management should accrue to the debtor, not to the creditor. The reason goes all the way back to Lockean Labor Theory.

Some items of collateral, however, generate income so passively and with such minimal managerial expertise or other input that the debtor has hardly contributed anything toward the income-generation. If people own their labor and the products of their labor and if the key difference between debt and equity is that equity involves sharing the products of labor, often joint labor, whereas debt involves merely the transfer in advance of passive or mostly passive income, then those traditional notions of debtor/creditor roles should influence equitable outcomes. The line between what constitutes wholly passive income that the creditor deserves and actively-generated income that the debtor should accede to due to the debtor’s labor input, however, remains a moving, facts-and-circumstances-dependent target.

As one commentator purportedly said:

[...]f you have a $100,000 debt secured by a genuine Fred Jones sculpture worth $50,000 at the time of filing and Fred then helpfully dies, making the sculpture worth $125,000, none of us would doubt that your secured claim is now oversecured. Why not the same result when your $50 goose lays a $100,000 egg? And if

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156 See JESSE DUKE MINIER & JAMES E. KRIER, PROPERTY 15 (5th ed. 2002) (paraphrasing JOHN LOCKE, TWO TREATISES OF GOVERNMENT, Book II, Ch. V. (c. 1690)) (“Though the earth and all inferior creatures be common to all men, yet every man has a property in his own person. This nobody has any right to but himself. The labor of his body, and the work of his hands, we may say, are properly his. Whatsoever then he removes out of the state that nature has provided, and left it in, he has mixed his labor with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature placed it in, has by this labor something annexed to it, that excludes the common right of other men. For this labor being the unquestionable property of the laborer, no man but he can have a right to what that is once joined to, at least where there is enough, and as good left in common for others.”).

157 Id.

158 Id.

159 See, e.g., In re Cafeteria Operators, L.P., 299 B.R. 400, 405 (Bankr. N.D. Tex. 2003) (“From a plain reading of § 552, revenues generated post-petition solely as a result of the debtor's labor are not subject to a pre-petition lender's security interest.”); In re Delbridge, 61 B.R. 484, 489–90 (Bankr. E.D. Mich. 1986) (“Just as the answer to the question of whether the cup is half empty or half full is yes, the question of whether milk is produced by the cow or the farmer is yes. Neither is wrong.”); In re Gunnison Ctr. Apartments, LP, 320 B.R. 391, 398 (Bankr. D. Colo. 2005) (“It is clear in this case that there would be no proceeds to fight over if the property is not operated.” Still, the Gunnison court gave apartment complex rents to the secured creditor yet allowed the debtor to deduct operating expenses.).
that is true, why not the proceeds of lotsa ordinary eggs? Or rents?\textsuperscript{160}

Why, however, should only the undersecured creditor or only the debtor accrue the benefits of accumulating post-petition income? The debtor must protect the creditor from any downside through adequate protection.\textsuperscript{161} Who deserves the upside, however, should remain debatable. Assumedly, the debtor deserves the upside generally since the debtor’s efforts caused the upside, or at least significantly influenced the upside’s creation. The creditor only generally deserves the upside when the upside is so pronouncedly passive that generation of the upside can have little to do with the debtor’s time, toil, and effort. These tradeoffs that are inherent in the traditional understanding of the debtor/creditor relationship are explored and discussed in proceeds-or-not-proceeds cases like \textit{In re Cafeteria Operators}, \textit{In re Delbridge}, \textit{In re Gunnison Center Apartments}, and others.\textsuperscript{162} Discussions about the nature of the debtor/creditor relationship, like the discussions found in the foregoing cases, belong in Bankruptcy Court decisions that deal with the treatment of income from income-producing collateral for undersecured creditors during bankruptcy proceedings. Such discussion is virtually mandated by the Bankruptcy Code’s language when it says that security interests can continue in debtor’s property acquired after the petition date “unless the court . . . based on the equities of the case . . . orders otherwise.”\textsuperscript{163}

When Congress granted bankruptcy courts discretion with the “unless the court . . . orders otherwise”\textsuperscript{164} language, Congress did not leave bankruptcy courts to write on an blank slate. Instead, Congress said that (a) undersecured creditors get no security in debtor’s property that is

\textsuperscript{160} Averch, Berryman, & Collins, \textit{supra} note __, at 703 n. 88.
\textsuperscript{161} 11 U.S.C.A. § 362–64.
\textsuperscript{163} 11 U.S.C.A. § 552(b).
\textsuperscript{164} \textit{Id.}
acquired after the petition date unless the property is proceeds, products, offspring, profits, rents,\textsuperscript{165} or payments or use or occupancy of lodging properties, (b) even if the property is proceeds, products, offspring, profits, rents, or payments for use or occupancy of lodging properties, the bankruptcy court retains ultimate discretion over whether the creditor gets security in the after-acquired property, and finally (c) if the property is some form of income, but not proceeds, products, offspring, profits, rents, or payments for use or occupancy of lodging properties, then in such case and only in such case, does the bankruptcy court lack discretion over the issue, and in such case the court must find that the creditor lacks security.\textsuperscript{166} A case like Scopac needs a Delbridge/Cafeteria Operators/Gunnison Center-style discussion of the nature of the debtor/creditor relationship and whether the timber sales properly constitute “proceeds” of the timber or whether the debtor has invested too much service, material, and effort in processing the timber for sale for the timber sales to be considered a mere distribution of the creditor’s substantially-unmodified collateral. In other words, are the sales mostly the product of the debtor’s labor or was the debtor’s labor mostly negligible in generating the sales? The discussion in a case like Scopac must go farther, however, than the discussion in a case like Delbridge, Cafeteria Operators, or Gunnison Center because the proceeds-or-not-proceeds issue is not black-or-white in bankruptcy court like it is in state court under UCC Article 9. Instead, the issue is multiple shades of grey because the issue is only black or white to the extent that the bankruptcy court does not “order otherwise.”\textsuperscript{167} The Fifth Circuit, sitting as a court of appeal, in

\textsuperscript{165} A discussion of how rent treatment has evolved including comments on the 1994 legislation amending Section 552(b), while germane to the issue of how income from income-producing collateral is treated in bankruptcy for undersecured creditors, is beyond the scope of this article. Still, for more information, see R. Wilson Freyermuth, The Circus Continues-Security Interests in Rents, Congress, the Bankruptcy Courts, and the “Rents Are Subsumed in the Land” Hypothesis, 6 J. Bankr. L. & Prac. 115, 117 (1997); David Gray Carlson, Rents in Bankruptcy, 46 S.C. L. Rev. 1075, 1145 (1995).

\textsuperscript{166} Id.

\textsuperscript{167} Id.
In re Scopac, seemed to come dangerously close to usurping the bankruptcy court’s congressionally-granted equitable discretion.

**ii. Who really does deserve the income generated during bankruptcy from secured collateral—the debtor or the undersecured creditor?**

In Dewsnup, the Supreme Court said that, within the special circumstances of the case, post-petition appreciation “rightly accrues” to the creditor.\(^{168}\) Dewsnup offers virtually no reasoning for this bold assertion, which makes application of the Dewsnup principle difficult if not impossible. Instead, Dewsnup expressly purported to limit itself to its own facts and it expressly did so because it was a liquidation case with unique circumstances.\(^ {169}\) Courts have subsequently warned against applying Dewsnup’s adage to reorganization proceedings.\(^ {170}\) Furthermore, as discussed above in Section IV(A)(i), the Dewsnup principle, if it belongs anywhere, does not belong in reorganization proceedings when dealing with the treatment of income from income-producing collateral for an undersecured creditor with a bifurcated Section 552 claim. Section 552 in no way allows a court to say, “When in doubt, give it to the creditor.”

Despite the Dewsnup principle’s conspicuous flaws, courts have cited Dewsnup when allowing creditors, even undersecured creditors, to capture the benefit of post-petition appreciation by including such value in a re-appraisal later on in the proceedings.\(^ {171}\) Consequently, in bankruptcy, undersecured creditors may receive downside protection and still capture upside benefit. In other words, they may have their cake and eat it. Imagining why an

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\(^{168}\) Dewsnup, 502 U.S. at 417.  
\(^{169}\) Id.  
\(^{170}\) In re Addison Properties Ltd. P’ship, 185 B.R. 766, 774 (Bankr. N.D. Ill. 1995).  
\(^{171}\) Id. at 784.
“obstreperous and thoroughly unharmed creditor” deserves upside benefit with downside protection is difficult.\textsuperscript{172}

The debate over who should benefit from upside value in bankruptcy rages on.\textsuperscript{173} The “flexible approach” does not go far toward resolving the issue, at least in a bright-line way.\textsuperscript{174}

The “flexible approach” should mean that the answer to the question, “Does post-petition income and appreciation accrue to the benefit of the creditor or to the debtor?” should, in large part, be that the answer depends on analysis of whether the income or appreciation arose primarily due to the debtor’s post-petition labor or primarily due to passive accumulation. This requires an analysis similar to the analysis done in the proceeds cases.\textsuperscript{175} However, in bankruptcy, due to the equities-of-the-case rule,\textsuperscript{176} neither the debtor nor the undersecured creditor must get all-or-nothing. Instead of fighting over single valuation, dual valuation, and continuous valuation, bankruptcy courts should analyze whether post-petition income or appreciation results from the debtor’s labor or from wholly passive accumulation and award the benefit accordingly. Over time, trends will form, Congress will tweak those trends, and our English system of law production will work. Eventually, we will have more than just an “equities of the case” rule coupled with three very different and hopelessly conflicting valuation methodologies. The “flexible approach” moves in this direction. It moves away from rigid valuation methods and toward more particular-facts-and-circumstances-driven analysis.

This view of the flexible approach comports with \textit{Timbers of Inwood Forest}. Under \textit{Timbers}, bankruptcy law represents a “conscious allocation of reorganization benefits and losses

\textsuperscript{172} \textit{Timbers of Inwood Forest}, 484 U.S. at 375.
\textsuperscript{173} \textit{See id.} (summarizing the various positions and reasoning behind each).
\textsuperscript{174} \textit{Matter of T-H New Orleans Ltd. P’ship}, 116 F.3d 790, 798 (5th Cir. 1997) (The court said “we reject the single valuation approach \textit{under the particular facts of this case}.” In other words, valuation rules for purposes of determining post-petition interest entitlement under Section 506(b) remain distinct from valuation rules for purposes of determining whether post-petition income and appreciation will accrue to the debtor’s or to the creditor’s benefit).
\textsuperscript{175} \textit{Cafeteria Operators}, 299 B.R. 400; \textit{Delbridge}, 61 B.R. 484; \textit{Gunnison Center}, 320 B.R. 391.
\textsuperscript{176} 11 U.S.C.A. § 552.
between undesecured and unsecured creditors.” This “conscious allocation” sounds at first blush like an endorsement of the Warren theory of bankruptcy policy over the Baird theory. An abstract policy discussion, however, goes beyond the scope of this article. Still, undersecured creditors have, since Vanston, been treated like a hybrid class of creditors entitled to neither the solid property-like rights of fully secured creditors, nor the weak whatever-scraps-are-left-over rights of fully unsecured creditors. Therefore, striking a fact-specific middle ground for undersecured creditors does not revolutionize bankruptcy law. The novel approach would be to adopt a hard-and-fast valuation methodology that determines results without analysis of the individual circumstances of the case.

ii. The Separate-and-Distinct-Item-of-Collateral Theory Relies on the Problematic Analogy to What Would Have Happened if no Bankruptcy Occurred

As one commentator pointed out, “the values derived by bankruptcy courts are not objective or even subjective facts. Rather, they are subjunctive facts—facts that can be assessed only contingently in the context of a hypothetical universe which can never be.” The separate-and-distinct-item-of-collateral theory derives a great deal of its appeal from the idea that it gives effect to what would have happened if no bankruptcy had disrupted the relations of the parties.

177 Timbers of Inwood Forest, 484 U.S. at 373.
178 Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 777 (1987) (“I see bankruptcy as an attempt to reckon with a debtor’s multiple defaults and to distribute the consequences among a number of different actors.” “According to Baird, the only goal of bankruptcy is to enhance the collection efforts of creditors with state-defined property rights.”).
180 Timbers of Inwood Forest, 484 U.S. at 373.
Even if one accepts that because normally a secured creditor’s rights in collateral are defined by state law that bankruptcy cannot, or should not, alter those rights, then how far those rights extend in bankruptcy is nearly impossible to determine.

For example, inside bankruptcy the debtor is continually monitored while outside bankruptcy a one-time seizure of the collateral occurs, unless some kind of state law receivership is set up. Outside bankruptcy, under Article 9 of the Uniform Commercial Code (“UCC”), security interests extend broadly to original collateral and to any proceeds of such collateral.  

However, Section 9-332 of the UCC generally cuts off security interests as soon as the debtor converts collateral to money, and then spends such money. The broad proceeds rule is further limited by UCC Sections 9-320(a) (buyer in ordinary course of business) and by 9-317(b) (buyer of goods who gives value). Inside bankruptcy, Section 552 of the Bankruptcy Code addresses proceeds by saying that security interests still extend to proceeds “to the extent provided for by [the security agreement] and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.” In other words, proceeds in bankruptcy work as proceeds work outside of bankruptcy unless the court orders otherwise.

Treating proceeds the same inside bankruptcy as outside, however, is easier said than done. For example, inside bankruptcy, as soon as the debtor converts collateral to cash, the collateral becomes cash collateral and the court, after notice and a hearing, must authorize the use of the cash. Outside bankruptcy, the debtor can freely convert the collateral to cash, spend the cash, and then Section 9-332 of the UCC cuts off the security interest. Inside bankruptcy, where the court and the lawyers monitor all the transactions, UCC Section 9-332 is rendered

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183 U.C.C. § 9-315.
useless. Section 9-332 “affords broad protection to transferees who take funds from a deposit account and to those who take money.”\textsuperscript{185} It “helps to ensure that security interests in deposit accounts do not impair the free flow of funds.”\textsuperscript{186} Inside bankruptcy, however, this limitation on the risk that the creditor will obtain a windfall double recovery through seizure of both collateral and proceeds effectively vanishes.

Inside bankruptcy, all asset transfers are monitored and regulated, while outside bankruptcy, asset transfers happen as they happen with no judicial oversight. Creditors hoping to exercise their rights simply must piece together what the debtor did after the fact as best as they can. Consequently, secured creditors outside of bankruptcy have broad rights including a right to proceeds that could result in a windfall in the form of a fortuitous double recovery.\textsuperscript{187} State law typically tempers this broad right with significant limitations.\textsuperscript{188} Inside bankruptcy, however, all transactions and relationships are revealed. Consequently, the need for broad rights tempered by limitations that are calculated to avoid, to the extent practicable given the lack of oversight, fortuitous windfalls no longer exists within the aegis of the federal court.

In bankruptcy, all claims must be filed; otherwise the discharge will extinguish them.\textsuperscript{189} The debtor must disclose current financial statements and the debtor has ongoing periodic reporting obligations.\textsuperscript{190} Outside of bankruptcy, secured creditors can lose rights in their collateral in countless ways, e.g., debtor name changes,\textsuperscript{191} hidden liens,\textsuperscript{192} or perfection

\begin{footnotes}
\item[185] U.C.C. § 9-332 Off. Cmt. 2.
\item[186] Id. at Off. Cmt. 3.
\item[187] In re Tower Air, Inc., 397 F.3d 191, 198 (3d Cir. 2005).
\item[188] See, e.g., U.C.C. §§ 9-332, 9-320(a), 9-317(b).
\item[189] 11 U.S.C.A. § 524.
\item[191] U.C.C. § 9-507 (c).
\end{footnotes}
failures. Inside bankruptcy, however, all interests are compiled, tracked, and monitored. The many ways that a creditor can lose her interest simply do not exist inside the bankruptcy process.

The whole purpose of federal bankruptcy, at least for large corporations, is to replace the equity receivership process available in state law. Hypothesizing, first, whether a receivership would have taken place without a bankruptcy, and then, how the receivership would work assuming that the Federal government had never exercised its Article I, Section 8 powers to craft a uniform bankruptcy law simply requires too much conjecture.

In summation, the separate-and-distinct-item-of-collateral theory fails in its purported attempt to preserve inside bankruptcy rights that exist outside of bankruptcy. The bankruptcy process differs too greatly from whatever would have happened outside of bankruptcy. Because determining what creditor’s rights would have been had no bankruptcy occurred requires too much conjecture, bankruptcy cannot be thought of as a mere “happenstance.”

A. The Flexible Approach

The Fifth Circuit has said, “we reject the single valuation approach under the particular facts of this case.” The Court determined that an undersecured creditor whose collateral’s value is increasing or whose claim is reduced by cash collateral payments can become, at some point in time prior to confirmation, oversecured and entitled to post-petition interest. This determination solves the valuation timing issue. It does not, however, solve the rent treatment issue. The lender’s claim can be reduced by cash collateral payments, but the Court expresses no opinion on rent valuation. In other words, the rents might be added to the property value as in In

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195 In re Timbers of Inwood Forest Associates, Ltd., 808 F.2d 363, 384 (5th Cir. 1987) (Jones J. dissenting) (saying that the creditor’s right to seize collateral should be unaffected by the “happenstance” of bankruptcy) aff’d sub nom. United Sav. Ass’n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988).
197 Id.
re Bloomingdale, Flagler-at-First, or In re Addison, or the rents might not factor into valuation as in Reddington/Sunarrow or Matter of Cont’l Airlines.198

V. Conclusion

The equities-of-the-case rule in Section 552 of the Bankruptcy Code is mandatory. Consequently, every case dealing with the treatment of income from income-producing collateral for undersecured creditors should include detailed analysis of the equities of the case including description of the factors considered and weight assigned to each. The flexible approach of the Fifth and First Circuits essentially mandates this approach. The future of how income from income-producing collateral is treated in bankruptcy for undersecured creditors lies in development of a non-exclusive factor test, not in adoption of a particular valuation methodology like the addition method or the subtraction method. Because the Bankruptcy Code grants equitable discretion to the court in this area, appellate review should be limited to abuse of discretion.

Furthermore, for the foregoing reasons, the separate-and-distinct-item-of-collateral theory should be laid to rest along with the Dewsnup aphorism. The answer is not, “When in doubt, give the income to the undersecured creditor.” Dewsnup was a case that explicitly recognized its own limitations, limitations which were then promptly ignored by some lower courts. Income generated during bankruptcy from income-producing collateral does not automatically accrue to the undersecured creditor as “separate collateral” and such an idea conflicts pronouncedly with the Code.