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Adequate Protection: A New Hope, or Perhaps, the Empire Strikes Back

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Title: Adequate Protection: Has it Changed or is it the Same?

Executive Summary: This presentation evaluates the trends of adequate protection in the use, sale or lease of property of the estate. The presentation reviews the legal trends and types of adequate protection which courts have either approved or which may become more common in the future, especially as interest rates rise [if they do] and liquidity tightens [if it does].

I. INTRODUCTION

“A Long Time Ago in a Place Far, Far Away,” there was the notion that the absence of liquidity could still allow for adequate protection to be demonstrated for a debtor’s use, sale or lease of property. When banks fail, buyers evaporate, and jobs disappear, cash flow to make periodic payments is hard to come by. By today’s reality, these “ancient” notions of adequate protection seem irrelevant. In the aftermath of the Great Recession where trillions of dollars have been issued to provide liquidity to the system of credit that runs our economy, have the determinants of adequate protection irrevocably changed—or is it still the same? Stated differently, will the empire of traditional adequate protection strike back, or is there a new hope for struggling debtors by which ever appreciating asset values lead to a refinancing or sale of every secured loan?

Importantly, recall this is first and foremost a constitutional issue. In the beginning, there was the Fifth Amendment. This is America after all. The Fifth Amendment provided that property could not be taken away without due process of law.¹ In a bankruptcy case, this constitutional protection is the cornerstone to the concept of providing a secured creditor with adequate protection. The Bankruptcy Clause gives Congress broad powers to modify the rights of secured creditors subject to the constraints of the Due Process Clause of the Fifth Amendment.² Adequate protection is required: (1) for the debtor’s use, sale or lease of the encumbered property under section 363 of the United States Code (the “Bankruptcy Code”), or (2) in circumstances where the existing secured creditor is proposed to have its senior position subordinated to a new secured lender under Section 364(d) of the Bankruptcy Code.

Congress explained the need for adequate protection plainly when it promulgated the Code:

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

¹ See *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935); *In re Gulf States Steel, Inc. of Alabama*, 285 B.R. 497, 511–512 (Bankr. N.D. Ala. 2002).

² See, e.g., *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502, 518 (1938) (“Property rights do not gain any absolute inviolability in the bankruptcy court because they are created and protected by state law. Most property rights are so created and protected. But if Congress is acting within its bankruptcy power, it may authorize the bankruptcy court to affect these property rights, provided the limitations of the due process clause are observed.”).

or seriously detrimental to the bankruptcy laws. Thus, [11 U.S.C. § 361] recognizes the availability of alternate means of protecting a secured creditor's interest. . . . Though the creditor might not be able to retain his lien upon the specific collateral held at the time of filing, the purpose of the section is to insure that the secured creditor receives the value for which he bargained.³

These principles have not changed – but the world today seems radically different from what was.

II. THE STANDARD DEFINITION OF ADEQUATE PROTECTION UNDER THE CODE

A. Adequate Protection is defined specifically, but the concept is flexible and not exclusive

“Do . . . or do not. There is no try.” – Yoda

The purpose of adequate protection is to guard the secured creditor's interest from a decline in value of the collateralized property.” *In re JCP Props.*, 540 B.R. 596, 613 (Bankr. S.D. Tex. 2015). Generally, “adequate protection” requires that a secured lender receive compensation or something of value during the pendency of the bankruptcy case to protect it against the diminution or erosion in value through depreciation, dissipation, or any other cause. *Id.* Specifically, section 361 of the Bankruptcy Code states that:

[A]dequate protection may be provided by—

- (1) **requiring the trustee to make a cash payment or periodic cash payments** to [an entity with interest in the debtor's property], 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.

11 U.S.C. § 361 (emphasis added). But adequate protection is not perfect protection.

³ Bankruptcy Reform Act of 1978, P.L. 95-598, S. Rep. 95-989 (1978), 95th Cong., 2nd Sess. 1978, 1978 U.S.C.C.A.N. 5787, 5839.

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