

IN THE UNITED STATES BANKRUPTCY COURT FOR THE
EASTERN DISTRICT OF TENNESSEE

In re)	
)	
INOVE' GRAPHICS, INC.)	Case No. 92-35243
)	Chapter 11
)	
Debtor)	

MEMORANDUM

This matter is before the court on the objection of the debtor to the claim of General Electric Capital Corporation ("GECC"). The debtor contends that GECC's claim should be reduced by the amount of adequate protection payments made by debtor to GECC postpetition. The court agrees.

I.

This Chapter 11 was filed on November 9, 1992. On December 18, 1992, GECC filed a motion for relief from the automatic stay¹ alleging that the debtor was obligated to it pursuant to a certain machinery contract which obligation was secured by a security interest in a Miehle/Roland 40" Four Color Printing Press ("Four

¹Although no code section was cited, it is clear that GECC was proceeding in reliance on 11 U.S.C. § 362(d) which provides in relevant part:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay-

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest...

Color Press"). GECC asserted that the Four Color Press was depreciating and declining in value due to its use by debtor and requested that the automatic stay be lifted to allow it to foreclose on its security interest or in the alternative, that the debtor be required to make adequate protection payments to it.

Pending final hearing on GECC's motion, the debtor agreed to pay GECC one adequate protection payment of \$6250.00.² Thereafter, the parties reached an agreement as to future adequate protection payments, the value of the Four Color Press, and the treatment of GECC's secured claim, which agreement was incorporated in an agreed order entered February 12, 1993. Pursuant to the terms of the order, the debtor agreed to make additional adequate protection payments to GECC during March, April and May of 1993, totalling \$12,000.00, which payments "would not reduce GECC's secured claim." Thereafter, commencing on June 15, 1993, the debtor would amortize and pay GECC's secured claim of \$325,000.00,³ with interest of 10.9% in sixty equal monthly payments of \$7050.09. The agreement provided that this repayment plan would be incorporated into the reorganization plan filed by the debtor, and that the parties' agreement "does not affect or resolve GECC's claim to the extent it is secured by equipment or collateral other than the Four Color Press or to the extent it is unsecured."

²GECC had contended in its motion that the Four Color Press was declining at the rate of at least \$6,250.00 per month and requested adequate protection payments of this amount.

³"Based upon appraisals conducted by both parties, the parties agree that the value of the Four Color Press is approximately \$325,000.00."

As stipulated by the parties, the agreed adequate protection payments totalling \$18,250.00 were made by the debtor. The debtor's confirmed plan of reorganization⁴ provides for GECC to have a secured claim in the amount of \$325,000.00. Specifically, the plan provides as follows with respect to GECC:

General Electric Credit Corporation which is secured by a four color press shall be paid \$325,000.00 for its allowed secured claim together with interest at the rate of 10.9% in sixty monthly installments of \$7,050.09 which commenced on June 15, 1993. It's [sic] undersecured claim shall be paid in accordance with Class 10.⁵

Creditors in Class 10, which consists of all allowed unsecured claims greater than \$2,000.00, are to be paid a pro rata share of certain payments by debtor over the next five years.⁶

The parties agree that as of the filing of this Chapter 11 case, GECC was owed \$488,473.23 and GECC has filed a proof of claim in this amount. The debtor does not dispute that GECC is secured to the extent of \$325,000.00, but asserts that GECC's unsecured claim for the balance should be reduced by \$18,250.00, the amount of the adequate protection payments. GECC contends that because adequate protection payments are for the purpose of compensating the secured creditor for any decrease in value of its collateral, the payments can not be applied to reduce the indebtedness owed.

⁴By order dated December 29, 1993, as amended March 1, 1994.

⁵First amended plan of reorganization, section IV, Treatment of Classes, Class 4, subsection A.

⁶First amended plan of reorganization, Section IV, Treatment of Classes, Class 10.

The court disagrees.

II.

By definition, a security interest in property is granted to secure performance of certain contractual obligations, including and usually most importantly payment of the indebtedness. UNIFORM COMMERCIAL CODE § 1-201(37); BLACK'S LAW DICTIONARY 1217 (5th ed. 1979). Under the Uniform Commercial Code, a secured party has the right upon default to take possession of the collateral and apply it in satisfaction of the indebtedness. UNIFORM COMMERCIAL CODE §§ 9-503 and 9-504. This right is stayed pursuant to the automatic stay provisions of § 362(a)⁷ of the Bankruptcy Code upon the filing of a bankruptcy petition. It is commonly recognized that if the property is declining in value during the term of the stay, the secured party is harmed because it has less security for its debt and the amount it will ultimately be able to apply toward the debt is diminished. *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 108 S. Ct. 626, 629 (1988).

⁷11 U.S.C. § 362(a) provides in relevant part:

Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, operates as a stay, applicable to all entities, of-

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.

The purpose of adequate protection is to insure that the value of the collateral will be maintained so that the desired result will be achieved, *i.e.*, repayment of the debt. *In re Spacek*, 112 B.R. 162, 165 (Bankr. W.D. Tex. 1990). Thus, when adequate protection cash payments are made they must be applied to the debt; there is no separate interest in the property for which the secured party is entitled to compensation.

Every court which has considered this issue has applied the adequate protection payments to some portion of the debt.⁸ See *In re Flagler-At-First Associates, Ltd.*, 114 B.R. 297 (Bankr. S.D. Fla. 1990); *In re Spacek*, 112 B.R. at 162; *In re Club Associates*, 107 B.R. 385 (Bankr. N.D. Ga. 1989), *aff'd*, 956 F.2d 1065 (11 Cir. 1992); *In re Sherwood Square Associates*, 87 B.R. 388 (Bankr. D. Md. 1988); *In re Kain*, 86 B.R. 506 (Bankr. W.D. Mich. 1988); *In re Canaveral Seafoods, Inc.*, 79 B.R. 57 (Bankr. M.D. Fla. 1987); *In re Rich International Airways, Inc.*, 50 B.R. 17 (Bankr. S.D. Fla. 1985).

In the most detailed discussion of the issue, Judge Murphy in *Club Associates* initially noted that:

⁸As noted by GECC in its brief, the issue in the majority of these cases is whether the adequate protection payments should reduce the creditor's secured claim. See, *e.g.*, *In re Flagler-At-First Associates, Ltd.*, 114 B.R. 297 (Bankr. S.D. Fla. 1990); *In re Spacek*, 112 B.R. 162 (Bankr. W.D. Tex. 1990); *In re Sherwood Square Associates*, 87 B.R. 388 (Bankr. D. Md. 1988). That precise issue is not present in this case because the debtor does not contend that GECC's secured claim should be reduced. However, these cases are still relevant because in all the cases, the courts agreed that the payments should be applied to the principal indebtedness - the only question was whether they should reduce the secured portion or the unsecured portion.

[a]lthough the Bankruptcy Code recognizes in §§ 361, 362, 363, and 364 that adequate protection payments may be required in certain circumstances, nowhere does the Bankruptcy Code address how such payments should be treated upon the confirmation of a debtor's plan of reorganization.

In re Club Associates, 107 B.R. at 394. As in the present case, the debtor in *Club Associates* maintained that the debt should be reduced by the adequate protection payments while the creditor asserted that the payments were not allocable to reduce any portion of the debt because they were compensation for the deterioration in value of the collateral. In holding that such a result would be inconsistent with the policies of the Bankruptcy Code, the court observed that the Supreme Court in *Timbers* had indicated that the purpose of adequate protection payments is to protect an unsecured creditor from diminution in value of its collateral during the pendency of a bankruptcy case. The court concluded that this purpose could be accomplished by reducing the principal amount of the creditor's claim in an amount equal to the adequate protection payments, noting that to hold otherwise would result in a windfall to the creditor:

[n]ever has the policy of bankruptcy law been to pay unsecured creditors twice. [Allocation of the payments to the principal balance of the note] will have the net effect of paying the portion of [the creditor's] secured claim which has become unsecured during the pendency of the case.

Id. at 394.

Similarly, in *Rich International Airways* the bankruptcy court held that adequate protection payments made by the debtor during

the course of the Chapter 11 proceedings should be credited against the principal balance of the creditor's indebtedness. The court reasoned that a creditor should not be paid more "than the amount owed and agreed upon prepetition" and that "[a] secured creditor should not receive more than the benefit of his bargain." *In re Rich International Airways, Inc.*, 50 B.R. at 18.

Relying on the decisions in *Rich International Airways* and in *Timbers*, the court in *Kain* held that postpetition payments "must be applied to reduce the total allowed claim of the [creditor]." *In re Kain*, 86 B.R. at 515.

GECC maintains that the amount it is owed can not be reduced by the adequate protection payments because a decline in value is equivalent to the accrual of the interest, and interest payments do not reduce the principal indebtedness. However, as an undersecured creditor, GECC is not entitled to postpetition interest. *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 108 S. Ct. at 631.⁹ To allow GECC to keep the cash adequate protection payments and not apply them to the debt would be comparable to awarding GECC postpetition interest. Such a result is not authorized under the Code.

The conclusion that adequate protection payments are not compensation in and of themselves, but are instead, security for the repayment of the debt, is shown by the alternative forms of

⁹See also 11 U.S.C. §§ 502(b)(2) and 506(b).

adequate protection set forth in § 361 of the Code.¹⁰ Periodic cash payments are only one means of adequate protection. Under § 361, adequate protection may also be in the form of an additional or replacement lien to the secured creditor or may be provided by giving the creditor such other relief as will result in the creditor receiving the indubitable equivalent of its interest in the collateral. If the secured creditor is entitled to be compensated for the decline in the value of the collateral, but is not required to apply the compensation to the indebtedness, then an alternative form of adequate protection such as the grant of another lien can never be sufficient compensation.

Finally, GECC contends that because the debtor agreed as set forth in the February 12, 1993, order that the adequate protection payments would not reduce its secured claim of \$325,000.00, the payments can not be applied to reduce the unsecured component of its claim. However, the February 12, 1993, agreed order only prohibited reduction of GECC's secured claim by the adequate protection payments. The agreement contains no corresponding

¹⁰11 U.S.C. § 361 provides:

When adequate protection is required under section 362...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...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...results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief...as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

prohibition on the reduction of GECC's unsecured claim. To the contrary, the agreement specifically recites that it "does not affect or resolve GECC's claim...to the extent it is unsecured". Accordingly, the terms of the agreed order do not bar reduction of GECC's unsecured claim by the adequate protection payments.

The court will enter an order in accordance with this memorandum sustaining the debtor's objection to the claim of GECC, and reducing the undersecured portion of the claim in the amount of the adequate protection payments.

ENTER: March 17, 1994

BY THE COURT

A handwritten signature in cursive script that reads "Marcia P. Parsons".

MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY COURT