The UNCITRAL Model Cross-Border Insolvency Law: The Stay of Proceedings and Adequate Protection*

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I. Introduction

The United Nations Commission on International Trade Law [hereinafter UNCITRAL] adopted a Model Law on Cross-Border Insolvency in 1997 [hereinafter the Model Law].[1] Much has already been written on the Model Law, including very comprehensive guidelines that UNCITRAL itself prepared.[2] Most scholars and law commissions praise UNCITRAL for attempting to harmonize a very difficult and, at times, unfair state of the law involving the reorganization of businesses with operations in two or more countries.[3] The Model Law is nothing more than a law that the United Nations and others hope countries will adopt.[4] As a result, it suffers from the same problem this writer has when trying to find a suit—what looks so good on a mannequin, simply does not look good on the writer. UNCITRAL recognized this shortcoming by saying "a State may modify or leave out

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1. UNCITRAL Model Law on Cross-Border Insolvency With Guide to Enactment, U.N. CITRALOR, 30th Sess., Sales No. E.99.V.3 (1999). UNCITRAL created the Model Law through formal conferences or "negotiations" among a diverse group of delegates from various countries. The delegates included insolvency practitioners, judges, government officials and scholars [hereinafter the Working Group]: U.N. CITRAL, Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, UNCITRALOR, 30th Sess., UN Doc. A/CN.9/442 (1997) at 17–18 [hereinafter Guide].

2. Guide, *id.*

3. "Countries" in this paper, is used in the colloquial sense. This is a personal choice, as use of terms such as "state" or "nation state" might be overly cumbersome and confusing. For a discussion of the difference among the various terms this paper could use, *see* Albert V. Dicey and John H. C. Morris on The Conflict of Laws 26–29 (Lawrence Collins et al., eds., 13th ed. 2000).

4. The United Nations General Assembly, in its resolution passed on December 15, 1997:

> Recommends that all States review their legislation on cross-border aspects of insolvency to determine whether the legislation meets the objectives of a modern and efficient insolvency system and, in that review, give favourable consideration to the Model Law, bearing in mind the need for and internationally harmonized legislation governing instances of cross-border insolvency: G.A. Res. 52/158, U.N. GAOR, 52d Sess., Supp. No. 49, para. 3, U.N. Doc. A/RES/52/158 (1997). (*Continued overleaf*)

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some of its provisions,"[5] but to make the Model Law workable in practice, UNCITRAL recommended "that States make as few changes as possible in incorporating the model law into their legal systems."[6] Furthermore, the legal systems or normative values of some countries might not allow them to adopt the Model Law without some tinkering with its wording or, for that matter, the principles that underlie it.

Having said that, the purpose of this paper is not to criticize the Model Law. In fact, this paper recognizes that the Model Law is the first step towards harmonization of a very complex area of law and practice that will become more prevalent

4. (*Cont.*) As at October 2003, several countries have enacted the Model Law, with or without changes. The countries that have enacted the Model Law without changes are Eritrea, Mexico, Montenegro, Poland and Romania. Japan has enacted it with changes. South Africa has enacted it but it is not yet operative: David Burdette, *New Developments in South Africa: The Introduction of a Unified Insolvency Act*, INSOL WORLD—FOURTH QUARTER 2003 27, 28. The South African legislation will become operative once the Minister of Justice designates the states to which the act will apply. Countries that are expected to adopt the Model Law based on their recommendations to their legislatures are Argentina, Australia, Spain, the United Kingdom and the United States.

In Canada, the Standing Senate Committee on Banking, Trade and Commerce published its report in November 2003 entitled "Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act", *available at* http://www.parl.gc.ca/37/2/parlbus/commbus/senate/com-e/bank-e/rep-e/bankruptcy-e.pdf [hereinafter Canadian Senate Report]. The Canadian Senate Report recommends (at 117):

> The Bankruptcy and Insolvency Act be amended to incorporate the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency. Consideration should be given to adding a reciprocity provision and provisions that would assure the creation of a creditors' committee, consisting of Canadian creditors, to protect their interests. The reasonable expenses of the members of this committee should be paid by the foreign debtor, if considered appropriate by the Canadian Court.

One should note two things from this recommendation. First, the Canadian Senate Report does not recommend that Canada adopt the Model Law without some changes. These changes are not insubstantial and require some examination. Second, the Canadian Senate Report recommends the adoption, with changes, of the Model Law into the Bankruptcy and Insolvency Act, R.S.C., ch. B-3 (1985) (Can.) [hereinafter BIA] and not the Companies' Creditors Arrangement Act., R.S.C., ch. C-36 (1985) (Can.) [hereinafter CCAA].

Canada has a bifurcated reorganization regime for insolvent businesses made up of the CCAA and the proposal provisions contained in the BIA. Generally, the CCAA is the only statute a multinational entity would use as its financial reorganization regime. The CCAA may only be used by "a debtor company or affiliated debtor companies where the total of claims . . . against the debtor company or affiliated debtor companies exceeds five million dollars": CCAA §3. Accordingly, if a country injects a reciprocity provision in its adoption of the Model Law and the Canadian Parliament adopts the Canadian Senate Report's recommendation, a Canadian CCAA proceeding might not be recognized by that other country.

The BIA might not be the best regime on which the foreign representative might want to rely, as it does not have the necessary flexibility to accommodate a complex reorganization. Rather, it might want to rely on the more flexible regime contained in the CCAA. As to the tension that exists between these two regimes, the reader is referred to the writer's testimony that appears in the Canadian Senate Report, which says:

> Professor Keith Yamauchi, of the Faculty of Law at the University of Calgary, supported the status quo as well, and argued that "the flexible, court-driven nature of a proceeding under the Companies Creditors Arrangement Act lends itself to large multinational entities." At the same time, "the rigid provisions of the Bankrutpcy and Insolvency Act fit quite nicely with the reorganization of small to medium-sized businesses." He believed that the system in Canada "works well from a practitioner's perspective." The wide judicial discretion given by the CCAA's provisions has not been abused, in his view, but has instead been used "wisely to effect results that could not otherwise be reached in a strict, rule-oriented system": Canadian Senate Report at 171–72.

The Canadian Senate Report then recommends that the BIA and CCAA "continue to exist as separate statutes": Canadian Senate Report at 173.

5. Guide, *supra* note 1 at 19.

6. *Id.*

as trade and communications become freer. This paper, however, will illustrate a potential danger when a country proposes to adopt the Model Law without examining the Model Law's effects on its internal financing and other systems.

The Model Law contains the term "adequate protection." A court may, on the application of a foreign representative,[7] stay the commencement or continuation of actions or proceedings against a debtor or execution against the debtor's assets.[8] In so doing, "the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are *adequately protected*" (emphasis added).[9] What does this seemingly innocuous term mean? Did the Working Group[10] intend it to be a term of art or leave it broad and undefined to allow the court hearing the application to use its discretion and give the term whatever meaning it chooses?

In the United States, the concept of adequate protection is contained in the Bankruptcy Reform Act of 1978[11] [hereinafter Code] and it has a very rich history.[12] This paper will examine that history and case law to determine whether a foreign court should use them to interpret the concept's meaning. The discussion will be limited to financial reorganizations, but some comments will be made at the end of this paper on the impact the concept may have in a liquidation proceeding. It will also deal primarily with the protection of creditors that hold some type of security against the debtor or the debtor's property.

II. **The Stay of Proceedings**

Because adequate protection has its most crucial importance under the Model Law once a stay of proceedings is imposed on creditors and others, it would be useful to examine the stay of proceedings under the Code and compare it to the stay of proceedings under the Model Law.

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7. The Model Law defines "foreign representative" in art. 2 as a:

> person or body, including one appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of the foreign proceeding,

and defines "foreign proceeding" as:

> a collective judicial or administrative proceeding in a foreign state, including an interim proceeding, pursuant to a law realting to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

8. Model Law, arts. 19–21.
9. Model Law, art. 21, para. 2.
10. *Supra* note 1.
11. Pub. L. No. 95-598, 98 Stat. 2549.
12. Although one might be inclined to think that the Working Group's, *supra* note 1, American delegates introduced the concept for insertion in the Model Law, those delegates actually sought to eliminate its inclusion because of the concept's rich history and "conceptual baggage" which this paper discusses. Without this rich history, the concept could, indeed, capture the general notion that the interests of the creditors and other interested persons, including the debtor, be protected adequately in the circumstances. This would be based on equitable grounds or a pure definitional use of the term. However, this paper discusses the American history of the term and the dangers parties and the courts could face when attempting to interpret it. The concern is magnified when an American creditor, debtor or other interested person is involved in the reorganization proceeding.

In the United States, the stay of proceedings is automatic and Code §362(a) defines its scope.[13] The legislative history intended the scope of the stay of proceedings to be broad and encompass not only judicial proceedings, but also arbitration, licence revocation and administrative proceedings against the debtor, as well as civil actions and all proceedings even if they are not before governmental tribunals.[14] The stay of proceedings also prevents a secured creditor from repossessing or realizing its collateral through self-help remedies or judicial process.[15] To appreciate the breadth of the stay of proceedings under the Code, one only needs review the definition of "entities,"[16] to which the automatic stay of proceedings is applicable. An entity includes, among others, a governmental unit and a person, which is defined as including an individual, partnership and corporation.[17] Although neither Code §362(a) nor the definitions of "entity" or "person," refer to creditors or, more specifically, secured creditors, Code §362(a) applies to them. One should also note that a "claim against the debtor" includes a claim against the debtor's property[18] and Code §541 comprehensively describes the debtor's property as "property of the estate."

The court's discretion further augments the Code's automatic stay of proceedings. Under the Code, courts use Code §105(a) to issue injunctions against parties or proceedings not otherwise stayed by Code §362(a). Code §105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua

13. Code §362(a):

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1070 (15 USC 78eee(a)(3)), 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;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained 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;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

The automatic stay of proceedings becomes effective on the filing of the petition to commence the proceeding and was described by one court as "self-executing": *In re* LPM Corporation, 269 B.R. 217, 220 (9th Cir. 2001).

14. H.R. Rep. No. 95-595 at 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. (598 Stat.) 5963 [hereinafter House Report].

15. Robert L. Jordan & William D. Warren, Bankruptcy 754 (1985); Code §362(a)(3).

16. Code §101(15).

17. Code §101(41).

18. Code §102(2).

sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.[19]

In the United States, courts first face issues involving the automatic stay of proceedings on an application by a disgruntled creditor to have the court lift the stay of proceedings. The Code gives the court some direction concerning alternate remedies it could grant on such an application. Specifically, the court may "carve out" a creditor's interest on proof of certain facts or provide the creditor "adequate protection."[20] As the court need not deprive the debtor of its opportunity to reorganize and as the secured creditor will be entitled to have its interest "adequately protected," the court balances the respective interests of the debtor and secured creditor when determining whether to lift or continue the stay of proceedings. One American writer described the challenge to the continuation of the stay of proceedings as "the main event in many chapter 11 cases."[21]

Before embarking on an analysis of this "main event," we must address two matters. First, the importance of the concept of adequate protection in an American proceeding cannot be overstated. The theory underlying American litigation involving the stay of proceedings is that, so long as the challenging secured creditor is adequately protected or has an opportunity to repossess the collateral at some future time, that creditor should not have the right to question the debtor's

19. See, *e.g. In re* Gruntz, 202 F.3d 1074, 1082 (9th Cir. 2000), which held that "[a]ny state court modification of the automatic stay would constitute an unauthorized infringement upon the bankruptcy court's jurisdiction to enforce the stay"; *see also In re* Otero Mills, Inc., 25 B.R. 1018 (D.N.M. 1982) [hereinafter Otero] where the creditor brought an action against the guarantor of obligations of the debtor that was subject to protection under Code §362(a). The debtor asserted that the guarantor was going to contribute personal assets to it to effect the reorganization plan. The court, pursuant to Code §105(a), prohibited the creditor from enforcing its judgment against the guarantor. Enforcement against the guarantor would affect the debtor's estate and adversely influence and pressure the debtor through the guarantor: Otero, *id.* at 1019–1020. The importance of this case lies in the formulation by the Bankruptcy Court of the test to determine whether the court would grant an injunction to enjoin a creditor from pursuing a co-debtor or guarantor. In such a case, the debtor must show:

1. irreparable harm to the debtor's estate if the injunction does not issue;
2. strong likelihood of a successful plan of reorganization; and
3. no harm or minimal harm to the other party or parties; Otero, *id.* at 1021, quoting the Bankruptcy Court.

To this, the District Court added a fourth factor, which appeared to be the overriding and most influential factor. The court held that "in the bankruptcy setting, the public interest lies in promoting successful reorganization": Otero, *id.* at 1021. The court reinforced this factor by stating:

> At the beginning of the reorganization process, a court must work with less evidence than might be desirable and should resolve issues in favour of reorganization.... Although reorganization by any bankrupt may be speculative early in the proceedings, [the creditor] is protected in that if a reorganization plan is not approved, it may apply to the bankruptcy court to lift the injunction: *id.*

Therefore, the stay provisions may apply to a secured creditor even though the creditor seeks a remedy for which the stay provisions appear inapplicable. *Compare* Lynch v. Johns-Manville Sales Corp., 710 F.2d 1194, 1197 (6th Cir. 1983) where the court said it "...would distort congressional purpose to hold that a third party solvent co-defendant should be shielded against his creditors by a device intended for the protection of the insolvent debtor and creditors thereof."; *see also* David R. Kuney, *The Bank Guaranty Agreement: The Emerging Threat of the Bankruptcy Stay*, 1985–86 Bus. Law. 77.

20. Code §362(d)–(g).

21. Martin J. Bienenstock, Bankruptcy Reorganization 132 (1987).

reorganization efforts.[22] The reorganization process is not harming the secured creditor, so the debtor may continue operating the business while formulating a plan of arrangement.

The second is that throughout the discussion that follows, passing reference will be made to the conduct of the parties. Although, generally, courts do not expressly state that their decisions are influenced by the parties' conduct, that conduct appears to have some influence over their decisions. One writer noted:

> . . . [W]hile economic or financial factors are significant in automatic-stay litigation, these factors are not the only consideration that courts apply. Instead, litigation by creditors to lift the stay is often reached in light of the creditor's and debtor's behavior before and during the bankruptcy case. The result is a general balancing of equitable factors, especially in business cases, that is significantly more complex than the pure economic evaluation often suggested in the literature.[23]

Code §362(d) through (g) govern relief from the automatic stay of proceedings.[24] For a creditor to obtain relief from the automatic stay of proceedings, it must take a positive step to seek such relief. A court may not act *sua sponte*.[25]

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22. This is subject to Code §362(d), which allows a court to grant a party relief from the stay of proceedings if "the debtor does not have equity in the property" and "such property is not necessary to an effective reorganization." The effect of this provision will be discussed, *infra* note 50–55 and accompanying text.

23. Raymond T. Nimmer, *Real Estate Creditors and the Automatic Stay: A Study in Behavioral Economics* 1983 ARIZ. ST. L.J. 281.

24. Code §362(d)–(g):

(d) 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; or
  (2) with respect to a stay of an act against property under subsection (a) of this section, if—
    (A) the debtor does not have an equity in such property; and
    (B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than thirty days after the conclusion of such preliminary hearing.

(f) Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

(g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section—
  (1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and
  (2) the party opposing such relief has the burden of proof on all other issues.

25. Ronald M. Martin, *Creditor Alternatives to Obtain Relief From Automatic Stays in Bankruptcy*, 98 BANKING L.J. 525, 536 (1981).

If the creditor were to do nothing, the stay of an act against property of estate continues until the property is no longer property of the estate and the stay of an act against the debtor continues until the case is closed or dismissed or the court grants or denies the debtor's application for a discharge, whichever first occurs.[26]

A creditor that seeks relief from the stay of proceedings must request that relief by way of motion on reasonable notice to the debtor[27] and other interested parties.[28] The court, however, may allow the creditor to make the application *ex parte* in appropriate circumstances.[29] After notice and hearing,[30] the court shall grant relief from the stay "for cause, including lack of adequate protection of an interest in property of" the creditor.[31] The lack of adequate protection is merely one "cause" that may result in the court granting relief from the stay of proceedings and only one alternative on which the creditor may rely when seeking relief from the stay of proceedings. On a hearing for relief from the stay of proceedings, the court considers only the issue of whether it will grant the requested relief[32] and it is limited to dealing with the applicant's interests and not the interests of others. The granting of relief from the stay of proceedings may or may not dispose of the reorganization proceeding.

American courts are reluctant to grant relief from the automatic stay of proceedings in the early weeks of the proceeding.[33] This gives all parties an opportunity to assess the situation and determine the creditor's status, the enforceability of the creditor's security, whether adequate protection is necessary and in what form and whether the possibility of formulating a successful reorganization plan is feasible.

Code §362(d) prescribes four types of relief from the automatic stay, which are nonexclusive. The court may:[34]

1. terminate the stay of proceedings with respect to the applicant creditor or generally. Termination allows the creditor to pursue its remedies to their full extent;[35]

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26. Code §362(c).
27. FED. R. BANKR. P. 4001(a) (1), 9014.
28. FED. R. BANKR. P. 1007(d), 4001(a)(1); Code §1102.
29. FED. R. BANKR. P. 4001(a)(2).
30. This phrase is defined in Code §102(1):

(1) "after notice and hearing", or a similar phrase—
  (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but
  (B) authorizes an act without an actual hearing if such notice is given properly and if—
    (i) such hearing is not requested timely by a party in interest; or
    (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act;

31. Code §362(d)(1).
32. House Report, *supra* note 14 at 344.
33. JORDAN & WARREN, *supra* note 15 at 786.
34. Frank R. Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 177, 253–54 (1978).
35. *Id.* at 253. *See*, *e.g.* *In re* White, 851 F.2d 170 (6th Cir. Ohio 1988).

2. annul the stay of proceedings which terminates it *ab initio.* Annulment generally operates retroactively to the date of the filing of the petition[36] and validates any violation of the stay of proceedings that occurred before the annulment;[37]
3. modify the stay of proceedings to allow one act or one creditor to pursue a remedy, such as allowing an action to continue to judgment but disallowing enforcement;[38] or
4. place a condition on the stay of proceedings that, if breached or unsatisfied, may automatically terminate the stay.[39]

The court must grant relief from the stay of proceedings if the applicant shows cause for granting that relief. The court is given a very broad discretion when it is asked to determine whether circumstances justify a finding of cause.[40] Cause includes a lack of adequate protection.[41] It also includes an action that lacks any connection or will not interfere with the case, such as a personal injury action against the debtor and its insurer[42] or actions involving the debtor's postpetition activities.[43] These types of actions are unrelated to the purpose of the stay of proceedings, which is to protect the debtor from its creditors.[44]

An application seeking relief from the automatic stay of proceedings based on cause invites the court to make a broad inquiry into the facts. The courts examine economic factors and may examine behavioural and equitable factors.[45] The facts of each case will determine whether relief is appropriate in the circumstances[46] but courts have been responsive to many types of requests. For example, the debtor's *mala fides* or misconduct is a cause that may result in the court granting the relief.[47] In fact, *mala fides* may be a ground on which the court may dismiss the case in its entirety.[48]

The applicant could also seek to have the case converted to a liquidation case pursuant to Code §1112. Although the facts may not warrant a complete dismissal

36. Sikes v. Global Marine, Inc., 881 F.2d 176 (9th Cir. 1989); *see also In re* Albany Partners, Ltd., 749 F.2d 670 (11th Cir. 1984). Annulment of the stay of proceedings retroactively has been described as an extraordinary remedy that should be granted only in "limited", *In re* Albany Partners, Ltd., *id.* at 675, or "extreme", *In re* Shamblin, 890 F.2d 123, 126 (9th Cir. 1989), circumstances.

37. *In re* Siciliano, 13 F.3d 748, 751 (3d Cir. Pa. 1994); Sikes v. Global Marine, Inc., *id.* at 178.

38. Kennedy, *supra* note 34 at 254; *In re* Holtkamp, 669 F.2d 505 (7th Cir. 1982).

39. *In re* Blazon Flexible Flyer, Inc., 407 F.Supp. 861 (D.C.N.D. Ohio 1976), where the court required the debtor to continue transmitting financial information to it and the secured creditor on a regular basis. Although the court did not order automatic termination of the stay of proceedings on the debtor's failure to meet the condition, it confirmed the right of the secured creditor to apply on short notice for a revision of the order (*id.* at 865).

40. *In re* Kissinger, 72 F.3d 107, 109 (9th Cir. 1995); *In re* Laguna Assocs. Ltd. Partnership, 30 F.3d 734, 737 (6th Cir. 1994).

41. Code §362(d)(1). *See infra* notes 79–146 and accompanying text.

42. *In re* Holtkamp, *supra* note 38.

43. House Report, *supra* note 14 at 343–44.

44. *Id.*

45. Nimmer, *supra* note 23 at 284. A recent example of a court considering behavioural factors in reaching its decision was in *In re* Kleinman, 156 B.R. 131, 132 (Bankr. S.D.N.Y. 1996), where the court granted the secured creditor relief from the automatic stay and, in so doing, noted the financial irresponsibility of the debtors and the fact that one of the debtors "has undertaken a scorched earth campaign of litigation, including making numerous attacks on the court's integrity."

46. House Report, *supra* note 14 at 344.

47. *In re* Albany Partners, Ltd., *supra* note 36; *see also In re* Laguna Assocs. Ltd. Partnership, *supra* note 40 at 738, in which the court provides a nonexhaustive list of factors a court might consider when determining whether the debtor is acting in good faith.

48. *In re* Albany Partners, Ltd., *supra* note 36.

or conversion of the case, facts evidencing the causes listed in Code §1112(b) may be sufficient to obtain relief from the stay of proceedings.[49]

The court must also grant relief from the stay of proceedings if, with respect to property, the debtor does not have equity in the property *and* the property is not necessary to an effective reorganization.[50] The paragraph requires both elements to be present. If both elements are not present, the court will dismiss the application, but the secured creditor could attempt to show a lack of adequate protection at that hearing or subsequently, or some other cause that entitles it to relief from the stay of proceedings.

With respect to the first element, the Code does not define equity. When courts determine whether the debtor has equity in the property, however, they seem to look at the difference between the property value and the total value of all liens against the property and not just the value of the lien of the creditor seeking relief from the stay of proceedings plus all senior liens.[51]

With respect to whether the property is necessary to an effective reorganization, the United States Supreme Court in *In re* Timbers of Inwood Forest Assoc. Ltd.[52] provides us with the burden the debtor must meet:

> What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect.* This means . . . that there must be a reasonable possibility of a successful reorganization within a reasonable time. (emphasis original)[53]

49. Code §1112(b):

(b) Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including—
(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;
(2) inability to effectuate a plan;
(3) unreasonable delay by the debtor that is prejudicial to creditors;
(4) failure to propose a plan under section 1121 of this title within any time fixed by the court;
(5) denial of confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan;
(6) revocation of an order of confirmation under section 1144 of this title, and denial of confirmation of another plan or a modified plan under section 1129 of this title;
(7) inability to effectuate substantial consummation of a confirmed plan;
(8) material default by the debtor with respect to a confirmed plan;
(9) termination of a plan by reason of the occurrence of a condition specified in the plan; or
(10) nonpayment of any fees or charges required under chapter 123 of title 28.

50. Code §362(d)(2).

51. Stewart v. Gurley, 745 F.2d 1194 (9th Cir. 1984). *Compare In re* Indian Palms Assocs., 61 F.3d 197 (3d Cir. N.J. 1995), where the court held that when a creditor seeks relief under Code §362(d)(1), liens junior to the applicant's lien are not taken into account when determining the value of the debtor's equity. *See* a more thorough discussion of this in note 109.

52. 793 F.2d 1380 (5th Cir. 1986), *aff'd*, 484 U.S. 365, 98 L. Ed. 740 [hereinafter *Timbers*, cited to L.Ed.]. Courts have embraced this requirement, *see, e.g., In re* Canal Place Ltd. P'ship, 921 F.2d 569 (5th Cir. 1991); *In re* Snapwoods Apartments of Dekalb County Ltd., 153 B.R. 524 (Bankr. S.D. Ohio 1993); *In re* Grand Traverse Dev. Co. Ltd. P'ship, 150 B.R. 176 (Bankr. W.D. Mich. 1993).

53. *Id.* at 751.

It is insufficient for a single-asset debtor to argue that it requires the sole asset for an effective reorganization[54] or that the property is indispensable to the debtor's survival and ultimate rehabilitation.[55]

The Model Law imposes an automatic stay of proceedings once a court recognizes a foreign proceeding that is a foreign main proceeding.[56] The court may exercise its discretion to grant a stay of proceedings before the hearing of the application for recognition and on recognition of any other foreign proceeding, whether main or non-main.[57] Because of their importance for the purposes of the discussion that follows, articles 19, 20 and 21 of the Model Law provide:

Article 19. Relief that may be granted upon application for recognition of a foreign proceeding

1. From the time of filing an application for recognition until the application is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature, including:
   (a) Staying execution against the debtor's assets;
   . . .
   (c) Any relief mentioned in paragraph 1 (c), (d) and (g) of article 21.
2. *[Insert provisions (or refer to provisions in force in the enacting State) relating to notice.]*[58]
3. Unless extended under paragraph 1 (f) of article 21, the relief granted under this article terminates when the application for recognition is decided upon.
4. The court may refuse to grant relief under this article if such relief would interfere with the administration of a foreign main proceeding.

Article 20. Effects of recognition of a foreign main proceeding

1. Upon recognition of a foreign proceedings that is a foreign main proceeding,
   (a) Commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities is stayed;
   (b) Execution against the debtor's assets is stayed; and
   (c) The right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended.
2. The scope, and the modification or termination, of the stay and suspension referred to in paragraph 1 of this article are subject to *[refer to any provisions of law of the enacting*

54. BIENENSTOCK, *supra* note 21 at 135–36.
55. NORTON BANKRUPTCY LAW AND PRACTICE §20.27. William L. Norton, Jr., ed., 2nd ed. 1994).
56. Model Law, art. 20, para. 1.
57. The Model Law defines these rather confusing terms in art. 2, as follows:

> "Foreign proceeding" means a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation;
>
> "Foreign main proceeding" means a foreign proceeding taking place in the State where the debtor has the centre of its main interests;
> "Foreign non-main proceeding" means a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment within the meaning of subparagraph (f) of this article;
> "Establishment" means any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.

All of these defined terms have their own problems of interpretation. This paper will not, however, examine those problems.
58. The italicized portions are in the Model Law.

State relating to insolvency that apply to exceptions, limitations, modifications or termination in respect of the stay and suspension referred to in paragraph 1 of this article].

3. Paragraph 1 (a) of this article does not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.
4. Paragraph 1 of this article does not affect the right to request the commencement of a proceeding under *[identify laws of the enacting State relating to insolvency]* or the right to file claims in such a proceeding.

Article 21. Relief that may be granted upon recognition of a foreign proceeding.

1. Upon recognition of a foreign proceeding, whether main or non-main, where necessary to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including:
   (a) Staying the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities, to the extent they have not been stayed under paragraph 1 (a) of article 20;
   (b) Staying execution against the debtor's assets to the extent it has not been stayed under paragraph 1 (b) of article 20;
   (c) Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under paragraph 1 (c) of article 20;
   . . .
   (f) Extending the relief granted under paragraph 1 of article 19;
   (g) Granting any additional relief that may be available to *[insert title of a person or body administering a reorganization or liquidation under the law of the enacting State]* under the laws of this State.
2. Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court, provided that the court is satisfied that the interests of creditors in this State are adequately protected.
3. In granting relief under this article to a representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets that, under the law of this State, should be administered in the foreign non-main proceeding or concerns information required in that proceeding.

The stays of proceedings that the foregoing provisions impose are very broad. They cover not only actions against the debtor and its assets, but also any judicial or extra-judicial enforcement measures that a creditor could take against the debtor or its assets.[59]

59. Guide, *supra* note 1 at 57–58.

The relief intended by article 19 of the Model Law applies only if the court, in its discretion, considers the relief to be urgently needed. The foreign representative may make the application immediately on its filing of its application for recognition. The italicized portion of paragraph 2 appears to allow the enacting state to insert provisions relating to notice that the foreign representative must give before it makes its application.[60] The relief is provisional and expires once the court decides the issue of recognition. The article's intent, it seems, is to protect the debtor's assets from being dismembered until the foreign representative has had an opportunity to examine the assets and any claims to those assets. If the assets would be otherwise distributable among the debtor's creditors, this article preserves the assets to allow for such distribution. The urgent nature of the application and the limits of the stay of proceedings to execution proceedings and proceedings necessary to protect the value of the assets, bears out this intent. Article 19 provides no mechanism for an affected party to apply to the court to have the stay of proceedings lifted.

The relief requested under article 21 is also discretionary.[61] It is relief that is supplementary to the relief courts grant under article 20, which is discussed below, or relief they may grant on recognition of a foreign non-main proceeding. The scope of the stay of proceedings is very broad and the Model Law gives courts much latitude in the relief they may grant.[62] The relief covers creditors' individual actions and judicial and extra-judicial proceedings, including execution proceedings.[63] The stay of proceedings applies to the debtor, as well as creditors.[64] This is sensible, as it is intended to prevent the debtor from transferring its assets during the pendency of the case, whether such transfer is fraudulent, negligent or innocent. From the debtor's perspective, the safeguard is that the relief courts may grant is discretionary and courts could require the foreign representative to insert a clause in the

60. Although the bracketed portion refers to "notice," one wonders whether a legislature could allow a foreign representative to make the application for article 19 relief *ex parte*. If the legislature of an enacting state allows applications of this nature to be made *ex parte*, the court hearing the application in the first instance could deny the application or require the foreign representative to provide notice to the affected creditor. Also, the order itself could allow an affected party to make an application to have the court hear the matter afresh or contain provisions allowing the court to lift the stay of proceedings.

61. Neither the Model Law nor the Guide, *supra* note 1, provides the court with any guidance on the factors it should consider when hearing an application for a stay of proceedings. As the imposition of the stay of proceedings is discretionary, the inclusion of such factors could be seen to be fettering the court's discretion. Undoubtedly the factors the court should consider will develop over time. However, while the Model Law is in its infancy, a court might consider the factors that have developed in the common law countries where the stay of proceedings is discretionary relief. For example, under the CCAA, *supra* note 4, where the relief is discretionary, the current trend is for the courts to examine the *bona fides* exhibited by the debtor and the feasibility of a successful reorganization from the perspective of the creditors and from an economic perspective; *see*, *e.g.*, *Re* Philip's Mfg. Ltd., 9 Can. Bankr. Rep. (3d) 25 (B.C.C.A. 1992), *leave to appeal denied*, 15 Can. Bankr. Rep. (3d) 57 (S.C.C. 1993); Bargain Harold's Discount Ltd. v. Paribas Bank of Canada, 10 Can. Bankr. Rep. (3d) 23 (Ont. Gen. Div. 1992). The analysis the courts conduct in these cases is not unlike the analysis conducted by American courts when considering whether to grant a secured creditor relief from the automatic stay the Code imposes.

62. Model Law, art. 21, para. 1(g).

63. Guide, *supra* note 1, at 57–58.

64. Model Law, art. 21, para. 1(c).

order that any affected party may return to the court to have a particular matter heard.

Article 21 of the Model Law points to the distinction between recognition of a foreign main proceeding and a foreign non-main proceeding. It limits the relief courts may grant the foreign representative of a foreign non-main proceeding.[65]

Article 20 of the Model Law could pose the largest challenge to courts hearing a foreign representative's application for a stay of proceedings, as it requires courts very early in the proceedings, to balance the respective interests of the debtor and creditors. Once a court recognizes a foreign main proceeding, the stay of proceedings is automatic.[66] This is not unlike the automatic stay of proceedings that occurs under the Code and in some countries immediately on the commencement of a reorganization or liquidation proceeding.[67]

What is the policy underlying the imposition of an automatic stay of proceedings once a court recognizes a foreign main proceeding? The Guide states "[t]he automatic consequences envisaged in article 20 are necessary to allow steps to be taken to organize an orderly and fair cross-border insolvency proceeding."[68] This is in keeping with the Model Law's general policy, but what if the imposition of the stay of proceedings is materially prejudicial to a creditor in the enacting State? The Model Law allows the legislature of the enacting state to limit the scope of the automatic stay of proceedings and make allowances for its modification and termination, based on the insolvency laws of the enacting state.[69] What if the insolvency laws of the enacting state are not consistent with the policies underlying the Model Law? Must the court weigh the policies underlying the Model Law with the rights of domestic creditors (or the debtor)? Do the parties have to apprise the court of the laws of the state where the debtor maintains its main interests? These are extremely difficult questions that courts currently face when they are presented with issues involving recognition and enforcement of any foreign orders or judgments. Thus, legislatures must exercise care when they outline these limitations and allowances. The options open to the legislatures are seemingly endless, from fairly flexible[70] to inflexible.[71] Given the enacting legislature's ability to place such

65. Model Law, art. 21, para. 3.
66. Guide, *supra* note 1, at 56.
67. *See*, *e.g.*, Code §362(a). The Code impose an automatic stay of proceedings on the commencement of business reorganization proceedings and the BIA, *supra* note 4, imposes it on the filing of the notice of intention to file a proposal or the proposal itself. Under the CCAA, *supra* note 4, a stay of proceedings is not automatic. It is a discretionary remedy granted by the court on an application under CCAA §11, *supra* note 4; *see*, Northland Prop. Ltd. v. Guardian Trust Co., 73 Can. Bankr. Rep. (N.S.) 163 (B.C.C.A. 1989). In keeping with the philosophy that a business reorganization will be beneficial to all creditors, the CCAA, *id.*, allows "any person interested in the matter" to make the application, although usually it will be the debtor which seeks the stay.
68. Guide, *supra* note 1, at 57.
69. Model Law, art. 20, para. 2.
70. *See*, *e.g.*, BIA §69.4, *supra* note 4, which provides that a creditor may have the stay of proceedings lifted if the stay is "materially prejudicial" or "that it is equitable on other grounds" to lift the stay of proceedings.
71. Code, §304(c)(2), which provides that recognition of a foreign insolvency order will be made provided American claim holders are protected against "prejudice and inconvenience in the processing of claims in such foreign proceeding."

limitations or allowances, the Model Law might lack the power to facilitate "an orderly and fair cross-border insolvency proceeding" which the Working Group had envisioned. If the legislature of the enacting state chooses not to place such limitations and allowances, a court hearing a foreign representative's application for recognition of a foreign main proceeding might choose not to recognize that proceeding on the ground that it could be prejudicial to local creditors. This would completely frustrate the Model Law's objectives and place us in no better position than we are today.[72]

III. Adequate Protection

What are legislatures trying to accomplish when they pass legislation that allows a business debtor to reorganize its financial affairs and how well do those laws contribute to meet those objectives? Laws facilitating financial reorganization must attempt to strike a delicate balance between "the desire to achieve equity and fairness in the distribution of the [debtor's] funds"[73] and assets, on the one hand, and the contractual rights of creditors, including, perhaps most importantly, secured creditors, on the other.[74] The United States Congress attempted to strike this

72. *See*, *e.g.*, *In re* Toga Mfg. Ltd., 28 B.R. 165 (E.D. Mich 1983); *Re* Singer Sewing Mach. Co. of Can. Ltd., 18 Can. Bankr. Rep. (4th) 127 (Alta. Q.B. 2000).

73. Bank of Marin v. Eng., 385 U.S. 99, 103 (1966). The American courts have also made reference to this balancing when they describe the automatic stay of proceedings; *see*, *e.g.*, *In re* MacDonald, 755 F.2d 715, 717 (9th Cir. 1985), where the court said the "automatic stay gives the bankruptcy court an opportunity to harmonize the interests of both the debor and creditors while preserving the debtor's assets for repayment and reorganization of his or her obligations."

74. In this paper, "secured creditor" refers to a creditor that has a valid security interest in tangible real or personal property or intangible property of the debtor. This discussion, then, might not be relevant to countries that do not have adequate legislative or government machinery that provides for the broad forms of security instruments that are intended to grant security to creditors. For example, South African legislation allows creditors to take security in real property, but provisions for security over tangible or intangible personal property of the debtor is weak.

The Report on the Review of the Law of Insolvency: Project 63 prepared by the South African Law Commission, *available at* http://wwwserver.-law.wits.ac.za/salc/report/project63.html, outlines this weakness. It said:

> 7.9 The creation of security instruments in connection with farming operations or a registration system for the pledge of movables (or other security devices regarding movable property such as cession of rights or reservation of ownership) appears to merit consideration, but does not form part of the review of the law of insolvency. *It is recommended that consideration should be given to the introduction of a Pledge Registration Office, where pledges of movable objects could be registered. The registration of such pledges must be simple and cheap.* (emphasis original)

Furthermore, the Security by Means of Movable Property Act 57 of 1993 (S. Af.), limits the application of the act to "movable property specified and described in the bond in a manner which renders it readily recognizable." This likely limits the field of application of these bonds and could exclude, for example, after-acquired property. These factors weaken the concept of adequate protection in South Africa with respect to certain types of security instruments, despite the reference to it in the Cross Border Insolvency Act 42 of 2000, §21(2) and 22(1), GN 1371 in GG21899 of 15 December 2000, *available at* http://www.saflii.org/za/legis/consol_act/cia42o2000293/. The writer's discussion with the South African Law Commission in May of 2003, indicated that the likelihood of anything resulting from this recommendation was minimal.

balance with the concept of adequate protection.[75] American commentators do not agree on whether the United States Congress struck this balance. For example, when discussing the concept of adequate protection under the Code, one writer said:

> In resolving the conflict, many bankruptcy courts appear to give undue deference to the secured creditor's rights, leading them to impose standards of adequate protection that seriously impede and often arrest the debtor's reorganization.[76]

Others say that "the balance is usually in favour of the debtor so as to effectuate the underlying bankruptcy policy of rehabilitation."[77]

The concept of adequate protection has very practical and serious ramifications for parties in interest. From the debtor's perspective, a determination adverse to its interests may destroy the possibility of its effecting a reorganization of its financial affairs. Conversely, creditors may find themselves unable to cope financially with the consequences of a court not granting them adequate protection and may face the possibility of their own insolvency.

American courts have developed a specific meaning for the term adequate protection aided, in part, by the Code. Should other countries embrace the term without this development in their laws or an understanding of its meaning or limitations? This would not be advisable, especially when the country does not have a developed personal and real property security system, as it makes the concept of adequate protection illusory or pointless, for that matter.[78]

IV. The American Approach to Adequate Protection

The Code does not define adequate protection, though it uses that term in the sections describing an application for relief from the automatic stay of proceedings,[79] use, sale or lease of property of the estate when such property is subject to a lien in favour of a secured party[80] and the obtaining of credit.[81] The objective of adequate protection is to ensure that the creditor receives "essentially what he bargained

75. *See In re* Alyucan Interstate Corp., 12 B.R. 803, 805 (Bankr. Utah 1981), in which the court shows us why Congress wanted the courts to undertake this balancing and how the courts would accomplish this task:

> Adequate protection is not defined in the Code. This omission was probably deliberate. Congress was aware of the turbulent rivalry of interests in reorganization. It needed a concept which would mediate polarities. But a carefully calibrated concept, subject to a brittle construction, could not accommodate the "infinite number of variations possible in dealings between debtors and creditors." H.R. Rep. No. 95-595, 95th Cong. & Admin. News 1978, 5787, 6295. This problem required not a formula, but a calculus, open-textured, pliant, and versatile, adaptable to "new ideas" which are "continually being implemented in this field" and "varying circumstances and changing modes of financing." *Id.* Adequate protection was requisitioned to meet these needs. Its meaning, therefore, is born afresh out of the "reflective equilibrium" of each decision, understood through analysis of the reorganization context and the language of Section 362(d). (footnotes omitted)

76. Comment, *Adequate Protection and the Automatic Stay Under the Bankruptcy Code: Easing Restraints on Debtor Reorganization* (1982) U. PA. L. REV. 423, 426.

77. Donald Price, *Adequate Protection Under the Bankruptcy Act of 1978*, 71 KY. L.J. 727, 742 (1982–83).

78. *See*, *e.g.*, the discussion regarding South Africa, *supra* note 74.

79. Code §362(d).

80. Code §363(e).

81. Code §364(d).

for"[82] unless receipt of that benefit frustrates or seriously interferes with the purposes of the Code's reorganization provisions. In the latter case, creditors will receive the benefit of the bargain by alternate means.[83]

Code §361 describes the three ways in which the debtor or trustee may provide adequate protection to creditors:

> 361. When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
>
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
> (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or
> (3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

These means are neither exclusive nor exhaustive.[84] They are, however, intended to protect the creditor's interest in property which, in most cases, is a security interest. With respect to secured creditors, adequate protection applies only to the "interest of an entity in property" and not to the amount of the debt or the value of the property, both of which may be more or less than the secured creditor's interest in the property.[85] This appears to be reasonable. For example, without the stay of proceedings, the secured creditor could recover only the amount of the debt or the value of the collateral, whichever is less.[86] It follows, then, that if the secured creditor's interest has no value, there is nothing to protect.[87]

The Fifth Amendment to the Constitution of the United States of America [hereinafter the Fifth Amendment],[88] which protects a creditor from being deprived of its property without due process of law or just compensation,[89] is the source of the concept of adequate protection. Adequate protection seeks to address

82. House Report, *supra* note 14, at 339.
83. *Id*.
84. *Id*.; *see also Re* Cook, 205 B.R. 437, 439 (N.D. Fla. 1997).
85. *In re* Alyucan Interstate Corp., *supra* note 75, at 808; *In re* Pine Lake Village Apartment Co., 19 B.R. 819 (Bankr. S.D.N.Y. 1982).
86. The issue of whether compensation for lost opportunity cost is a component of the secured creditor's bargain has been the subject-matter of much debate. This topic will be examined *infra* notes 114–143 and accompanying text.
87. *See, e.g., In re* 620 Church Street Building Corp., 299 U.S. 24 (1936), which held that, if a parcel of land on which there are a number of mortgages has an appraised value of less than the amount of the first mortgage, the subordinate mortgagees have no interest in that property which requires adequate protection.
88. U.S. Const. amend. V.
89. Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co., 294 U.S. 648 (1935); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935). One must question, however, whether imposing a stay of proceedings is a "deprivation" of property or merely a temporary interference with rights. Of course, a stay of proceedings imposes a lost opportunity cost on creditors which is discussed *infra* notes 115–144. However, a discussion of whether a stay of proceedings is a "deprivation" is beyond the scope of this paper.

both issues raised by the Fifth Amendment. While acknowledging the constitutional basis of the concept, the legislative history indicates that public policy played a significant role in the development of the concept and the drafting of Code §361.[90] The Fifth Amendment protects the rights of creditors. Public policy focuses primarily on debtor rehabilitation through reorganization by the preservation of businesses and employment, the continuation of credit[91] and the protection of investment. Debtor rehabilitation also preserves essential and viable industries. Thus, the concept of adequate protection requires American courts to attempt to balance all these interests.[92]

Negotiation and agreement among stakeholders on a method and procedure for providing adequate protection are the most efficient ways to deal with it.[93] One writer suggested that the requirement of adequate protection should foster cooperation between the debtor and its creditors.[94]

Once a creditor requests a court to provide adequate protection of its interest, the onus is on the debtor or trustee to propose a method of adequately protecting the creditor. The debtor will likely propose a method that will be acceptable to the creditor while minimizing the effect on its efforts to reorganize.[95] If the creditor objects to the proposed method, the court determines the adequacy of the protection and the debtor has the burden of establishing that the creditor will be adequately protected.[96] The court will not, in the first instance, suggest the method of protection, as this would place the court in an administrative role.[97]

Code §361 (1) which allows the debtor to make periodic cash payments and Code §361 (2) allows the debtor to grant additional or replacement liens. These methods compensate the secured creditor for the "decrease in the *value of such entity's interest* in such property" (emphasis added), not an interest in specific collateral. The decrease could be the result of depreciation in the value of the secured creditor's collateral during the reorganization process.[98] If this is the case, the secured creditor is allowed cash payments or additional or replacement liens to ensure that this value remains

90. House Report, *supra* note 14, at 339.

91. John L. Smaha, *Automatic Stay Under the 1978 Bankruptcy Code: An Equitable Roadblock to Secured Creditor Relief*, 17 San Diego L. Rev. 1113, 1123 (1980).

92. *See*, *e.g.*, Louisville Joint Stock Land Bank v. Radford, *supra* note 89.

93. Fed. R. Bankr. P. 4001(d) prescribes a procedure for the approval by the court of a settlement agreement between the debtor and its creditors concerning adequate protection. Although the federal Bankruptcy Rules do not mandate *a priori* approval, it has been held to be the preferred approach: *In re* Blehm Land & Cattle Co., 859 F.2d 137, 140 (10th Cir. 1988). Otherwise, the creditor is at risk that the court will refuse to sanction the agreement *post facto*, as being inequitable or contrary to the intent and purpose of the Code. Rule 4001(d) seeks to preserve the due process rights of third party creditors who are entitled to notice of an application for approval of such an agreement.

94. Andrew N. Karlen, *Adequate Protection Under the Bankruptcy Code, Its Role in Business Reorganizations*, 2 Pace L. Rev. 1, 33 (1982) where he states:

> Adequate protection may encourage a spirit of cooperation and negotiation between the debtor and its secured creditor, since it is to both party's advantage to confirm a plan to revitalize the debtor's business, and to provide adequate protection in the interim.

95. Harvey R. Miller & Martin.R. Bienenstock, *Adequate Protection for Property in Bankruptcy* 8:1 ALI-ABA Course Materials J. 31 (1983).

96. *In re* Farmer, 257 B.R. 556, 559 (D. Mont. 2000).

97. House Report, *supra* note 14, at 338.

98. *In re* Deico Elecs., Inc., 139 B.R. 945, 947 (9th Cir. 1992).

constant.[99] For example, periodic cash payments may be appropriate to compensate for depreciation of property at a relatively fixed rate.[100] Conversely, if there is no decrease in the value of the interest, the creditor is not entitled to receive adequate protection.[101] Similarly, an additional or replacement lien gives the secured creditor alternate or additional property on which to realize the decreased value of the collateral.[102]

Much of the early case law that attempted to define adequate protection deals with the protection necessary to provide the secured creditor the "indubitable equivalent" of its interest in the collateral. The United States Congress borrowed the term "indubitable equivalent" from the frequently-quoted statement of Judge Learned Hand in *In re* Murel Holding Corporation.[103] In that case, when discussing the power given to a judge to provide a creditor adequate protection, he stated:

> In construing so vague a grant, we are to remember not only the underlying purposes of the section, but the constitutional limitations to which it must conform. It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[104]

The Code's legislative history indicates that the term "indubitable equivalent" was a general category intended to provide the courts with the necessary flexibility to fashion "new methods of financing."[105] However, the protection courts usually award conforms to traditional methods of financing such as government mortgage guaranties,[106] a combination of equity in the property, current payments and insurance coverage,[107] curing defaults under a security agreement or lease, undertaking to meet payments as they fall due or providing the creditor with a security deposit.[108]

More novel, is the court's use of an equity or value cushion as adequate protection.[109] When the amount of the debt is greater than the value of the secured

99. See also In re Addison Properties Ltd. Partnership, 185 B.R. 766, 769 (Bankr. N.D. Ill. 1995).

100. House Report, *supra* note 14, at 339. *See, e.g., In re* Bermec Corporation, 445 F.2d 369 (2d Cir. 1971), which originated the periodic cash payment method. In that case, the debtor was in the business of leasing trucks and tractor-trailers. A number of secured creditors provided financing on security of the vehicles and opposed the reorganization petition. The court found that the secured creditors were adequately protected by the trustee's proposal to pay the "'economic depreciation' on the secured creditor's equipment so as approximately to preserve their status quo": *id.* at 369.

101. Timbers, *supra* note 52 at 1382 (5th Cir. 1986); Confederation Life Ins. Co. v. Beau Rivage Ltd., 126 B.R. 632, 640 (N.D. Ga. 1991).

102. Id.

103. 75 F.2d 941 (2d Cir. 1935) [hereinafter *Murel*].

104. Murel, *id.* at 942.

105. Id.

106. Pennsylvania State Employee's Retirement Fund v. Roane, 14 B.R. 542 (Bankr. E.D. Pa. 1981); *contra In re* Heath, 9 B.R. 665 (Bankr. E.D. Pa. 1981).

107. In re Rose, 21 B.R. 272 (Bankr. D.C.N.J. 1982); *see also In re* Melson, 44 B.R. 454, 457 (D. Del 1984).

108. In re Walker, 3 B.R. 213 (Bankr. W.D. Va. 1980).

109. For the purposes of establishing the equity cushion, the courts use "the value of the property after deducting the claim of the creditor seeking relief from the automatic stay and all senior claims", *In re* Indian Palms Assocs., Ltd., *supra* note 51, at 207. The reason for this is that a secured creditor seeking adequate protection does so for its own claim and not the claims of others. On the other hand, "equity" in Code §362(d)(2) is intended to protect all creditors and not just a creditor seeking adequate protection, *id. See also In re* Mellor, 734 F.2d 1396, 1402 (9th Cir. 1984).

creditor's interest in the collateral, the secured creditor is undersecured. In that case, the secured creditor's interest in the collateral is adequately protected, subject to any protection the court may allow under Code §361. The debtor, in other words, has no equity in the collateral. Conversely, when the amount of the debt is less than the secured creditor's interest in the collateral, the secured creditor is over-secured. In that case, the full value of the secured creditor's interest in the collateral should be adequately protected and the courts hold, in some cases, that the "equity cushion" provides sufficient adequate protection.[110] This is so despite the fact that the estate may use the equity cushion to pay administrative and ordinary course business expenses.[111]

Several writers are critical of the evolution of the equity cushion concept[112] where the equity cushion is eroding through depreciation or accruing interest and costs, such as when the court holds the equity cushion in real estate to be adequate protection, without more.[113] These writers do not dismiss the notion of an equity cushion as a component of adequate protection in a proper case, so long as the debtor provides the creditor with additional forms of adequate protection, such as periodic

110. See, *e.g.*, *In re* Mellor, *id.*, at 1401, where the court held that an equity cushion of approximately 20% was sufficient adequate protection; *In re* Shapiro, 109 B.R. 127, 135 (Bankr. E.D. Pa. 1990), where the court held that a 30% value over the secured obligations was a sufficient equity cushion to adequately protect the secured creditor. Shapiro, *id.*, is also interesting in that it points to a common problem in these types of cases, which is the issue of conflicting appraisals. *Contra In re* Westchester Ave. Marina Realty, Inc., 124 B.R. 161, 166 (Bankr. S.D.N.Y. 1991), where the court provides us with the factual circumstances it used to hold that the equity cushion was not sufficient to adequately protect the secured creditor:

> . . . the debtor has offered no additional payments, there exists a declining value of the secured claim in the face of declining real estate values, there is unpaid interest required to be paid . . . , there are unpaid real estate taxes and there is no plan of reorganization proposed by the debtor after more than four months following the filing of the Chapter 11 petition.

See also In re Lane, 108 B.R. 6 (Bankr. D. Mass. 1989), where the court provides a very compelling argument against the use of the equity cushion as adequate protection; *See also In re* Alyucan Interstate Corp., *supra* note 75, 810–812.

111. Code §363(e); *In re* James Wilson Assocs., 965 F.2d 160, 171 (7th Cir. 1992).

112. James McCafferty, *'Value Cushion' Reexamined: A Critical Review of Value Cushion as Adequate Protection in Chapter 11 Real Estate Cases* 89 COMM. L.J. 31 (1984); Evan D. Flaschen, *Adequate Protection for Oversecured Creditors* 61 AM. BANKR. L.J. 341 (1987); John L. Fellows, *In re Alyucan Interstate Corporation: Determining Adequate Protection in Actions for Relief From the Automatic Stay*, 1982 UTAH L. REV. 383. Flaschen, *id.* at 348 uses the term ''collateral cushion'' and defines it as the amount by which the value of the collateral exceeds the amount loaned by an asset-based lender.

113. McCafferty, *id.* at 33. These types of cases prompted McCafferty, *id.* at 32, to state:

> [The equity cushion as adequate protection] has now been applied to frustrate completely the rights of creditors secured by sluggishly illiquid real property in the hands of speculators, where the margins of value in excess of liens have been so narrowed as to make the *Blazon* financing arrangement look like the best loan Citicorp ever made!

Courts have also been critical of the equity cushion as adequate protection when it value is being eroded: *In re* Development, Inc., 36 B.R. 998, 1007 (Bankr. D. Haw. 1984), where the court said ''. . . even where there is some equity in the property, when the equity cushion is being eroded by the continuous increase in the daily interest costs of the mortgage, there is no adequate protection to the mortgagee'': *In re* Lane, *supra* note 110. Compare *In re* Rogers Development Corp., 2 B.R. 670 (Bankr. E.D. Va. 1980), where the court held that the equity cushion, without more, provided the secured creditors adequate protection where the equity cushion was valued at between $81,000 and $130,000 and the real property in which the equity cushion was established was appreciating in value. In that case, the debtor owed the secured creditors approximately $619,000.

payments or replacement liens. However, several courts have held that the equity cushion itself should not be adequately protected through such means.[114]

One form of adequate protection the writers suggest is for the court to provide oversecured creditors with compensation for lost opportunity cost.[115] Compensation for lost opportunity cost usually concerns undersecured creditors. However, secured creditors that are adequately protected through the equity cushion alone, with the debtor paying no current interest, might also seek that compensation. *Timbers* defined lost opportunity cost as the loss a secured creditor incurs by not being permitted to foreclose its lien, sell the collateral and reinvest the proceeds.[116] Code §506(b) provides:

> *To the extent that* an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, *is greater than the amount of such claim*, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, *costs*, or charges *provided for under the agreement under which such claim arose.* (emphasis added)

While Code §506(b) allows an oversecured creditor to recover postpetition interest, fees and costs to the extent of the value of the collateral exceeding the amount of its secured claim, it still loses the time value of those amounts and thereby suffers a loss. An award of periodic payments to cover its lost opportunity cost[117] would fully compensate the secured creditor in such circumstances.[118] While one may argue that compensation for lost opportunity cost,[119] should be awarded to an oversecured creditor, there is no statutory authority for awarding it to an undersecured creditor.[120] Unlike an oversecured creditor which may recover postpetition interest, fees and costs, the Code has no provision entitling an undersecured creditor to recover such amounts.[121] This has resulted in some uncertainty concerning the

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114. See, e.g., In re Delta Resources, Inc., 54 F.3d 722 (11th Cir. 1995).

115. Flaschen, *supra* note 112 at 353; McCafferty, *supra* note 112 at 35.

116. Timbers, *supra* note 52 at 1382 (5th Cir. 1986).

117. Flaschen, *supra* note 112, at 354.

118. Note, however, that many jurisdictions prohibit an award of interest on prepetition or prejudgment interest. For example, the Alberta Judgment Interest Act, R.S.A., ch. J-1 (2000) (Can.), which allows the court to award interest on a judgment from the date the cause of action arose to the date of the judgment, prohibits a court from awarding interest on interest. It says:

> 2. (2) The court shall not award interest under this Part
>
> . . .
>
> (b) on interest awarded under this Act;

119. A secured creditor would be well-advised to include a provision in its security agreement allowing its recovery of compensation for lost opportunity cost. This would allow the argument to be made that such cost was contemplated by the agreement.

120. Timbers, supra note 52.

121. In fact, American courts have required undersecured creditors to apply adequate protection payments against the secured portion of their claims rather than against the unsecured portions. *See In re* Spacek, 112 B.R. 162, 165 (W.D. Tex 1990) and *In re* Weinstein, 227 B.R. 284 (9th Cir. 1998). To hold otherwise would give the undersecured creditor a windfall, as it would be receiving payments on the unsecured portion of its claim without having to share it with the other unsecured creditors, *Weinstein*, *id.* at 297. The courts see this as allowing these undersecured creditors to receive compensation for lost opportunity cost, *id. But see* the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, §218, 108 Stat. 4106 (1994), which added a new Code §362(d)(3). That section provides that in a single asset real estate case, as defined in Code §101(51B), should the debtor fail to file its plan within 90 days after the entry of an order for relief, the debtor must commence making monthly payments to each undersecured creditor in an amount equal to interest at the current fair market rate on the value of such creditors' interest in the asset.

position of undersecured creditors. To understand the uncertainty, reference is made to Judge Hand's notion that adequate protection should be "completely compensatory" and that "payment ten years hence is not generally the equivalent of payment now."[122] Many American Bankruptcy and District Courts in the early 1980s held that a secured creditor's right to repossess, sell and reinvest the proceeds is a valuable right worthy of protection and, following Judge Hand's opinion in *Murel*, awarded compensation for the present value of that right.[123] In 1984, the Ninth Circuit Court of Appeals in *In re* American Mariner Industries Inc.[124] upheld this position. It held that the central issue in the case was not to determine how to provide adequate protection but whether[125] the value of the collateral or the present value of the undersecured creditor's interest in the collateral is an interest that must be protected. While the court acknowledged that neither the Code's legislative history nor the Code itself expressly mentioned protection of a secured creditor's right to foreclose, sell and reinvest the proceeds of sale, it held that, " . . . these are valuable rights of secured creditors, and nothing in the reports suggests that they are not among those equitable and legal interests entitled to protection."[126] Therefore, the court concluded that lost opportunity cost was an interest that required protection for the secured creditor to realize the benefit of its bargain.[127] The court acknowledged that it was being "guided by equitable principles"[128] and held that the award was consistent with Judge Hand's wording that the United States Congress adopted by enacting Code §361 (3),[129] which "at least encourages if not requires a present value analysis."[130] The court also acknowledged several times that it was standing on less than firm ground. From a pure public policy perspective, however, the decision is defensible.[131] The policy underlying the decision is obvious from the following:

> To the extent that the debtor in bankruptcy can prevent the secured creditor from enforcing its rights against collateral while the debtor benefits from the creditor's money, the debtor and his unsecured creditors receive a windfall at the expense of the secured creditor.[132]

122. *Murel*, *supra* note 103 and accompanying text.
123. *In re* Anchorage Boat Sales, Inc., 4 B.R. 635 (Bankr. E.D.N.Y. 1980); *In re* Virginia Foundry Co. Inc., 9 B.R. 493 (D.C.W.D. Va. 1981); Metropolitan Life Insurance Co. v. Monroe Park, 17 B.R. 934 (D.C.D. Del. 1982).
124. 734 F.2d 426 (9th Cir. 1984) [hereinafter *American Mariner*].
125. *American Mariner*, *id.* at 430.
126. *American Mariner*, *id.* at 431.
127. House Report, *supra* note 14, at 339.
128. *American Mariner, supra* note 124, at 432.
129. *American Mariner*, *id.* at 434.
130. *American Mariner*, *id.* at 432.
131. See, *infra* notes 140–144 and accompanying text.
132. *American Mariner*, *supra* note 124, at 435. The Fourth Circuit Court of Appeals followed the *American Mariner*, *id.*, reasoning in Grundy National Bank v. Tandem Mining Corporation, 754 F.2d 1436 (4th Cir. 1985). The Eighth Circuit Court of Appeals in *In re* Briggs Transportation Co., 780 F.2d 1339 (8th Cir. 1985), also accepted that, in an appropriate case, interest payments for the delay in foreclosing, liquidating and reinvesting the proceeds may be awarded but refused to "hold as a matter of law that a creditor is always entitled to 'such compensation'." [*id.* at 1350]. The result of this case, while recognizing compensation for lost opportunity cost, was to require each court to examine on a case by case basis whether such interest is worthy of such protection. This approach would have resulted in considerable litigation and lack of predictability and, accordingly, it was widely criticized. *See*, *e.g.*, Note, *'Adequate Protection' and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy* 100 HARV. L. REV. 1106, 1120 (1987).

Meanwhile, other American courts concluded that neither *Murel* nor the Code[133] intended to protect the foreclosure, liquidation and reinvestment interest and, therefore, refused to require compensation for loss of that "right." This position ultimately prevailed. In *Timbers*, the United States Supreme Court unanimously denied the undersecured creditor compensation for its lost opportunity cost.[134] The court did not accept any of the equitable arguments the creditor put forth, as the Code presented the court with no ambiguity.[135]

The law review articles that critique *Timbers* bear witness to the fact that this decision gives us a logical approach to the issue. However, those articles do not give credit to the soundness of the public policy concerns that *American Mariner* was attempting to address. When discussing a case that supported the public policy concerns outlined in *American Mariner* and was "notable for its misconceptions," one author wrote that the judge " . . . was apparently unaware or chose to ignore the fact that the bankruptcy laws are designed specifically to help debtors . . . . "[136] Another author, when referring to the fact that awarding compensation for lost opportunity cost would have adverse consequences on reorganizations and would result in more liquidations said "accordingly, granting undersecured creditors lost opportunity costs would be poor public policy."[137]

While *Timbers* is sound based on the Code's wording, awarding compensation for lost opportunity cost is not necessarily poor public policy, for the reasons set forth in *American Mariner*.[138] Financial reorganization law is not designed exclusively for debtors or unsecured creditors. It seeks to balance the interests of all stakeholders. Is it poor public policy to allow an undersecured creditor the benefit of its bargain while allowing the parties that have the most to gain from a reorganization and the least to lose from its failure, to use part of the assets on which the secured creditor based its bargain? Several writers expressed the concern that *Timbers* would result in secured creditors requiring increased margins or higher borrowing costs which could result in fewer out of court settlements and increased bankruptcies.[139] One wonders if this is sound public policy. *Timbers* is an exercise in statutory

133. *See*, *e.g.*, *In re* Pine Lake Village Apartment Co., *supra* note 85; *In re* Alyucan Interstate Corp., *supra* note 75; *In re* South Village, Inc., 25 B.R. 987 (Bankr. D. Utah 1982). As the conclusions reached by these courts accord with the decision of the United States Supreme Court in *Timbers*, *supra* note 52, a discussion of the reasoning in these cases will not be undertaken.

134. Immediately following the decision in *Timbers*, *supra* note 52 numerous law review articles praised the Supreme Court's decision as being strictly in accordance with statutory interpretation and provided undersecured creditors with strategies to assist them in coping or circumventing the decision in *Timbers*, *id*. These articles pointed to the possible narrowness of the decision and criticized previous decisions that were contrary to the approach in *Timbers*, *id.*, as being ill-conceived. If *Timbers*, *id.* was so obviously correct, one wonders why there was any uncertainty in the first place.

135. *Timbers*, *id.*

136. Tazewell T. Shepard III, *The Plight of Secured Creditors After In re Timbers of Inwood Forest Associates, Ltd.* 1989 COMM. L.J. 26, 39.

137. Carlos J. Cuevas, *Lost Compensation Costs and the Undersecured Creditor: A Journey Into the Inwood Forest*, 33 N.Y.L. SCHOOL REV. 1, 40 (1988).

138. *Supra* note 124.

139. Pamela Mable, *The Resolution: United States v. Timbers of Inwood Forest Associates*, 41 ALA. L. REV. 503, 522 (1989–90); Joseph U. Schorer, *The Right of the Undersecured Creditor to Postpetition Interest in Bankruptcy on the Value of its Collateral: Implications of Recent Cases*, (1988) 21 U.C.C.L.J. 61, 70 (1988).

interpretation, so one wonders whether it is of use to us when examining the Model Law.[140]

As American courts seem to be moving away from fully compensatory adequate protection, several writers have suggested that creditors will be moving more quickly to seek relief from the automatic stay of proceedings and require the debtor to show that it has a reasonable possibility of successfully reorganizing its financial affairs within a reasonable time.[141] The result will be dismissal of the case or conversion to liquidation cases at an earlier stage in the proceedings.[142] It appears, therefore, that American jurisprudence is moving to an approach of questioning the feasibility of financial reorganization at the outset of the proceeding and forcing the court to look at the debtor's chances of success rather than the creditor's right to protection. Unfortunately, there have been few reported cases that test this hypothesis.[143] As one writer noted, "[f]ew undersecured creditors waste time filing early motions for stay relief, and few bankruptcy courts are willing to write extensive opinions on a matter that has been clearly decided against the creditor's position."[144]

To avoid the risk of leaving the reader with the idea that adequate protection is available only in the narrowest of circumstances, it may be useful to summarize the concept. When it is warranted, the court must grant adequate protection to a creditor on the creditor's request.[145] Adequate protection protects the secured creditor from a decrease in the value of its collateral and it may assure the creditor that it will ultimately receive the value of its collateral at the dismissal or conclusion of the case. It also requires the debtor to maintain the property and not expose the property to noncompensable loss through a lack of insurance. Finally, it is arguable that adequate protection would protect the "collateral cushion" or lending margin of an oversecured creditor. However, it does not provide an undersecured creditor with compensation for its lost opportunity cost. To that extent, it is not completely compensatory, as it deprives the undersecured creditor of the right to foreclose, sell and reinvest the proceeds, which is the "essence of secured lending."[146]

140. For example, the court held that Code §506(b) allows postpetition interest to oversecured creditors only and not to undersecured creditors. As to oversecured creditors, they are only entitled to postpetition interest to the extent of the value of the collateral. Undersecured creditors as to the unsecured portions of their claims, must share the benefits and losses of a business reorganization with other unsecured creditors. They should not be given the benefit of interest on their secured claims before unsecured creditors receive any principal payments. Furthermore, Code §502(b) prohibits the payment of unmatured interest and Code §726(a)(5) permits the payment of interest at the legal rate to creditors only after the principal amounts are paid to all allowed claims of secured and unsecured creditors.

141. *Timbers, supra* note 52 at 751.

142. Pat H. Scanlon, *Adequate Protection and Secured Creditors' Strategies After Timbers*, (1989–90) MISS. C. L. REV. 59, 76.

143. The reported cases to date merely confirm *Timbers*, *supra* note 52. *See*, *e.g. In re* Reddington/Sunarrow Limited Partnership, 119 B.R. 809 (Bankr. D.N.M. 1990).

144. Shepard, *supra* note 136 at 43.

145. U.S. v. Booth Tow Services, Inc., 64 B.R. 539, 541 (W.D. Mo. 1985).

146. Lauris H. Molbert, *Adequate Protection for the Undersecured Creditor in a Chapter 11 Reorganization: Compensation for the Delay in Enforcing Foreclosure Rights*, 60 N. DAKOTA L. REV. 515, 517 (1984).

V. Adequate Protection Under the Model Law

The Model Law allows a court to provide creditors adequate protection when granting an order under articles 19 and 21.[147] Why are creditors not given the same protection when the automatic stay occurs under article 20? Paragraph 2 of article 21 allows the court to ensure that local creditors are adequately protected, but only if distribution of the debtor's assets located in the enacting state are entrusted to the foreign representative. It is arguable that a distribution relates only to a case involving a liquidation proceeding and not to a reorganization proceeding. If this is the case, local creditors in a reorganization proceeding are not given adequate protection, so the assets otherwise available to those creditors could fund the proceeding. To protect creditors against this eventuality in the case of a reorganization proceeding, the court must be allowed to ensure that local creditors are adequately protected and the enacting state must make this clear. Paragraph 2 of article 20 could make provision for this as part of the "provisions of law of the enacting State relating to insolvency that apply to exceptions . . . in respect of the stay." Furthermore inserting a notion of adequate protection for local creditors in a reorganization proceeding could help to "organize an orderly and fair cross-border insolvency proceeding."

A well-defined concept of adequate protection might assist the court in its attempt to balance the interests of local creditors with those of the debtor and foreign creditors. In other words, if the debtor provides the local creditors with adequate protection of their interests, the court might be inclined to recognize the foreign main proceeding with its attendant automatic stay.

In a proceeding involving an American debtor or American creditors, it would be difficult for parties and courts outside the United States to understand arguments involving adequate protection without some understanding of how American courts have interpreted and applied the concept. Although one could approach adequate protection in a vacuum and simply apply its grammatical meaning to a particular case, those parties would lose the decades of American development of the concept. If the Working Group and UNCITRAL had intended to give the courts unfettered discretion when protecting creditors during the stay of proceedings, they might have used other wording to ensure that such protection would not be encumbered with the meanings ascribed by American courts. Furthermore, by using the phrase adequate protection, UNCITRAL invites American courts to treat it as a term of art, rather than a new concept. Not surprisingly, a foreign representative or creditor who is not well-versed in the American jurisprudence might be taken aback by the technical arguments that ensue during an application seeking adequate protection in an American court and judges in a country other than the United States could be faced with those same technical arguments, without the benefit of knowing the American legislative and judicial history underlying them. To help a country proposing to adopt the Model Law and the judges that must

147. Model Law, art. 22, para. 1.

interpret it, those countries might consider incorporating a nonexclusive description of the term, similar to Code §361. To allow their courts the same flexibility as that which the United States Congress has given American courts, those countries might consider a judicial discretion clause, similar to Judge Hand's "indubitable equivalence" clause or something more indicative of the giving of that discretion. Finally, for the term adequate protection to have any use whatsoever, the country proposing to adopt the term must ensure that it has a sound personal and real property security regime. Without it, the concept of adequate protection is meaningless.

VI. Conclusion

If the objective of a reorganization system is to balance the respective interests of stakeholders and debtors with a view to having the debtor emerge as a healthy, viable business, one must question whether the Model Law will accomplish this objective. One must examine the Model Law, bearing in mind the normative basis of the system.

> Bankruptcy law does not exist in a vacuum, yet one cannot spend much time reading in the field without noting that few judges or scholars have taken this observation to heart. Too many seem to think that a bankruptcy proceeding provides, in the main, an essentially unlimited opportunity to do what appears at the moment to be good, just or fair without regard to the reasons for having a system of bankruptcy laws in the first place.[148]

The primary objective of a reorganization system should be to aid businesses that have the capacity and capability of surviving in the current marketplace. Not all businesses in all circumstances should have a right to attempt a reorganization. Although one writer described the American reorganization system as "a rejection of economic Darwinism,"[149] any sound reorganization system must ensure that the fittest businesses should survive and the unfit should perish, unless they reorganize in a way that will allow them to survive and meet the changing environment.

To accomplish the primary objective, the system must allow the stakeholders to determine whether the debtor is fit or unfit. A stay of proceedings allows the parties the time to make that determination. During the stay of proceedings, the legislation or courts must protect the rights of secured creditors. This does not derogate from the debtor's rights, as the stay of proceedings provides the debtor its most valuable resource, time. If a court provides a secured creditor adequate protection during this period, the secured creditor should have no difficulty in even a protracted stay

148. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984) (citations omitted).

149. Comment, *Adequate Protection and the Automatic Stay Under the Bankruptcy Code: Easing Restraints on Debtor Reorganization*, 131 U. Pa. L. Rev. 423 (1982).

of proceedings period as its "bargain"[150] is preserved.[151] In this manner, the reorganization system balances the interests of the debtor and secured creditors.

The system must also account for interests of the subordinate secured creditors and unsecured creditors, as they gain the same benefit as the debtor. If a liquidation ensues, at best, those creditors would receive a portion of their secured debts, in the case of subordinate secured creditors, or their *pro rata* share of the residual amount after payment of all secured and preferred claims, in the case of unsecured creditors. Should the reorganization be successful, they would receive those amounts plus their respective share of the enhanced value of the going-concern enterprise. Subordinate secured creditors whose security has some value should receive adequate protection based on that value.

As reorganization is a collective proceeding, a secured creditor must not expect to receive the full value of its bargain. Therefore, adequate protection must be based on the value of its interest in the property as at the date the reorganization proceeding commences, not the value of its debt. Usually, the value of the interest would be based on the lesser of the amount of the debt and the liquidation or net realizable value of the collateral. Liquidation or net realizable value is a concept distinct from a going-concern value. This reduced value is all it would realize in a liquidation scenario. However, the legislation should give the courts considerable flexibility with respect to valuation issues to apply properly the valuation concept in the light of the facts of the case, the conduct of the parties and other general equitable principles.[152]

The legislatures of the enacting states should also give the courts flexibility when establishing methods of adequate protection. Periodic payments should be the most common method of adequate protection. While, in many cases, the debtor's problems are the result of a lack of cash flow,[153] the legislatures must remember that secured creditors are entitled only to reduced payments (based on valuations referred to above) and the stay of proceedings operates to prevent secured creditors from further collection efforts during that period. Should cash flow still be a problem, the debtor must look to third party investors, subordinate creditors or additional financing. This is where "economic Darwinism" is most evident as, "[a]n inability to persuade anyone . . . that the firm should stay alive seems good evidence that it should not."[154]

Similarly, debtors might not have any unencumbered assets or assets that possess a significant "collateral cushion" in which to grant secured creditors additional or

150. The term "bargain" is used not to indicate the bargain which was negotiated by the parties at the commencement of their relationship. Rather, it is the bargain which is in effect immediately following the debtor seeking the protection of the appropriate reorganization statute. It is at this moment that, for example, valuation of the property is made and quantification of the debts is made and it is the reference point for determining pre-filing and post-filing conduct.

151. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, (1982) 91 YALE L.J. 857, 873 (1982).

152. House Report, *supra* note 14 at 339.

153. Dean C. Gordinier, *The Indubitable Equivalent of Reclamation: Adequate Protection for Secured Creditors Under the Bankruptcy Code*, 54 AM. BANKR. L.J. 299, 319 (1980).

154. Baird and Jackson, *supra* note 148 at 128.

replacement liens.[155] However, this should not derogate from the use of additional or replacement liens in appropriate circumstances.

Periodic cash payments and additional or replacement liens are merely two examples of methods of adequate protection. If legislatures of the enacting states accept the concept of adequate protection, then giving courts the necessary flexibility to develop and adapt the concept to changing circumstances should pose little difficulty. The legislatures must give the courts jurisdiction to provide adequate protection they consider necessary or appropriate in the circumstances. This will allow the required flexibility, without having to address the issue of whether and to what extent adequate protection should be "completely compensatory"[156] and whether the secured creditor should receive the "mere indubitable equivalent" or the "most indubitable equivalent."[157] The countries that choose to adopt the Model Law should learn from the American experience by avoiding the term "indubitable equivalent" and providing the court a general discretion. This will also have the benefit of allowing courts in the enacting state to provide a method of adequate protection that is appropriate to that state and its business culture.

An "equity cushion" should not be adequate protection of itself, as it fails to recognize the commercial reality of secured creditors generally requiring that cushion to cover accrued interest, expenses and other costs they incur when realizing on collateral. Of course, a significant equity cushion could suffice in appropriate circumstances.[158] However, the courts must rely on the commercial lending community to advise on the appropriate equity cushion required in any given circumstance. The underlying policy, in this situation, should be commercial reasonableness.

The debtor should be the party that proposes a method of adequate protection, once the creditor requests it. The debtor is best able to determine the capacity of the business and opportunities for third party financing. It also gives the debtor an opportunity to explore novel methods of adequate protection, without being constrained by precedent.

Legislatures of the enacting states should retain concepts that provide courts with flexibility concerning the conduct of the parties, determining whether a successful reorganization is likely, whether the property is necessary for a successful reorganization, whether the debtor is making progress towards a successful reorganization and, generally, other equitable factors that may govern in the circumstances.[159] The relief courts grant should include the right to terminate, modify or condition the stay of proceedings, in appropriate circumstances.

The foregoing model better addresses the objectives of a business reorganization system. It adopts many concepts developed under the Code, but seeks to avoid some of its pitfalls and inequities.

155. Donald Price, *Adequate Protection Under the Bankruptcy Act of 1978*, 71 KY. L.J. 727, 739 (1982–82).
156. *Murel, supra* note 103.
157. William J. Wahoff, *The Adequate Protection of Secured Creditors in Termination of Stay Litigation Under the Bankruptcy Code*, 43 OHIO ST. L.J. 715, 730 (1982). Baird & Jackson, *supra* note 148, have described this debate as one that is conducted in a ''vacuum'' and ignores the purposes of business reorganization legislation.
158. Such as in *In re* Blazon Flexible Flyer, Inc., *supra* note 39.
159. Kennedy, *supra* note 34 at 238–53.

The hallmark of the American reorganization system is to provide adequate protection to parties with an interest in the collateral and the Model Law adopts this concept, without explaining it. One may question the adequacy of the protection granted to American secured creditors, given their apparent discontent as exhibited by the volume of litigation and commentaries on the issue. The system, however, is more fair to parties with an interest in the collateral than a system that allows the debtor to use the collateral with no compensation or protection being given to the affected party. To take full advantage of the concept, however, countries that adopt the Model Law must provide its stakeholders and courts some guidance in the use of the concept. In so doing, the legislatures of the enacting states must provide a minimal standard from which to work, along with sufficient flexibility to provide adequate protection appropriate in the circumstances.

