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Court Rulings

The bankruptcy court denied both motions. On appeal, the district court held that the secured creditor was not entitled to superpriority status because:

(1) the adequate protection payments provided to the secured creditor were not “inadequate” where the secured creditor fully recovered the principal debt and interest owed to it as of the petition date;
(2) the secured creditor failed to address the effect the intervening subcontractors’ liens had on its claim;
(3) the secured creditor did not demonstrate that its collateral declined in value as a result of the debtor’s beneficial use of such collateral during the debtor’s Chapter 11 case; and
(4) the secured creditor was not entitled to recovery for any diminution in the value of the collateral securing the debtor’s obligation that occurred following the debtor’s conversion of its case to Chapter 7.

Addressing the first point, the court held that the relevant “interest” to be protected under 11 U.S.C. § 507(b) is the value of a creditor’s secured claim on the petition date, not the value of the collateral. The court reasoned that because the secured creditor received more from the estate than the value of its secured claim on the petition date, it had been adequately protected.

In the alternative, the court held that even if the “interest” to be protected under 11 U.S.C. § 507(b) is the value of the collateral instead of the value of the secured claim, the secured creditor had failed to prove that the diminution in the value of the debtor’s collateral was attributable solely to the debtor’s use of property prior to the conversion of the case from Chapter 11 to Chapter 7.

The court explained that “[a] superpriority claim only exists where the decline in the collateral’s value is attributable to an administrative expense,” i.e., the debtor must have used the collateral to “pay the actual, necessary costs and expenses of preserving the estate.” The court stated that any diminution in value that occurred after the case was converted to Chapter 7 could not be characterized as an administrative expense because “the mere opportunity to market collateral is [not] the type of concrete, actual benefit contemplated by § 503(b).” The district court affirmed the bankruptcy court’s holding that the secured creditor had failed to show that the diminution in value of the collateral was caused by the debtor’s use of the property “[b]ecause [the secured creditor] did not demonstrate the value of the debtor’s accounts receivable at the time of conversion.”

Addressing the secured creditor’s claim for post-petition interest, fees, costs and expenses under 11 U.S.C. § 506(b), the court held that because the secured creditor had failed to prove what portion of the funds collected on the debtor’s accounts receivable prior to the conversion to Chapter 7 were unencumbered by senior liens, the secured creditor had failed to bear its burden to show the extent of its oversecured position for purposes of § 506(b), and therefore could not recover under the section.
Takeaway

Construction Supervision should serve as a warning to secured creditors that they may not be able to use Section 507(b) to recoup post-petition interest, fees and expenses in addition to the value of their secured claim at the time a debtor files for bankruptcy. The case also highlights the necessity for creditors to support their claims with a detailed factual record and documentation or other evidence to support those facts. Here, the secured creditor was precluded from recovering under Section 506(b) because the secured creditor failed to prove what portion of the funds collected from the debtor’s accounts receivable during the debtor-in-possession period was unencumbered by the subcontractors’ liens.

Creditors that are oversecured on the petition date should work diligently throughout the pendency of the case to protect their interests, including seeking significant adequate protection payments and objecting to any other creditor’s effort to perfect liens on the property of the estate post-petition. Creditors should also ensure that the debtor meets all reporting requirements throughout the pendency of the case and carefully monitor their collateral to ensure that when the time comes, the creditor can meet its burden of showing the extent of its oversecured position necessary for a recovery under 11 U.S.C. § 506(b).

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