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Bankruptcy - Debtor's Exercise of the Cram Down Option - Valuation Standard for Collateral in Chapter 13

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Recent Decisions

BANKRUPTCY — DEBTOR'S EXERCISE OF THE CRAM DOWN OPTION — VALUATION STANDARD FOR COLLATERAL IN CHAPTER 13 — The Supreme Court of the United States held that section 506(a) of the Bankruptcy Code directs the application of the replacement value standard to collateral when a Chapter 13 debtor exercises the cram down option of section 1325(a)(5)(B) in its rehabilitation plan by retaining and using the collateral over the secured creditor's objection.

Associates Commercial Corp. v. Rash, 117 S. Ct. 1879 (1997).

In order to purchase a \$73,700.00 tractor truck for use in his freight hauling business, Elray Rash made a downpayment and pledged the truck to the seller as security for the remaining balance.¹ Associates Commercial Corp. ("Creditor") obtained the lien on the truck through assignment from the seller.² Three years later, Elray and Jean Rash ("Debtors") filed bankruptcy under Chapter 13.³ At the time of filing, the Debtors owed the Creditor

1. *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879, 1882 (1997).

2. *Associates Commercial*, 117 S. Ct. at 1882.

3. *Id.* Only a debtor who is an individual with regular income may be eligible for Chapter 13 bankruptcy. A Chapter 13 debtor who filed before April 1, 1998 must have unsecured debt of \$250,000.00 or less and secured debt of \$750,000.00 or less. MATTHEW BENDER, *COLLIER ON BANKRUPTCY* ¶ 1.03[6] (Lawrence P. King ed., 15th ed. 1997). For cases

\$41,171.00 on the truck loan.⁴

Pursuant to the cram down provision, section 1325(a)(5)(B) of the Bankruptcy Code,⁵ the Debtors provided in their Chapter 13 bankruptcy plan for retaining the truck for business use and paying the Creditor the present value of the truck over the life of the plan.⁶ The Creditor opposed the Debtor's plan and motioned for relief from the automatic stay so that it could pursue its state law remedies.⁷

filed after April 1, 1998, the debt limits have been adjusted upwards by the Judicial Conference of the United States which limits unsecured debt to \$269,250.00 and secured debt to \$807,750.00. 10 BANKR. L. REP. 224 (1998). The purpose of a Chapter 13 bankruptcy is rehabilitation not liquidation, thus the debtor may keep its assets and fund its Chapter 13 plan with any subsequent income earned. *Id.* In a Chapter 13 plan, the secured creditor must receive the "present value of its secured claim," while an unsecured creditor must, at a minimum, receive what it would have received in a Chapter 7 liquidation case. BENDER, *supra*, at 1-50. Chapter 13 plans are typically funded over a three to five year period. *Id.* at ¶ 1325.08[4][a]. If the debtor successfully completes the plan, the debtor receives a discharge of personal liability on all dischargeable debts. *Id.* at ¶ 1300.01. The overall policy of a Chapter 13 bankruptcy plan is to ensure a "fresh start" for the debtor by encouraging repayment plans instead of liquidation. *Id.* at ¶ 1300.02.

4. *Associates Commercial*, 117 S. Ct. at 1882. The Creditor held a secured claim on the truck, but only for the value of the truck. *Id.* The Bankruptcy Reform Act states that a lien on property is a secured claim:

to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting creditor's interest.

11 U.S.C. § 506(a) (1994).

5. Section 1325(a)(5) provides three alternative ways to bind secured creditors by modification of their rights. BENDER, *supra* note 3, at ¶ 1325.06[1][c]. Specifically, section 1325(a)(5)(B) authorizes the debtor to retain the property despite the creditor's objection. *Id.* at ¶ 1325.06[3]. However, in such a case, the debtor's plan must provide for payment of the present value of the secured claim over the life of the plan. *Id.* This provision is referred to as a "cram down" because it allows the debtor to modify the undersecured creditor's rights by paying only the value of the collateral, thereby cramming the plan down the creditor's throat. *Id.*

6. *Associates Commercial*, 117 S. Ct. at 1883. The Debtors purported that their truck was worth \$28,500.00. *Id.*

7. *Id.* The Debtors took exception to the Creditor's proof of claim reflecting a secured amount of \$41,171.00. *Id.* Interested in repossessing the truck, the Creditor sought relief from the automatic stay. *Id.* Upon the debtor's filing of the bankruptcy petition, the stay automatically begins. WILLIAM L. NORTON JR., NORTON ON BANKRUPTCY LAW AND PRACTICE § 118.1 (2d ed. 1993). The automatic stay prevents collection of pre-petition debts and enforcement of claims against estate property or the debtor's pre-petition property. *Id.* If relief from the stay is not granted, it continues until the case is closed or discharge is granted. *Id.* at § 118.2. Thus, in the instant case, the Creditor requested relief from the automatic stay so that it could pursue its state law remedy of foreclosure. *Associates Commercial*, 117 S. Ct. at 1883.

A determination of the collateral's value was made in a hearing before the Bankruptcy Court.⁸ The court approved the Debtors' plan and held that the truck was valued at its foreclosure value of \$31,875.00.⁹ On appeal, the United States District Court for the Eastern District of Texas affirmed the Bankruptcy Court's decision, but the district court was reversed by a panel of the United States Court of Appeals for the Fifth Circuit.¹⁰ The Fifth Circuit, on a rehearing en banc, rejected its earlier ruling and affirmed the district court, holding that section 506(a) requires the Creditor's secured claim to be measured by the foreclosure value.¹¹ The Fifth Circuit supported its holding by noting that the replacement value is incompatible with the Creditor's pre-petition secured status under state law that is based upon the truck's foreclosure value.¹² The court reasoned that application of the replacement value standard would, in many cases, afford the undersecured creditor more than what it would be entitled to receive upon the exercise of its state law foreclosure right.¹³

The Supreme Court of the United States granted certiorari to resolve the split among the circuits regarding the proper valuation standard to apply to collateral retained by a Chapter 13 debtor over the secured creditor's objection.¹⁴ Three different standards have

8. *Associates Commercial*, 117 S. Ct. at 1883. The Creditor asserted that the value of the truck should be based on its replacement value, which the Creditor defined as the amount the Debtors would have to pay for a like vehicle. *Id.* The Debtors believed that the standard should be the foreclosure value. *Id.* Determining the truck's value is particularly important because section 506(a) bifurcates an undersecured creditor's claim into its secured and unsecured portions and measures the secured component according to the truck's value. *Id.* at 1884. Bifurcating the claim is significant because, in a Chapter 13 bankruptcy, secured creditors are paid in full, whereas unsecured creditors only must receive at least what they would receive in a Chapter 7 liquidation. BENDER, *supra* note 3, ¶ 1.03.

9. *Associates Commercial*, 117 S. Ct. at 1883. See *In re Rash*, 149 B.R. 430, 434 (Bankr. E.D. Tex. 1993) (holding that because the value of the collateral must be valued from the creditor's standpoint, the secured component of the claim is measured by the truck's foreclosure value).

10. *Associates Commercial*, 117 S. Ct. at 1883. Appeals from the bankruptcy court are reviewed de novo by the district court. BENDER, *supra* note 3, at ¶ 3.03[3][a]. If the district court's decision is appealed, it is heard by an appellate court, and ultimately, the Supreme Court of the United States. *Id.* See *In re Rash*, 31 F.3d 325, 329-31 (5th Cir. 1994) (holding that the replacement value is the proper measure of the collateral's value, because if the foreclosure value were used, it would not give full effect to the language of section 506(a), and the secured creditor would not be fully compensated for the value of the collateral).

11. *Associates Commercial*, 117 S. Ct. at 1883. See *In re Rash*, 90 F.3d 1036 (5th Cir. 1996), *rev'd by Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997).

12. *Associates Commercial*, 117 S. Ct. at 1883. See *Rash*, 90 F.3d at 1041-42.

13. *Associates Commercial*, 117 S. Ct. at 1883.

14. *Id.* at 1884.

been employed by the district and circuit courts: the foreclosure value, the replacement value,¹⁵ and the midpoint value.¹⁶ The Supreme Court disagreed with the Fifth Circuit's interpretation that the first sentence of section 506(a) requires a foreclosure value standard.¹⁷ Specifically, the Court determined that the first sentence of section 506(a), which refers to "the creditor's interest in the estate's interest in such property," is devoid of reference to any method of valuation.¹⁸ Rather, the Supreme Court found that the first sentence of section 506(a) plainly states that the creditor's interest has two parts: a secured part that is measured by the value of the collateral, and an unsecured part that is measured as the amount by which the creditor's claim exceeds the collateral's value.¹⁹ The first sentence of section 506(a) merely allows the court to bifurcate a creditor's claim into secured and unsecured portions; it does not mandate one valuation standard over another.²⁰

Further, the Supreme Court held that the Fifth Circuit erred in its interpretation of section 506(a) because reading a foreclosure value standard, or any other standard, into the first sentence reduces the second sentence to mere surplusage.²¹ In the second sentence of section 506(a), Congress instructs that collateral value is measured according to its "disposition or use."²² Therefore, the Court reasoned, the creditor's secured status is measured with respect to the debtor's decision either to retain or to surrender the collateral.²³ If the debtor surrenders the property to the creditor,

15. *Id.* at 1883. The Supreme Court noted that the replacement value of the secured claim under section 506(a) is "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." *Id.* at 1884. See *In re Taffi*, 96 F.3d 1190, 1191-92 (9th Cir. 1996) (en banc); *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 74-75 (1st Cir. 1995); *In re Trimble*, 50 F.3d 530, 531-32 (8th Cir. 1995).

16. *Associates Commercial*, 117 S. Ct. at 1884. See *In re Hoskins*, 102 F.3d 311, 316 (7th Cir. 1996), *overruled by* *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997) (holding that the value of a vehicle retained by the debtor in a Chapter 13 bankruptcy proceeding is measured by the average of the retail and wholesale values of the collateral); *In re Valenti*, 105 F.3d 55, 62 (2nd Cir. 1997), *overruled by* *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997) (affirming the district court's holding that a vehicle in a Chapter 13 bankruptcy proceeding is valued by averaging its retail and wholesale values).

17. *Associates Commercial*, 117 S. Ct. at 1884.

18. *Id.*

19. *Id.*

20. *Id.* at 1884-85.

21. *Id.* at 1885. The second sentence of 11 U.S.C. § 506(a) states that "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."

22. *Associates Commercial*, 117 S. Ct. at 1885. See 11 U.S.C. § 506(a).

23. *Associates Commercial*, 117 S. Ct. at 1885. Bankruptcy Reform Act, 11 U.S.C. § 1325(a)(5) (1994) provides that a plan will be confirmed by the court if:

the creditor may pursue its state law remedies and sell the property at a foreclosure sale.²⁴ But if the foreclosure value is used to determine the secured status when the debtor retains the property and makes payments through the Chapter 13 plan, no distinction exists from the creditor's perspective between surrender and retention.²⁵ By exercising the cram down option, the debtor benefits from continued use of the collateral and avoids foreclosure.²⁶ The Supreme Court, therefore, held that in such a case the replacement value standard must be used to protect the creditor who incurs the risks of receiving neither the property nor its value, and to draw a meaningful distinction between the two "dispositions" or "uses" under section 1325(a)(5) from which the debtor must choose.²⁷

The Supreme Court also addressed the Fifth Circuit's perception that application of the replacement value standard derogates from state law, which limits the creditor's recovery to the collateral's foreclosure value.²⁸ The Court noted that federal bankruptcy law displaces state law and authorizes modification of creditors' state law rights by valuing collateral based upon its disposition and use.²⁹ The Supreme Court stated that since the federal law cram down option overrides conflicting state law foreclosure rights and adjusts creditors' rights, valuation based on "disposition or use" should be equally unobjectionable.³⁰

Finally, the Supreme Court rejected the midpoint valuation standard that splits the difference between the foreclosure and replacement value standards.³¹ The Court concluded that, to

(5) with respect to each allowed secured claim provided for by the plan —

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder.

24. *Associates Commercial*, 117 S. Ct. at 1885.

25. *Id.*

26. *Id.*

27. *Id.* The Court noted that application of the replacement value standard to property retained in exercise of a cram down option "accurately gauges the debtor's use of the property." *Id.*

28. *Id.* at 1886.

29. *Associates Commercial*, 117 S. Ct. at 1886.

30. *Id.*

31. *Id.* The Court reasoned that the Bankruptcy Code neither expressly nor implicitly authorizes the midpoint valuation approach. *Id.* According to the Court, valuation must be

maintain uniformity, a basic valuation rule is necessary.³² Thus, the Supreme Court held that section 506(a) of the Bankruptcy Code requires the application of the replacement value standard when a debtor retains and uses the collateral pursuant to the cram down option provided by section 1325(a)(5)(B).³³ The Fifth Circuit's judgment was reversed and remanded.³⁴

In a dissenting opinion, Justice Stevens stated that the foreclosure value standard is the correct standard.³⁵ He opined that the first sentence of section 506(a), which refers to "the creditor's interest in the estate's interest," compels calculation of the collateral's value from the perspective of the creditor rather than the debtor or a third party.³⁶ In interpreting the second sentence of section 506(a), Justice Stevens stated that the purpose of valuation is to place the creditor in the same position whether the debtor exercises the cram down option or the creditor repossesses and forecloses.³⁷ Whatever the debtor's choice, Justice Stevens stated, the creditor receives the present value of the property.³⁸ Justice Stevens argued that application of the replacement value standard provides a "general windfall to undersecured creditors at the expense of unsecured creditors."³⁹ Thus, he concluded that use of a foreclosure value standard promotes consistency throughout the Bankruptcy Code and avoids higher recoveries by secured creditors to the detriment of unsecured creditors.⁴⁰

Since Congress enacted the Bankruptcy Reform Act⁴¹ in 1978, the

based upon actual, not hypothetical use. *Id.*

32. *Id.* The Court noted that the midpoint valuation approach is far more complex than Congress intended because it would require two separate valuations and calculation of their average. *Id.*

33. *Id.* After stating that the replacement standard governs cram down cases, the Court noted that "[w]hether replacement value is the equivalent of retail value, wholesale value or some other value will depend on the type of debtor and the nature of the property." *Id.* at n.6.

34. *Associates Commercial*, 117 S. Ct. at 1887.

35. *Id.* at 1887 (Stevens, J., dissenting).

36. *Id.*

37. *Id.*

38. *Id.* at n.*. Justice Stevens therefore disagreed with the majority's conclusion that "surrender and retention are not equivalent acts." *Id.*

39. *Associates Commercial*, 117 S. Ct. at 1887 (Stevens, J., dissenting).

40. *Id.*

41. The first bankruptcy laws were passed by Congress in 1800. BENDER, *supra* note 3, ¶ 1.01[1]. The first bankruptcy act, the 1800 Bankruptcy Act, was enacted to create uniformity in the law of bankruptcy, but it was repealed in 1803. *Id.* at 1-3 to -4. After the enactment and repeal of two intervening Acts, the 1898 Bankruptcy Act was enacted, which ultimately formed the "basis of modern bankruptcy law." *Id.* at 1-4 to -5. It was not until repeal of the 1898 Bankruptcy Act and enactment of the 1978 Bankruptcy Reform Act that

valuation standard contemplated by section 506(a), which determines the secured status of a creditor in a bankruptcy proceeding, has been interpreted in three ways: the replacement value standard, the foreclosure value standard, or the midpoint value standard.⁴²

In 1980, in *In re Crockett*,⁴³ the Bankruptcy Court for the Northern District of Illinois examined how to value collateral in a Chapter 13 bankruptcy proceeding when the debtor chooses to retain a vehicle that was the subject of a perfected security interest.⁴⁴ The court reasoned that because the creditor's secured status is measured in reference to the value of the property to the estate, if the debtor's Chapter 13 plan provides for retention and use of the property, the debtor may not insist on valuing the creditor's secured claim at wholesale value.⁴⁵ In its analysis, the court identified retail value and wholesale value as the methods of valuation proposed by the creditor and debtor, respectively.⁴⁶ The court defined "wholesale value" as auction value; yet, the court equated the fair market value of the property to its wholesale value.⁴⁷ Thus, because neither the creditor nor the debtor requested a valuation hearing, the court held that it was compelled to use the wholesale/fair market value as the standard for determining the creditor's secured status.⁴⁸

In contrast to the Illinois court in *Crockett*, the Bankruptcy Court

Congress dramatically changed bankruptcy law. *Id.* at ¶ 1.01[2]. The 1978 Bankruptcy Reform Act established bankruptcy courts independent of the district courts. *Id.* at ¶ 1.01[1]-[2]. The Supreme Court, however, found the jurisdictional grant unconstitutional because a bankruptcy court was a non-Article III court and could not be given such jurisdiction. *Id. See also*, Northern Pipeline Constr. Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982). The Bankruptcy Amendment and Federal Judgeship Act of 1984 remedied this problem by granting Article III district courts jurisdiction over bankruptcy cases and the authority to refer bankruptcy cases to the bankruptcy courts. BENDER, *supra* note 3, at ¶ 1.02[2]. From 1986 to 1994, the Bankruptcy Code was subjected to frequent amending. *Id.* at ¶ 1.02[4]-[5]. The 1994 Bankruptcy Reform Act, however, established a Commission to evaluate ways in which the Bankruptcy Code could be improved. *Id.* at ¶ 1.02[5].

42. *Associates Commercial*, 117 S. Ct. 1879.

43. 3 B.R. 365 (Bankr. N.D. Ill. 1980).

44. *Crockett*, 3 B.R. at 365. The creditors insist that they are entitled to the retail value of the vehicle, but the debtors argue that the creditor is only entitled to the amount it would realize at a foreclosure sale. *Id.* at 366.

45. *Id.* at 367. The court noted that the value of the creditor's claim is increased by the debtor's retention and use of the vehicle, and such increase must be accounted for in the debtor's plan payments to the secured creditor. *Id.*

46. *Id.*

47. *Id.* at 368.

48. *Id.*

for the Southern District of California in *In re Miller*⁴⁹ employed a different valuation method.⁵⁰ The parties agreed that the correct standard of valuation of the collateral was the replacement value standard.⁵¹ The court reasoned that section 506(a) provides a valuation method based on the use of the property that is an adaptable standard; and that, in this case, is based on the debtor's choice to retain the vehicle.⁵² Although the parties agreed that the replacement cost was the appropriate standard of valuation, they disagreed on how the replacement value should be measured.⁵³ The creditor favored the retail value that it defined as "what a consumer would pay a dealer."⁵⁴ The court noted, however, that the retail cost would include hidden sales costs and dealer profits.⁵⁵ Favoring the debtor's midpoint approach, the court defined replacement cost as the "open market value between private parties," which is the average of the wholesale and retail values.⁵⁶ Thus, the court held that the creditor was secured to the extent of the wholesale/retail average.⁵⁷

The United States Bankruptcy Court for the Northern District of Georgia, confronted with the same issue in *In re Reynolds*,⁵⁸ held that the proper valuation standard, the replacement value, was measured by the collateral's retail value.⁵⁹ In its determination that replacement/retail value was the standard to apply, the court noted that liquidation value, which it defined as wholesale value, would be "inconsistent with the continued use of the vehicle and the rehabilitative purpose of this Chapter 13 plan."⁶⁰ The court found that the debtors' choice to retain their vehicle increased the value of the creditor's claim because it facilitated the debtors'

49. 4 B.R. 392 (Bankr. S.D. Cal. 1980).

50. *Miller*, 4 B.R. at 392.

51. *Id.* at 393. The court had to determine how to measure the replacement value. *Id.* The creditor argued that the retail price of the car was its replacement value, whereas the debtor argued that the midpoint between the retail and wholesale value was its replacement value. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Miller*, 4 B.R. at 393.

56. *Id.* at 394. The court recognized that the wholesale value would be significantly lower because few dealer costs would be incurred. *Id.* at 393-94. Furthermore, the court noted that dealings between private parties also would not entail hidden sales costs but would involve open market conditions that differed from wholesale market conditions. *Id.*

57. *Id.* at 394.

58. 17 B.R. 489 (Bankr. N.D. Ga. 1981).

59. *Reynolds*, 17 B.R. at 493.

60. *Id.*

rehabilitation.⁶¹ Consequently, the court stated that the debtors' continued use of the vehicle "connotes a going concern value" and the court, therefore, held that the replacement/retail value of the vehicle was the correct valuation standard.⁶²

In 1989, the United States Bankruptcy Appellate Panel of the Ninth Circuit addressed the issue of valuation in a Chapter 13 cram down in *In re Malody*.⁶³ The court carefully considered the legislative history of section 506(a).⁶⁴ The court also recognized the fact that three valuation standards have been utilized and that no precise formula exists.⁶⁵ In affirming the Bankruptcy Court's decision, the Bankruptcy Appellate Panel reasoned that the replacement value ignores the risk that the creditor assumed when it made the loans and permits the creditor to receive more than it would have if the vehicle were repossessed.⁶⁶ The court noted that the creditor is merely entitled to the amount that a commercially reasonable sale would generate.⁶⁷ The facts indicated that a commercially reasonable sale of the vehicle would yield a wholesale amount.⁶⁸ Finally, the court noted that the collateral has a far greater value in the hands of the debtor than in the creditor's possession.⁶⁹ Fear of repossession would ultimately coerce the debtor into paying the creditor more than it would recover upon

61. *Id.*

62. *Id.*

63. 102 B.R. 745 (B.A.P. 9th Cir. 1989).

64. *Malody*, 102 B.R. at 748. The court looked at the Senate report that stated that the determination of value is to be made on an individual case basis, and that valuation is to be determined based on the "purpose of the valuation and the proposed disposition or use of the subject property." *Id.* at 747 (citing S.Rep. No. 989, 95th Cong., 2d Sess. 68 (1978), 1978 U.S.C.C.A.N. 5787, 5845). The court also looked at the House Report that states that "value" does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine on a case by case basis, taking into account the facts of each case and the competing interests in the case." *Id.* (citing H.R.Rep. No. 595, 95th Cong., 1st Sess. 356 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5854, 6312).

65. *Malody*, 102 B.R. 745, 747 (B.A.P. 9th Cir. 1989). The creditor asserts that the value of the vehicle should be based on its retention and use by the debtor, because the debtor does not have to seek a replacement vehicle. *Id.* at 748. The debtors assert, however, that wholesale value should be used because their retention of the vehicle is only "incidental to their ability to produce income." *Id.* at 749.

66. *Id.* at 749.

67. *Id.*

68. *Id.* at 750.

69. *Id.* (citing *Cook*, 38 B.R. at 873 (quoting H.R. Rep. 595, 95th Cong., 1st Sess. 124 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6085). The court stressed that collateral may have a negligible resale value, but still have a substantial replacement value due to the collateral's consumer and personal nature. *Id.*

repossession.⁷⁰ Therefore, imposing a replacement value would inflate the creditor's secured status by measuring the collateral's value according to the debtor's typically higher cost of replacement.⁷¹

The United States Bankruptcy Court for the District of Idaho followed the *Malody* court's reasoning in *In re Johnson*.⁷² The court emphasized that no bright line test exists for determining secured status because section 506(a) instructs that valuation must be measured in light of its purpose and the disposition and use of the collateral.⁷³ The court acknowledged that the valuation procedure is designed to assure that the creditor receives at least the amount it would receive upon sale of the collateral "in a commercially reasonable manner."⁷⁴ Following the teachings of *Malody*, the court noted that the replacement value may be the proper valuation tool in some cases, but may not be in others.⁷⁵ The court suggested that the replacement value may be appropriate where the collateral is instrumental in effecting the reorganization, whereas the wholesale value may be more suitable if the collateral is nonessential.⁷⁶ Therefore, market conditions, as well as the debtor's proposed use of the collateral, will influence the valuation.⁷⁷ Although the court found that the vehicle was not essential to the debtor's reorganization and although the court followed the reasoning of *Malody*, it, nevertheless, found the vehicle's value to be the amount the creditor would receive upon resale of the vehicle in the present demanding market, a sum substantially higher than its wholesale value.⁷⁸

In 1990, the Bankruptcy Court for the Middle District of Pennsylvania confronted the same issue in *In re Chapman*.⁷⁹ The court examined whether the debtor's retained vehicle should be measured by its retail value or its wholesale value.⁸⁰ Without

70. *Malody*, 102 B.R. at 750.

71. *Id.*

72. 117 B.R. 577 (Bankr. Idaho 1990).

73. *Johnson*, 117 B.R. at 580.

74. *Id.*

75. *Id.* at 581 (citing *In re Malody*, 102 B.R. at 749 (B.A.P. 9th Cir. 1989)).

76. *Id.* at 581.

77. *Id.*

78. *Johnson*, 117 B.R. at 581. The court based the valuation on its conclusion that the vehicle would not be auctioned because of the demand for like vehicles in the retail market. *Id.* at 581-82.

79. 135 B.R. 11 (Bankr. M.D. Pa. 1990).

80. *Chapman*, 135 B.R. at 11. Both parties referenced the N.A.D.A. official used car guide, but the debtor favored the wholesale value and the creditor favored the retail value.

providing any analysis, the court simply decided that the fairest value was the average of the retail and wholesale values of the car.⁸¹ The court, however, failed to articulate the equitable factors it considered to substantiate its application of the midpoint valuation standard.⁸²

The decisions of the United States Courts of Appeals on the valuation of collateral under Chapter 13 are as inconsistent as the decisions of the United States Bankruptcy Courts. The Ninth Circuit was the first circuit court to explore the issue in its 1992 decision, *In re Mitchell*.⁸³ The court recognized that in the majority of bankruptcy court decisions, the wholesale value standard was used.⁸⁴ The court rejected the creditor's argument that the debtor's retention of the collateral warrants application of the retail value standard, because this argument disregards the statute's focus on the value of the creditor's interest.⁸⁵ Thus, the court held that the proper valuation standard is the wholesale value of the collateral, which is the value of the collateral in the hands of the creditor.⁸⁶ The dissent opined, however, that although it is the creditor's interest that is being measured, that interest must be measured in light of the debtor's retention and use of the collateral.⁸⁷ The dissent noted that the debtor certainly will not wholesale the vehicle and, therefore, application of the wholesale value disregards the statutory mandate of valuing on the basis of its disposition or use.⁸⁸

Upon examining this issue in *In re Trimble*,⁸⁹ the Eighth Circuit reached a different conclusion.⁹⁰ The court recognized that the cases that applied the foreclosure/wholesale value standard focused primarily on the first sentence of section 506(a), whereas the cases

Id. at 14.

81. *Id.* at 14. The court stated, however, that the creditor would likely sell the vehicle at auction and, therefore, only receive its wholesale value. *Id.*

82. *Id.*

83. 954 F.2d 557 (9th Cir. 1992), *overruled by In re Taffi*, 96 F.3d 1190 (9th Cir. 1996).

84. *Mitchell*, 954 F.2d at 560. The court also acknowledged that the leading bankruptcy decision in the Ninth Circuit, *Malody*, held that the wholesale value should be applied. *Id.*

85. *Id.*

86. *Id.* Although the court held that the wholesale value should be applied, it noted that it does not imply that the debtor's use of the collateral should never be considered. *Id.* The court further suggested that if the collateral were instrumental in effecting a rehabilitation, the replacement value may be appropriate. *Id.*

87. *Id.* at 562 (Noonan, C.J., dissenting).

88. *Id.*

89. 50 F.3d 530 (8th Cir. 1995).

90. *Trimble*, 50 F.3d at 530.

that applied the replacement/retail value standard focused on the second sentence of section 506(a).⁹¹ The courts favoring the wholesale value measured the creditor's interest as a "lien interest" which is more than a right to sell the collateral after repossession.⁹² However, the Eighth Circuit stated that the courts favoring the retail value measured the creditor's interest as the right to receive a "stream of payments."⁹³ Agreeing with the cases that focused on the second sentence of section 506(a), the court held that application of the wholesale valuation standard would wholly disregard the statutory instruction to value according to disposition and use.⁹⁴

The First Circuit's 1995 decision in *Winthrop*⁹⁵ was consistent with the Eighth Circuit's decision in *Trimble*.⁹⁶ Specifically, the First Circuit considered whether the property that a Chapter 11 debtor chooses to retain under his bankruptcy plan must be valued at its liquidation value or its fair market value.⁹⁷ In making its determination, the court recognized that the replacement or fair market value standard gives effect to the debtor's choice to retain rather than surrender the collateral, whereas the foreclosure value standard, which exclusively focuses on the creditor's interest in the collateral, contemplates a hypothetical disposition.⁹⁸ By giving meaning to both sentences, the creditor's secured status is

91. *Id.* at 531.

92. *Id.* at 531 (quoting *In re Green*, 151 F.3d 501, 505 (Bankr. D. Minn. 1993)). A "lien" is a "claim, encumbrance, or charge on property for payment of some debt, obligation or duty." BLACK'S LAW DICTIONARY 922 (6th ed. 1990).

93. *Trimble*, 50 F.3d at 531.

94. *Id.* at 532. The court's decision was based on its opinion that only the replacement/retail value gives full effect to both the first and second sentences of section 506(a). *Id.*

95. 50 F.3d 72 (1st Cir. 1995).

96. *Winthrop*, 50 F.3d 72.

97. *Id.* Chapter 11 offers business debtors the chance to reorganize their businesses and affords bankruptcy protections to individuals whose debts exceed the Chapter 13 debt limitations. BENDER, *supra* note 3, at ¶ 1100.01. Chapter 11 enables a debtor to continue operating its business as a debtor in possession. *Id.* Therefore, typically a trustee is not appointed in a Chapter 11 case. *Id.* Creditors are divided into classes which vote on the debtor's Chapter 11 plan. *Id.* at ¶ 1100.09[2][d]. If the mandates of Chapter 11 of the Bankruptcy Code are satisfied, the court may confirm the plan over the creditors' objections, thereby effecting a Chapter 11 cram down. *Id.* at ¶ 1100.09[2][e].

98. *Winthrop*, 50 F.3d at 75. The court stated that:

By retaining collateral, a Chapter 11 debtor is ensuring that the very event Winthrop proposes to use to value the property - a foreclosure sale - will not take place. At the same time, the debtor should not be heard to argue that, in valuing the collateral, the court should disregard the very event that, according to the debtor's plan, will take place - namely, the debtor's use of the collateral to generate an income stream.

Id.

measured by the actual use of the collateral rather than an alternate disposition (surrender and foreclosure) which never occurs.⁹⁹ Thus, the court held that the Bankruptcy Court properly interpreted the statute by valuing the collateral at its fair market value or replacement value.¹⁰⁰

In 1996, the Ninth Circuit revisited this issue in *In re Taffi*¹⁰¹ and distinguished its 1992 decision in *Mitchell*.¹⁰² On rehearing en banc, the court addressed the question of which valuation method should be used to value real property that the debtors choose to retain under their Chapter 11 plan.¹⁰³ In its analysis, the court noted that a divided panel of the Ninth Circuit distinguished *Mitchell* because *Mitchell* addressed the valuation standard for a vehicle.¹⁰⁴ The court stressed that wholesale and retail values are both measures of a vehicle's market value; however, the fair market value of a house cannot be measured by its foreclosure value due to the depressed conditions of a foreclosure sale.¹⁰⁵ The court, focusing on the second sentence of section 506(a), held that valuation must be based on the actual use of the collateral, not on possible or alternative uses.¹⁰⁶ Consequently, the court held that the proper valuation standard is the property's fair market value, which is the "price which a willing seller under no compulsion to sell, and a willing buyer under no compulsion to buy, would agree upon after the property has been exposed to the market for a reasonable time."¹⁰⁷ Finally, although the court overruled *Mitchell* in part, it refused to address whether wholesale or retail value should be used to assess a vehicle's fair market value.¹⁰⁸

In 1996, the Seventh Circuit encountered the valuation issue in *In re Hoskins*,¹⁰⁹ and its analysis of the issue differed from the

99. *Id.*

100. *Id.* The court's decision was based on the fact that the debtor proposed to retain his property for use in producing income. *Id.* at 76.

101. 96 F.3d 1190 (9th Cir. 1996), *cert. denied*, *Taffi v. United States*, 117 S. Ct. 2478 (1997).

102. *Taffi*, 96 F.3d at 1190.

103. *Id.*

104. *Id.* at 1192.

105. *Id.* The court emphasized that the foreclosure value has no application to the instant case because the debtor was keeping the house and, therefore, no foreclosure sale would occur. *Id.*

106. *Id.*

107. *Taffi*, 96 F.3d at 1192. In defining "fair market value," the court noted that it cannot be equated to "replacement value" because the house is not being replaced." *Id.* The court did not define or explain how replacement value is measured, however. *Id.*

108. *Id.* at 1193.

109. 102 F.3d 311 (7th Cir. 1996), *overruled by Associates Commercial Corp. v. Rash*,

decisions by the other circuit courts.¹¹⁰ In making its decision, the Seventh Circuit stated that it did not want to favor either the creditor or the debtor in its final decision.¹¹¹ The court recognized that the midpoint between the wholesale value and the retail value would put both parties in a better position than if one of these valuation methods were preferred.¹¹² If retail value were imposed, the secured creditor would receive a benefit at the expense of unsecured creditors because the secured creditor would not have received retail value if it had foreclosed.¹¹³ If wholesale value were imposed, the unsecured creditor would receive the benefit because the secured creditor would receive a lesser amount, thereby leaving more funds available for the unsecured creditor than non-bankruptcy proceedings would yield.¹¹⁴ Thus, the court held that when a debtor retains a vehicle that produces income in a Chapter 13 bankruptcy plan, the average of the foreclosure/wholesale and replacement/retail values of the collateral must be used to determine secured status.¹¹⁵

Similar to the Seventh Circuit, in 1997, the Second Circuit applied the midpoint valuation standard in *In re Valenti*.¹¹⁶ Initially, the court examined the language of section 506(a) and concluded that if only the first sentence were considered, the wholesale/liquidation value would apply, but if the second sentence were considered, the collateral would be valued by its replacement cost.¹¹⁷ The court rejected retail value as the measure of the vehicle's replacement value, however, because a vehicle could be replaced at a price below retail through a private party purchase rather than a dealer transaction.¹¹⁸ Additionally, the court stated that application of the retail value disregarded the creditor's

117 S. Ct. 1879 (1997).

110. *Hoskins*, 102 F.3d at 311.

111. *Id.* at 313-314. The court recognized "that while the bank would not agree to forgive or stretch out the loan for less than a package of rights worth as much as the wholesale price of the car, the Hoskinses would not agree to refinance the loan on the basis of a value of the car greater than its retail value." *Id.* at 315-16.

112. *Id.* at 316. The midpoint standard is based on the inevitable point that both parties would come to if in a bargaining situation and the goal was to achieve a fair result. *Id.*

113. *Id.* at 317.

114. *Id.*

115. *Hoskins*, 102 F.3d at 316.

116. 105 F.3d 55 (2d Cir. 1997), *overruled by* *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997).

117. *Valenti*, 105 F.3d at 61.

118. *Id.* at 62. The court analogized application of the retail value to reaffirmation of the debt. *Id.*

interest, which is limited to the wholesale value.¹¹⁹ Noting that the two operative sentences of section 506(a) suggest conflicting valuations, the court rejected the application of a fixed value.¹²⁰ The court held that “as long as the final valuation of [the] claim reflects § 506(a)’s dual considerations” of purpose and disposition or use, section 506(a) is satisfied.¹²¹ Thus, the court affirmed the district court’s application of the midpoint valuation standard because section 506(a)’s dual considerations were satisfied.¹²² The court stressed, however, that neither the midpoint standard nor any other standard is the fixed method of valuation.¹²³

Cognizant of the inconsistencies in the appellate courts’ decisions, the Supreme Court of the United States granted certiorari in *Associates Commercial Corporation*.¹²⁴ In an eight-to-one decision, the Court decided that it wanted to give full meaning to both sentences of section 506(a) by applying the replacement valuation standard.¹²⁵ The Court recognized that the legislature would not have placed the second sentence of section 506(a) in the statute if it were meaningless.¹²⁶ Thus, the Court followed the Ninth Circuit in *Taffi*,¹²⁷ the Eighth Circuit in *Trimble*,¹²⁸ and the First Circuit in *Winthrop*,¹²⁹ by choosing the replacement value standard as the appropriate measure of secured status. The Supreme Court concluded that the first sentence alone does not even suggest that the wholesale value applies. It simply provides that a creditor’s claim may be bifurcated into its secured and unsecured portions. The mere presence of the second sentence suggests that a recognizable difference exists between surrender and retention, and that the disposition and use of the collateral must be accounted for in measuring the value of the creditor’s security.

Although the Supreme Court held that the replacement standard was the proper method of valuation, the Court failed to identify

119. *Id.*

120. *Id.*

121. *Id.*

122. *Valenti*, 105 F.3d at 63.

123. *Id.* at 62.

124. *Associates Commercial Corp.*, 117 S. Ct. 1879 (1997).

125. *Id.*

126. *Id.*

127. 96 F.3d 1190 (9th Cir. 1996), *cert. denied*, *Taffi v. United States*, 117 S. Ct. 2478 (1997).

128. 50 F.3d 530 (8th Cir. 1995).

129. 50 F.3d 72 (1st Cir. 1995).

any bright line test for determining replacement value. Replacement value, the Court held, is "the price a willing buyer in the debtor's trade, business or situation would pay a willing seller to obtain property of like age and condition."¹³⁰ The Court stated, however, that it leaves it to the "bankruptcy courts, as triers of facts, identification of the best way of ascertaining replacement value on the basis of the evidence presented."¹³¹ Thus, the Court's decision does not resolve the issue, because replacement cost could be either retail value, wholesale value, fair market value, or any other value chosen by the courts. By failing to provide a succinct definition, the Court has authorized the lower courts to determine replacement value on a case-by-case basis, which may virtually eliminate the distinction between replacement value and foreclosure value. This ambiguity will perpetuate the disharmony among the lower courts' decisions. Although the lower courts must apply the replacement value standard, they must define that value in each case. Consequently, cases will arise where a value closer to the collateral's foreclosure value will be applied. In such cases, although the courts theoretically will be applying the replacement value; in practice, they will be using the foreclosure or wholesale value, thereby rendering the distinction between the two measures a nullity. Thus, until the legislature decides to change the statute and provide definitions to remedy this ambiguity, the Supreme Court's decision will remain an unhelpful tool for resolving the valuation problem in Chapter 13 cram down cases.

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130. *Associates Commercial*, 117 S. Ct. at 1884 n.2.

131. *Id.* at 1886.