

Sixth Circuit Rules Hypothetical Costs Do Not Reduce Secured Claim

The United States Court of Appeals for the Sixth Circuit has recently held that when a debtor proposes to retain collateral under a reorganization plan in bankruptcy that the Bankruptcy Code does not require or permit a reduction in a creditor's secured claim in order to account for purely hypothetical costs of sale. The decision was handed down August 5, 1994 and is known as In Re: McClurkin.

McClurkin was the debtor in a Chapter 13 whose residence was appraised at \$138,000.00 and encumbered by a first mortgage in the amount of \$110,512.98. The second mortgage holder filed a secured proof of claim in the amount of \$19,186.23, claiming that amount as "fully secured" because of the apparent "equity cushion" of \$27,487.02 between the first mortgage and the value of the real estate.

The chapter 13 Trustee objected to the second mortgage holder's Proof of Claim on the basis that the second mortgage holder's secured claim would have to be reduced by hypothetical costs of sale which would result if the second mortgage holder would have to foreclose or the real estate would otherwise be sold, even though the debtor's Chapter 13 plan did not propose to sell the home. The Trustee estimated costs of sale would be ten percent of the home's value of \$138,000.00 and therefore argued that the second mortgage holder had a secured claim of only \$13,687.07, with the remainder of \$5,499.79 only an allowed unsecured claim.

The Bankruptcy Court had sustained the Trustee's objection and the District Court had affirmed. The Sixth Circuit, however, resolved the matter differently.

Prior to the Sixth Circuit's decision, those Courts that had allowed the deduction of "costs of sale," even where no sale was contemplated by a Debtor's reorganization plan, based their decision on an interpretation of Section 506 (a) of the Bankruptcy Code that equated the creditor's "secured claim" with the value of the creditor's interest in the collateral rather than the value of the collateral. Since the secured creditor's interest in collateral was only the right to force a sale of the collateral to satisfy the Debtor's obligation, those courts had concluded that the "creditor's

interest" in the collateral was merely an interest in the proceeds of the sale – that is, the valuation of a creditor's interest should be made in light of the "purpose" of the valuation and the proposed disposition or use of the collateral.

The Sixth Circuit, however, agreed with those Courts that had therefore previously held that no hypothetical costs should be deducted from the value of collateral when the liquidation of the property was not contemplated.

The Sixth Circuit therefore reversed the holding of the District Court and sent the case back down to the Bankruptcy Court for further proceedings.

The issue presented in Re: McClurkin also has application to workouts outside bankruptcy. Non-bankruptcy workouts between debtors and their creditors normally take into account what the creditors can expect to receive should the workout negotiations break down and a bankruptcy petition be filed. In such cases, if no sale of the creditor's collateral is anticipated – a common situation when the collateral consists of the debtor's principal residence – then the secured creditors should resist any attempt by the debtor to reduce the balance owed by the hypothetical cost of selling the collateral.

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