

## Chapter 13 Plan Must Pay Adequate Protection Payments Prior to Attorney's Fees

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### I. Introduction

In *In re Dispirito*, a decision of importance to Chapter 13 debtors' attorneys, the Bankruptcy Court for the District of New Jersey ruled that an undersecured creditor was entitled not only to adequate protection payments, but that the section 507(b), 11 U.S.C. § 507(b) (2006), "super-priority" status of the inadequate adequate protection provided during the case meant that the Chapter 13 plan had to pay those amounts before paying any of the debtor's attorneys fees. 371 B.R. 695, 695 (Bankr. D.N.J. 2007). This article will compare how the *Dispirito* court's ruling compares to other bankruptcy court's rulings. It will also analyze "super-priority" status in the context of benefits it confers to creditors and debtors and if it furthers bankruptcy law principles in general. It is the opinion of this author that the *Dispirito* court erred in its ruling, and in fact will likely hurt Chapter 13 proceedings without conferring much of a benefit to creditors.

Part II will examine the concept of adequate protection and what rights section 507(b) of the Bankruptcy Code confers to creditors in the context of adequate protection payments. Part III will discuss the *Dispirito* decision, analyzing how and why the court arrived at its decision. Part IV will discuss how other courts have ruled on this issue, giving perspective on how other

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bankruptcy courts have dealt with the issue of adequate protection and “super-priority, and whether *Dispirito* is consistent with these holdings. This article will conclude with a brief overview of how the *Dispirito* decision may, in fact, be against the goals of bankruptcy law and might potentially injure both creditors and debtors.

## II. Section 507(b) – What is Adequate Protection and this business about Priority?

When a debtor files for bankruptcy under Chapter 13, the debtor may remain in possession of property belonging to the estate. *See* 11 U.S.C. § 1306(b) (2006). The Bankruptcy Code does, however, limit this right of retention. In order to protect an undersecured creditor whose property is depreciating daily in value from the continued use by the debtor, Congress enacted section 363(e) which provides:

[A]t any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to *provide adequate protection of such interest*.

11 U.S.C. § 363(e) (2006)(emphasis added). Thus was established adequate protection. The Bankruptcy Code does not define adequate protection, but section 361 provides a non-exhaustive list of examples. Under subsection (1), if the creditor’s property is declining in value due to its use, sale or lease, the trustee may be required to make cash payments to the creditor for the continued retention. *See* 11 U.S.C. § 361(1). In theory, if the creditor was allowed to regain its property, it may resell it and avoid the loss. Because the debtor is allowed to retain the property, thus causing the value to depreciate, the adequate protection payments are intended to protect the creditor.

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In order to determine the depreciating value of the property, thus how much the adequate protection payments will be, courts have looked at “the most frequently used and most authoritative source of values for used automobiles[;] the N.A.D.A. Blue Book.” *In re Cook*, 205 B.R. 437, 440 (Bankr. N.D. Fla. 1997). The *Cook* court declared that “the average rate of decline in the Blue Book value of the particular automobile over a three (3) month period immediately preceding the date of the request for adequate protection should be used.” *Id.* at 441.

Section 507 under Chapter 11 of the United States Code lists the order in which creditors are paid under a debtor’s plan. 11 U.S.C. § 507 (b) (2006). While section (a) gives a list of the order to which a debtor must pay his creditors, section (b) gives a type of “super-priority” to certain payments. Section (b) provides:

If [a] trustee . . . provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if . . . such creditor has a claim [of administrative expenses] arising from the stay of action against such property . . . such creditor’s claim . . . shall have priority *over every other claim* allowable.

*Id.* (emphasis added). The United States Bankruptcy Court, District of Colorado established a three part test to determine if a payment will qualify for this “super-priority” status:

1. Adequate protection must have been provided . . . and that protection must have failed or must have been inadequate;
2. The creditor must have a claim [for administrative expenses]; and
3. The creditor’s claim must have arisen . . . from the use, sale, or lease of the collateral.

*In re Greenwald*, 205 B.R. 277 (Bankr. D. Colo. 1997).

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Both section 507 (b) and the second prong of the *Greenwald* test require that the creditor have a claim for administrative expenses. Administrative expenses are defined in section 503(b) of the Bankruptcy Code, and include “the actual, necessary costs and expenses of preserving the estate,” 11 U.S.C. § 503(b)(1)(A) (2006), and “reasonable compensation for professional services rendered by an attorney.” 11 U.S.C. § 503 (b)(4). In the *Dispirito* case, the parties argued as to which administrative expenses had priority or “super-priority” over the other.

### III. The *Dispirito* Decision

The litigation began when, several years after executing a retail installment contract in connection with the purchase of a Ford Explorer, Debtor filed a Chapter 13 proceeding. Ford Motor Credit Company objected to the debtor’s Chapter 13 plan for failure to provide adequate protection payments, violating 11 U.S.C. §§ 361, 1325 and 1326. *In re Dispirito*, 371 B.R. 695, 696 (Bankr. D.N.J. 2007); see 11 U.S.C. §§ 361, 1325 & 1326 (2006). The debtor modified the plan to include adequate protection payments, but objected to the creditor’s contention that those payments had super-priority over debtor’s attorney fees. *Dispirito*, 371 B.R. at 697. The debtor contended that adequate protection payments should be paid until confirmation; thereafter payments should be split pro rata between the creditor and debtor’s attorney. *Id.* at 697. The debtor argued that the adequate protection payments were not entitled to super-priority under 11 U.S.C. § 507(b) because creditor did not show that the payments represent actual and necessary costs to preserve the debtor’s estate. *Id.*

The court agreed with Ford Motor Credit, reasoning that the creditor, having a lien on the debtor’s property, must be afforded protection against the daily depreciation of its property. *Id.* at 698. The court relied on Judge Marvin Isgur’s opinion in *In re DeSardi*, 340 B.R. 790 (Bankr.

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S.D. Tex. 2006), for the position that adequate protection payments may be treated as an administrative expense if they related to the actual use of the creditor's property and conferred a concrete benefit upon the debtor's estate. *In re Dispirito*, 371 B.R. 695, 700 (Bankr. D.N.J. 2007) (citing *In re DeSardi*, 340 B.R. 790, 798 (Bankr. S.D. Tex. 2006)).

Because *DeSardi* had involved a vehicle the debtor used to commute to work to generate the income necessary for plan payments, the debtor in *Dispirito* argued that there was no benefit to the estate since his vehicle was used only for personal purposes. *Dispirito*, 371 B.R. at 700. The court rejected that position, holding that by seeking to confirm a plan that provides for payments owing on a vehicle, the debtor "implicitly acknowledges that such expenses are both reasonable and *necessary* for the maintenance and support of the debtor." *Id.*

Further, the court held that adequate protection payments have super-priority over other administrative expenses, such as attorney fees, under section 507(b) of the Bankruptcy Code. *Id.* at 701. Using the three-prong test as laid down in *In re Greenwald*, 205 B.R. 277 (Bankr. D. Colo. 1997), the court held Ford Motor Credit's claim satisfied all three prongs. The *Dispirito* court quoted Judge Isgur's opinion in *DeSardi* once again concluding, "[i]f attorney's fees are paid ahead of the adequate protection payments, then adequate protection fails; the funds that provide the adequate protection would be paid to someone besides the protected lender." *Dispirito*, 371 B.R. at 701 (quoting *In re DeSardi*, 340 B.R. at 801).

#### **IV. Is *Dispirito* Consistent with Other Courts?**

##### **A. Some courts agree that creditors should receive super-priority over attorneys**

The *Dispirito* opinion is consistent with several other decisions holding that the language of § 507(b) is controlling and gives "super-priority" to a creditor's inadequate adequate

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protection claim over administrative expenses. *Dispirito* cites two main decisions for the super-priority proposition; *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006), and *In re Cook*, 205 B.R. 437 (Bankr. N.D. Fla. 1997).

In *Cook*, the debtor filed a plan which provided for payment of attorney's fees prior to any payment to the creditor. *Cook*, 205 B.R. at 438. The creditor, General Motors Acceptance Corporation (GMAC), objected to this plan on grounds that its property, the automobile being retained by the debtor, was declining in value each day and the creditor was not adequately protected while the attorney's fees were being paid. *Id.* The creditors took issue with the fact that although typically in cases such as these, payments would be made to the creditor prior to confirmation, the debtor's plan called for no such payments. *Id.* The *Cook* court determined that because the creditor's property was declining in value due to the continued use by the debtor, adequate protection payments were required pre-confirmation. *Cook*, 205 B.R. at 439–40. The creditor next argued that it was entitled to payments post-confirmation at least equal in value to the depreciation of the automobile. The debtor's plan, however, called for full payment of attorney's fees first, thus leaving the creditor with delayed payments. The debtor rationalized this plan in that administrative fees, which include attorney's fees, are to be paid off first. The court held, however, that "the Bankruptcy Code does not require attorney's fees to be paid in full prior to payments to creditors, it simply requires that they be paid before or contemporaneously with payments to creditors." *Id.* at 443 (citing *In re Shorb*, 101 B.R. 185, 186 (B.A.P. 9th Cir. 1989).

The court went on to lay down a rule for confirmation:

A plan can not be confirmed over objection unless it provides that, upon confirmation, each secured creditor will receive payment at least equal to the amount of depreciation over the relevant time period. . . . If this cannot be accomplished while also allowing attorney's fees to be paid in full before commencement of payments to secured creditors, *the debtor will be faced with a*

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*choice between paying attorney's fees over a longer period of time under the plan on the one hand, and dismissal . . . on the other.*

*In re Cook*, 205 B.R. 437, 443 (Bankr. N.D. Fla. 1997)(emphasis added).

The court continued its rationale, addressing policy concerns. The debtors argued that Congress intended to encourage use of Chapter 13 proceedings, and that “fewer attorneys [will] be willing to receive their fees under debtors’ plans, and thus, fewer Chapter 13 cases would be filed.” *Id.* at 443. The court noted that some courts have recognized this as a legitimate concern, but in the present case, the creditors’ property is declining in value every day, and cannot be “required to fund debtors’ plans and pay debtors’ attorney’s fees, in effect, with the depreciation of their collateral.” *Id.* at 444. The court concluded, “[i]f the risk of non-payment of the debtor’s attorney fees . . . is too great to justify taking the case . . . [it] should say something about the case.” *Id.*

In *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006), the court addressed several issues concerning adequate protection. The creditors objected to the debtors’ Chapter 13 plans claiming they failed to protect the creditors’ interests in the collateral being retained by debtors.

The court began by analyzing the requirement of section 507(b) for payment of administrative fees. *Id.* at 798. It interpreted payment of “actual, necessary costs and expenses of preserving the estate” to include “adequate protection payments paid to enable the debtors to use their vehicles.” *Id.* at 798–99. It stipulated, however, that the wording of section 507(b) must be narrowly construed and include only *concrete* benefits to the estate “*as opposed to the loss a creditor might experience by virtue of the debtor’s possession of its property.*” *Id.* at 799 (emphasis in original). The court justified this finding by the fact that “[d]ebtors in chapter 13 often need their vehicles to drive to work, which in turn allows for preservation of the estate.” *Id.*

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at 799. Debtors need their vehicles to drive to work, or buy necessities for their families such as food or clothing, thus conferring a concrete benefit upon the debtor. *In re DeSardi*, 340 B.R. 790, 800 (Bankr. S.D. Tex. 2006).

The court next began its analysis as to the status of another type of administrative expense; attorney's fees. While conceding that attorney's fees are in fact an administrative expense and thus entitled to priority, it concluded that payments to attorneys are subordinate to a creditor's right to adequate protection payments. *Id.*, 340 B.R. at 790. The court looked at Congressional intent and ruled that Congress intended that if adequate protection payments prove to be inadequate to protect the creditor whose collateral is depreciating; these payments are to have super-priority over every other claim allowable under section 507. *Id.* at 801.

#### **B. Courts have found that a *per se* super-priority rule is inappropriate**

The *Dispirito* line of reasoning has been criticized as being too permissive towards creditors without looking at the circumstances surrounding the debtor's plan. In *In re Moses*, the creditor, DaimlerChrysler, objected to the debtor's Chapter 13 plan. 293 B.R. 711 (Bankr. E.D. Mich. 2003). The plan called for payment of administrative fees first, which included attorney fees. *Id.* DaimlerChrysler claimed that it was not adequately protected because payment would be delayed for one month while the attorneys' fees were paid. *Id.* at 712. After dismissing creditor's first claim that the attorneys should be paid in deferred cash payments, the court discussed creditor's adequate protection claim. *Id.* at 714. DaimlerChrysler found that the one month delay was unacceptable, because its property, the automobile, was declining in value each day.

In support of its contention, creditor cited *In re Johnson*, 63 B.R. 550 (Bankr. D. Colo. 1986). This case had similar facts to DaimlerChrysler's situation, but in *Johnson* the payment to

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creditor would be delayed for three and one-half years. *Moses*, 293 B.R. at 716. The court in *Moses* easily distinguished the debtor's plan from that of the plan in *Johnson* based on the length of the delay of payment to the creditor. The *Moses* court ultimately held that DaimlerChrysler may have an argument "in a case such as *In re Johnson*, with the three-and-a-half year delay in payments, [but] cannot . . . hold true in a case . . . where [creditor] is waiting only one month for distributions to begin. *Id.* at 717.

The court did note, however, that the decision "should not be read as a *per se* rule that a delay in payment to . . . creditors, caused by payment of the debtor's attorney's fees first and in full, can never be a valid basis for denying confirmation." *Id.* at 718. This stipulation gives creditors assurances that the circumstances of each case will be taken into account and the length of delay of payment will be considered a factor in the determination of confirming the debtor's plan.

## V. Conclusion

The *Dispirito* ruling can be criticized for undermining the Chapter 13 process. First, as the debtors argued in *Cook*, the purpose of Chapter 13 is to encourage its use. *In re Cook*, 205 B.R. 437, 443 (Bankr. N.D. Fla. 1997). The *Cook* court warns attorneys to be wary of what cases they take as they bear the risk of non-payment, thus chilling access to the process. *See Id.* at 443–44. If attorneys are last in line to be paid, this may, in fact, cause attorneys to reject taking these cases of this type. Those who need an attorney the most may be viewed as a liability and a risk. Are we shutting the doors of justice to the most despondent and down-trodden? While the area of *pro bono* services is growing successfully today, are we prepared to

classify Chapter 13 cases as a matter of free legal services? This ruling is a slippery slope and must be cautiously viewed.

Further, the court's interpretation of the necessity prong for administrative expense status renders it a nullity since that test will be met in every case involving a Chapter 13 plan. Finally, even if the adequate protection payments are entitled to super-priority status in an ultimate liquidation, that does not necessarily mean they must be given temporal priority by being paid out of the first plan installments.



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