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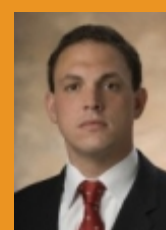
THE GAVEL:

Third Circuit Clarifies Burden of Proof with Respect to Secured Creditors Claims



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The Third Circuit recently clarified the burden of proof required with respect to the valuations of secured claims under *11 U.S.S 506 (a)*. In *In re: Heritage Highgate, Inc., et al.* the Court held that a burden – shifting framework controls valuations of collateral to decide the extent to which claims are secured pursuant to Section 506 (a). Although three approaches throughout the country have been used to value secured claims, the Third Circuit decided that the burden-shifting approach is more appropriate than concluding that the secured creditors have the burden of proof to prove their claim or that the debtor, the party usually challenging the claim, bears the burden.

Pursuant to the burden-shifting approach, the debtor bears the initial burden of proof to overcome the presumed validity and amount of the creditor's secured claim, but the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing the claim.

Since *11 U.S.S 506 (a)* and *Bankruptcy Rule 3001(f)* grants prima facie effect to the validity and amount of a properly filed claim, the initial burden is placed on the party challenging the secured claim's value. If the movant establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim because the collateral is of insufficient value, the burden shifts to the secured creditor to prove the extent and value of its secured claim.

In *In re: Heritage Highgate, Inc.,* a group of investors ("Cornerstone Investors") agreed to subordinate its lien on a series of construction loans to a group of banks, led by Wachovia ("Bank Lenders"). After building and selling a quarter of the planned units (the "Project"), the Debtors filed for Chapter 11 bankruptcy. In its initial plan, the Debtors proposed to pay the secured claims of the Bank Lenders first and the Cornerstone Investors second. The initial plan was based upon a set of projections for the completion of the development. Thereafter, the Official Committee of Unsecured Creditors (the "Committee") filed a motion to value the secured claims of the Cornerstone Investors at zero because the collateral securing the secured claim, the Project, was worth less than the Bank Lenders' secured claims. As proof, the Committee submitted an appraisal report previously accepted by the Bankruptcy Court as evidence of the Project's fair market value.

The Third Circuit agreed with the Bankruptcy Court and determined that the fair market value of the Project as of the confirmation date controls whether the Cornerstone Investors' claims are secured or not. Since the Cornerstone Investors stipulated that the appraisal submitted to the Bankruptcy Court correctly calculated the fair market value of the Project, the Third Circuit held that the claims of the Cornerstone Investors were wholly unsecured.

The Cornerstone Investors argued that denying them the future proceeds of lot sale proceeds from the project would amount to lien stripping, which is prohibited in a Chapter 7 liquidation proceeding. However, in agreeing with the majority of courts, the Third Circuit rejected this argument and stated that *Dewsnup's* holding should not be imported into Chapter 11 cases.

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