Chapter 3

Adequate Protection for Use of Collateral

I. Basic Concept of Adequate Protection

A. Introduction

Adequate protection is a concept that may apply both to rental income and to the real property collateral. This chapter discusses both, as the two topics overlap and have nearly identical underpinnings—other than the issue below as to whether they are separate forms of collateral, each of which is entitled to separate adequate protection.

Once it is determined or agreed that the rental income is "cash collateral," the next issue that typically arises is whether the mortgage lender is entitled to "adequate protection" for the "use" of the rental income by the debtor during the course of the case. The statutory basis for adequate protection is found in § 363(e), which states as follows:

> Notwithstanding any other provision of this section, 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.

The term "adequate protection" is not defined in the Code, but it is illustrated by three non-exclusive examples in § 361. When adequate protection is required, it can take the form of (a) cash payments, (b) a replacement lien or (c) the indubitable equivalent of the entity's interest in such property. Adequate protection in a real estate case can also be provided through application of the rents to maintenance of the property, through an administrative priority, and through the use of budgets to supervise expenditures.[216]

Adequate protection payments are required to protect the secured lender, but only against the "decline" in the value of the collateral and not to compensate for the time

216 The Code provides, however, that an administrative priority cannot be used to establish indubitable equivalent. Nonetheless, it is typically part of many consensual cash collateral orders. *See* 11 U.S.C. § 361(3).

delay caused by the stay, such as not being able to foreclose.[217] Indeed, § 361 speaks directly to the requirement for a "decline" in value stating that adequate protection is required only "to the extent that the stay under section 362 of this title, [or the] use, sale or lease under section 363 of this title ... results in a decrease in the value of such entity's interest in such property."

According to the Supreme Court in *United States Savings Ass'n v. Timbers of Inwood Forest Assoc. Ltd.*, "[I]t is now established that 'adequate protection' is meant only to assure that a secured creditor does not suffer a decline in the value of its interest in the estate's property, rather than to compensate the creditor for the bankruptcy-imposed delay in enforcing its rights in that property."[218] In *In re Mosello*,[219] the court stated:

> The purpose of "adequate protection" for a creditor "is to insure that the creditor receives the value for which he bargained prebankruptcy." "The goal of adequate protection is to safeguard the secured creditor from diminution in the value of its interest during the Chapter 11 reorganization."

In *In re Prichard Plaza Associates Ltd. Partnership*,[220] the court stated:

> It is now settled by the Supreme Court's decision in *Timbers, supra*, that adequate protection of a security interest consists of protection against decline in the value of the security interest rather than protection against loss of the opportunity of present realization on the collateral.[221]

Undersecured lenders may seek adequate protection, but only to protect against a decline in value of the collateral.[222] "Post-*Timbers* courts have uniformly required a movants seeking adequate protection to show a decline in value of its collateral."[223] An undersecured creditor, however, is not entitled to adequate protection if there is no risk of decline in value. The court in *In re Kalin*[224] stated:

> The Supreme Court, in affirming the Fifth Circuit [in *Timbers*] held that an undersecured creditor whose collateral is not declining in value is not entitled

217 *United States Savings Ass'n v. Timbers of Inwood Forest Assoc. Ltd.*, 484 U.S. 365, 108 S.Ct. 626 (1988).
218 *In re Addison Properties Ltd. Partnership,* 185 B.R. 766, 769 (Bankr. N.D. Ill. 1995).
219 195 B.R. 277, 288-289 (Bankr. S.D.N.Y. 1996).
220 84 B.R. 289 (Bankr. D. Mass. 1988).
221 *Id.* at 302.
222 *In re Flagler-at-First Assocs. Ltd.*, 114 B.R. 297, 303 (Bankr. S.D. Fla. 1990) ("Even an undersecured creditor... has the right to receive protection from any decline in the value of its collateral during the automatic stay"). "If the creditor is oversecured many courts hold that the equity cushion alone satisfies the adequate protection requirement of section 362(d)(1)." *In re Continental, supra* at 539.
223 *In re Continental Airlines,* 146 B.R. 536, 539 (Bankr. D. Del. 1992).
224 169 B.R. 503 (Bankr. D. R.I. 1994).

> to adequate protection payments during the pendency of the automatic stay, under 11 U.S.C. § 362(d)(1). *Id*. at 369-382; *see also In re Oaks Partners*, 135 B.R. at 449. The Supreme Court also ruled that under 11 U.S.C. § 506(b) an undersecured creditor is not entitled to interest on its claim. *Id*. 484 U.S. at 372. We conclude that *Timbers* is applicable to the instant case and that Northeast, as an undersecured creditor whose collateral is not declining in value, is not entitled to either adequate protection or post-petition interest on its claim.

The burden of proving adequate protection is on the debtor.[225]

Although adequate protection motions are typically resolved by the submission of a "consent cash collateral order," there are critical issues that arise and may determine the outcome of the case, as well as the ability to actually receive adequate protection payments. Some of the key issues are listed below:

- Is adequate protection measured from the date of the petition, or the date when a lender first seeks adequate protection or relief from the stay?
- Can adequate protection for use of rental income be established merely by using the rental income for ordinary maintenance?
- Can the debtor use cash collateral for payment to its lawyers if it provides adequate protection?
- How should the adequate protection payments be applied, *i.e.,* to interest or to principal?
- Can the debtor upstream the rental income for use by affiliated debtors and non-debtors (herein of *General Growth*)?
- How do the requirements to provide adequate protection relate to the debtor's right to use rental income "notwithstanding" the cash collateral obligations, as set forth in the SARE Amendments under § 362(d)(3)?

225 11 U.S.C. § 363(p) ("In any hearing under this section—(1) the trustee has the burden of proof on the issue of adequate protection."); *see also In re Constable Plaza Assocs. L.P.* 125 B.R. 98, 104 (Bankr. S.D.N.Y. 1991) ("[t]he debtor has the burden of demonstrating that the creditor will be adequately protected if it is authorized to use...cash collateral."); *In re Armenakis*, 406 B.R. 589, 620 (Bankr. S.D.N.Y. 2009) (However, a "secured creditor lacks adequate protection if the value of its collateral is declining as a result of the stay. It must, therefore, prove this decline in value—or the threat of a decline in order to establish a *prima facie* case").

B. Is Adequate Protection Measured from the Date of the Petition, or the Date When a Lender First Seeks Adequate Protection or Relief from the Stay?

There are various theories as to when the adequate protection payments should commence, and separately whether the decline in value is measured from the petition date or the date from when the motion was filed. "Courts remain divided on whether the petition date or the motion date is the appropriate date for valuing collateral for adequate protection purposes.[226] Because this issue remains unresolved, practitioners should almost always seek adequate protection immediately upon the filing.

The large amount of litigation on this issue was summarized by one commentator as follows:

> There has been extensive decisional law on the issue of whether to grant a secured party adequate protection of its interest in collateral as of (1) the petition date, (2) the date when the secured party makes a demand to the debtor for adequate protection, (3) the date of a motion to lift stay or for adequate protection, or (4) the date of a hearing with respect to a motion to lift stay or for adequate protection. The courts generally choose between either the petition date or the date of the motion.[227]

According to one court, *In re Best Prods. Co.,*[228] the Eighth Circuit is the only circuit to address this point and "unequivocally holds that the motion date is the relevant date," citing to *In Ahlers v. Norwest Bank*[229]:

> The starting date [for adequate protection] should not be when the petition is filed, but rather when the secured creditor seeks either possession of the collateral or adequate protection...this ruling will prevent a hardship to the debtor caused by an adequate protection motion filed well after the bankruptcy petition has been filed, which could require sizeable "makeup" payments. It is not unreasonable to require the creditor to be vigilant in requesting protection if it wants this protection.

226 *Compare In re Best Products Co. Inc*., 138 B.R. 155 (S.D.N.Y. 1992), with *In re Craddock-Terry Shoe Corp*., 98 B.R. 250 (Bankr. W.D. Va. 1988)."

227 Sidney G. Platzer and Son K. Le, "When a Creditor Is Entitled to Adequate Protection," 24-May Am. Bankr. Inst. J. 50 (2003).

228 138 B.R. 155, 157 (Bankr. S.D.N.Y. 1992).

229 485 U.S. 197, 108 S.Ct. 963 (1988).

In *In re Continental Airlines,* the Delaware Bankruptcy Court held that there was an absence of controlling circuit precedent and that adequate protection could only be awarded from the date of the motion:

> The court agrees with the Debtor that in the absence of controlling precedent the better view is that adequate protection may only be awarded from the date movants seek relief. *In re Best Products Co., Inc*. 138 Bankr. 155 (Bankr. S.D.N.Y. 1992). In *Best Products,* Chief Judge Lifland held that the motion date is the appropriate valuation date for collateral subject to the automatic stay. The secured creditor could only receive adequate protection to the extent the collateral declined in value after it filed its motion for adequate protection, rather than receiving compensation for all post-petition decline in value. *Id.* at 157.[230]

Other courts have followed *Continental* and held that adequate protection payments cannot commence until the motion is filed (and do not accrue pending a motion) and that the date for valuing decline is the motion date:

> Section 363(e) of the bankruptcy code provides that "on request of an entity that has an interest in property used ... by the trustee, the court, with or without a hearing, shall prohibit or condition such use ... as is necessary to provide adequate protection...."
>
> First, the language "on request" in § 363(e) strongly suggests that a secured creditor is entitled to adequate protection only upon a motion and only prospectively from the time protection is sought. 138 B.R. at 157. Moreover, valuing collateral as of the petition date for adequate protection purposes would reward inaction by secured creditors and subject reorganizing debtors to potentially crippling demands for "make-up" payments late in a case. *Id.*; *see also*, *e.g.*, *In re Continental Airlines*, 146 B.R. at 540. *But see*, *e.g.*, *In re Craddock-Terry Shoe Corp*., 98 B.R. at 255; *In re Ritz-Carlton of D.C. Inc.*, 98 B.R. 170, 173 (S.D.N.Y. 1989). It is worth noting that the only U.S. Court of Appeals to address this issue, the Eighth Circuit, indicates that the motion date is the date from which a creditor is entitled to adequate

230 *In re Continental Airlines,* 146 B.R. 536, 539 (Bankr. D. Del. 1992). At least one litigant has argued this is the majority view: "Significantly, the majority of bankruptcy courts have held that diminution in the value of a secured creditor's collateral is measured prospectively from the date of the request for adequate protection. *See, e.g., In re Cason,* 190 B.R. 917 (Bankr. N.D. Ala. 1996); *see also In re Continental Airlines Inc.*, 146 B.R. 536 (Bankr. D. Del. 1992); *In re Continental Airlines Inc.*, 146 B.R. 536 (Bankr. D. Del. 1992). Accordingly, any decrease in the value of AFS's collateral should be measured from Nov. 11, 2010, and any pre-petition diminution in the Collateral is irrelevant." *In re Dairy Productions Systems-Georgia LLC*, 2010 U.S. Bankr. Ct. Motions 11752 (Bankr. M.D. Ga. Dec. 8, 2010). *See also In re Kennedy*, 177 B.R. 967, 973 (Bankr. S.D. Ala. 1995) (adequate protection is granted "[o]nly prospectively from the date of the request").

> protection payments. *Ahlers v. Norwest Bank Worthington N.A.*, 794 F.2d 388, 395 & n.6 (8th Cir. 1986), *rev'd on other grounds sub nom., Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 99 L.Ed.2d 169, 108 S.Ct. 963 (1988).[231]

C. Can Adequate Protection Be Provided by Applying the Rental Income to the Maintenance of the Real Property?

An argument frequently made and accepted by some courts in contested cash collateral hearings is that a lender is not entitled to adequate protection because the rents are being used by the debtor for the normal maintenance of the project and that this suffices to provide adequate protection.[232] In *In re Constable Plaza Assoc. L.P.,*[233] the court stated:

> Manifestly, the application of the rent income solely to maintain and repair the property so as to prevent further deterioration will enhance the value of the property which serves as the collateral for the plaintiff-mortgagee's claim. The protection and maintenance of the plaintiff-mortgagee's collateral, without any diversion of funds to the debtor, clearly ensures that the plaintiff-mortgagee's investment is adequately protected.[234]

D. Should Adequate Protection Payments Be Credited against the Lender's Allowed Secured Claim?

A critical issue involving rental income is the determination of how the monies paid to the lender during the course of the case as "adequate protection" are to be credited by the lender. This issue will arise where periodic payments have been made under a cash collateral order, and then, at the end of the case, there has been no "decline in value" and accordingly, the payments are not compensation for such decline. Thus, the issue arises as to how such payments should be applied to the loan transaction. For example, are such funds to be deemed post-petition interest, or as payments on account of the principal debt, thus reducing the allowed secured claim? Do they reduce the unsecured claim? Or are the payments a form of adequate protection payments that are neither

231 *In re Waverly Textile Processing*, 214 B.R. 476, 479 (Bankr. E.D. Va. 1997). *See also Bluebird Partners L.P. v. First Fid. Bank,* 896 F.Supp. 152, 154 (S.D.N.Y. 1995) (citing with approval the decision of the bankruptcy court which followed *Continental*.)

232 *See, e.g., In re Prichard Plaza Associates Ltd. Partnership*, 84 B.R. 289, 302 (Bankr. D. Mass. 1988) ("To the extent that the debtor applies rental income to the operation and maintenance of the property ... the mortgagee may be considered to be adequately protected.").

233 125 B.R. 98, 105 (Bankr. S.D.N.Y. 1991).

234 *Id.* (citation omitted). *See also In re Prichard Plaza Assocs. Ltd. P'Ship*, 84 B.R. 289, 302 (Bankr. D. Mass. 1998) (adequate protection is satisfied if debtor applied rents to operation and maintenance of property).

interest nor principal? What about excess rental income that was accumulated but not paid to the lender during the course of the case—how should such accumulated cash be treated?[235]

The case law on the proper treatment remains sharply divided. If a lender is oversecured, presumably the excess rents should be applied to post-petition interest, since an oversecured lender is entitled to interest under § 506. If the lender is undersecured, then the lender is presumably not entitled to post-petition interest because of § 506. If the real property did not decline during the course of the case, it might be argued that the payments made were not "adequate protection" payments because there was no decline in the real property. If these payments reduce the allowed secured claim, then in essence, the payments to the lender, which were calculated based on the interest amount, are now principal. If these payments are considered to be on account of the secured portion of the debt, it could be viewed as favorable to the debtor because it converts what were interest payments (pre-bankruptcy) into principal reductions post-petition.[236] However, one court found this to be advantageous to lenders (and hence unfair) because it would represent a paydown of the principal debt during the case, while leaving the value of the real property unchanged.[237] Thus, the question arises in two contexts: How should payments made to the undersecured lender during the course of the case be applied or credited; and second, if excess rents were accumulated, but not paid, how should they be treated at the end of the case?

1. Theory One: Adequate Protection Payments Should Be Applied to Reduce the Lender's Allowed Secured Claim; the Subtraction Theory

One view of this issue is that since the payments can neither be interest nor adequate protection payments (in the absence of any decline), they should be viewed as principal payments, and hence the money paid under § 363 and perhaps under § 362(d)(3) should

235 The treatment of such payments is further complicated by 1994 amendments, which added § 362(d)(3), which addresses relief from the stay for single asset real estate cases. This section states that a debtor must begin making payments to the secured lender, or must have filed a plan within 90 days, in order to avoid being subjected to a motion for relief from the stay. These § 362(d)(3) payments are in an "amount" equal to contract interest, although they may not qualify as interest. Further, they may be made "in the debtor's discretion, notwithstanding section 363(c)(2)." Thus, under this section a debtor may be compelled to make payments to the lender that are not technically considered adequate protection payments, and, while measured by the contract rate of interest, may also not qualify as post-petition interest either under § 506.

236 In describing why this is pro-debtor, one court stated: "[T]he longer a debtor remains in bankruptcy, accumulating income, the better will be its chances of confirming a plan, since the accumulated cash may be used to reduce the creditor's secured claim, which does not increase during the case." *Addison, supra* at 773.

237 *In re Mullen,* 172 B.R. 473 (Bankr. D. Mass. 1994), cited with approval in *In re Barkley 3A Investors Ltd.,* 175 B.R. 755 (Bankr. D. Kan. 1994). It is suggested that the lender is not better off, because by reducing the secured claim, the debtor's plan payments are reduced because of the reduction in principal.

be applied to reduce the lender's allowed secured claim. This is a form of "stealth cramdown" because it effectively reduces the principal amount of the mortgage. Thus, the same dollars that would have been interest payments pre-petition now become principal payments. This theory is highly advantageous to debtors (and thus some judges criticize it as unfair). Under this approach, the debtor may be making what are initially referred to as adequate protection payments, but which will be applied to reduce the lender's allowed secured claim.

There are various cases that support the theory that any payments made during the case as "adequate protection" payments should be applied to reduce the allowed secured claim, provided that the underlying real property did not decline in value during the course of the case. *In re IPC Atlanta Ltd. Partnership*[238] is one of the leading cases that held that the allowed secured claim may be reduced by the amount of adequate protection payments for "use" of rental income.

The facts in *IPC* illustrate how this theory operates. The debtor was the owner of a multi-family apartment complex. The Federal Home Loan Mortgage Corporation (Freddie Mac) held a first trust against the real property and an assignment of the rents. As of the filing date, the mortgage claim was in the amount of $1,782,114. Shortly after the petition was filed, the parties entered into an agreed order for use of cash collateral, which provided for monthly payments to Freddie Mac. The consent order expressly stated that it was neither a waiver nor admission that the payments constituted adequate protection payments.

About five months later, the debtor proposed a plan of reorganization. The plan provided that the monies that had been paid under the consent cash collateral order, approximately $86,000, should be "applied and credited against the principal amount of such Allowed Claim."[239] The crediting against the claim would occur post-confirmation when the payments previously made under the consent cash collateral order would be applied to the post-confirmation mortgage note.

Freddie Mac objected to the reduction of the principal and made the kind of argument that was advanced in *Flagler*.[240] It said that the mere "use" of the rents had diminished the value of its collateral, and thus it was entitled to retain the adequate protection payments without any debt reduction. It argued that the rents were a "separate" form of

238 142 B.R. 547 (Bankr. N.D. Ga. 1992).
239 *Id.* at 551.
240 *In re Flagler-At-First Associates Ltd.*, 114 B.R. 297 (Bankr. S.D. Fla. 1990). *See* discussion *infra* at fn 248 (p. 78).

collateral from the real estate, and that even if the real estate had not declined in value, the rents had because the debtor had used and expended them during the case.[241]

The court rejected the "wash" approach articulated in *Flagler*, stating that where the real property is not declining in value, there is no entitlement to adequate protection, rejecting the notion that the rents were separate collateral, and stating as follows:

> Freddie Mac's argument that it should be able to keep the post-petition payments without crediting the amount received to the claim would allow Freddie Mac, an undersecured creditor, to receive the entire amount of its claim pursuant to the terms of the plan, and in addition, the post-petition payments paid by Debtor. Thus, Freddie Mac would be receiving more than its claim. *Id.* This, in effect, would allow Freddie Mac to receive interest payments or use value, in direct contravention of *Timbers* and § 506(b) of the Code. Second, if the value of the post-petition rents received by Debtor were included in the value of Freddie Mac's secured claim, the amount of that claim would continue to grow during the pendency of the case and the automatic stay. This also could not have been the intended result of the Supreme Court in *Timbers*. Therefore, this Court holds that the post-petition payments made to Freddie Mac pursuant to the April 16, 1991, Order must be credited to Freddie Mac's secured claim. To the extent that *Flagler* may be interpreted to allow an undersecured creditor to receive post-petition payments without having to apply them to the secured claim, solely because the creditor has a separate security interest in the debtor's rents, this Court respectfully disagrees.[242]

Some subsequent cases have continued to cite *IPC* with approval and illustrate how it should be applied. For example, in *In re Barkley 3A Investors Ltd.,*[243] the lender was undersecured on a commercial office building. A motion was presented early in the case to determine whether the rental income was cash collateral and whether the debtor had to make any payments during the course of the case, and if so, how the payments should be applied.

The court held that the rents were cash collateral and that the debtor did not have to make any adequate protection payments absent a showing of a decline in the value of the property. The court cited and followed Judge Queenan's decision in *In re Mullen,*[244] and

241 *Id.* at 558.
242 *In re IPC Atlanta Ltd. Partnership*, 142 B.R. 547, 559 (Bankr. N.D. Ga. 1992) (some citations omitted).
243 175 B.R. 755 (Bankr. D. Kan. 1994).
244 172 B.R. 473 (Bankr. D. Mass. 1994).

IPC Atlantic, and held that (a) the real property and the rental income were a "unitary" form of collateral, not separate; (b) the real property was not declining in value; (c) the constant new flow of rents was adequate protection; and (d) the lender was not entitled to any excess cash flow during the case as adequate protection payments.[245]

2. Theory Two: Adequate Protection Payments or Accumulated Rents May Not Be Used to Reduce the Lender's Mortgage Secured Claim: The "Wash" or "Addition" Theory

Some cases have rejected the approach taken in *IPC*, and have held that the adequate protection payments made during the course of the case may *not* be applied to reduce the lender's allowed secured claim. The payments may, however, reduce the unsecured-deficiency claim. These cases tend to treat the rent as a separate form of collateral, which when received by the debtor increases the collateral, and when paid to the lender, decreases the allowed secured claim, thus resulting in a wash. This theory has sometimes been referred to as the "addition theory" or the "wash theory."[246] Such cases tend to expressly reject the "subtraction" theory of *IPC.*

This theory tends to see the rents as a separate form of collateral, distinct from the real property itself.[247] Accordingly, as rental income is generated, so is additional collateral, and accordingly, the value of the claim that is secured is said to be increasing. Each adequate protection payment is a "discrete" paydown on the newly enlarged secured claim, thus resulting in a "wash." That is, the lender is liquidating its collateral and using the proceeds to make a payment on the debt. Several years ago, it was suggested that the addition rule was the majority rule.[248]

In re Flagler-At-First Associates Ltd.[249] is generally seen as the leading case that supports the addition theory. In this case, the court held that the allowed secured

245 *Id*. at 760. *See also In re Oaks Partners Ltd.*, 135 B.R. 440 (Bankr. N.D. Ga. 1991); *Confederation Life Ins. Co. v. Beau Rivage Ltd.*, 126 B.R. 632 (Bankr. N.D. Ga. 1991); *In re Reddington/Sunarrow Ltd. Partnership*, 119 B.R. 809 (Bankr. D. N.M. 1990); *In re Star Trust*, 237 B.R. 827 (Bankr. M.D. Fla.1999).

246 *See, e.g., In re Duvall Manor Associates,* 191 B.R. 622, 633 (Bankr. E.D. Pa. 1996), referring to this theory as the addition theory and comparing it to the "subtraction" theory, which permits reduction of the allowed secured claim.

247 "In cases involving undersecured creditors, I am persuaded that the better approach is that collateral consists of the sum of the creditor's separate security interests in the buildings and the accumulated post-petition rents. *See In re Union Meeting Partners*, 178 B.R. at 676 ('[W]e consider the rent payments to be nothing more than advance payments on account of the creditor's secured claim resulting from a "liquidation" of part of that creditor's collateral, *i.e.*, the rents themselves.')." *Beal Bank S.S.B. v. Waters Edge Ltd. Partnership,* 248 B.R. 668, 686 (D. Mass. 2000).

248 *See* Sally S. Neely, et al., *Post-petition Rents and the Claims of Undersecured Creditors with Assignment of Rents in Chapter 11 Cases,* SD24 ALI–ABA 363, 381 (1998) (surveying post-petition rent cases and deeming the "addition" cases the "majority approach"). *See also Beal Bank S.S.B. v. Waters Edge Ltd. Partnership,* 248 B.R. 668, 686 (D. Mass. 2000).

249 114 B.R. 297 (Bankr. S.D. Fla. 1990).

claim is not to be reduced by the amount of adequate protection payment made during the course of the case. In *Flagler,* the secured mortgage lender (Foremost) had been receiving adequate protection payments during the course of the case pursuant to an agreed cash collateral order. The amount of the payments were equal to the interest payable under the mortgage note.[250] Later, at the time of the plan confirmation, the issue arose as to how the funds received as "adequate protection payments" should be applied. The debtor argued that since Foremost was undersecured, it was not entitled to receive interest during the case, and since the building had not declined in value, the lender was not entitled to retain the adequate protection payments without applying them to the secured claim.

The court disagreed and held that adequate protection payments made from excess rental income do not have to be applied to reduce the allowed secured claim. "The correct question to address is whether [the mortgage lender] an undersecured creditor whose collateral consists of a mortgage on the [real property] *plus* a perfected interest in the post-petition rents derived therefrom, should be forced to credit post-petition payments received from the debtor to the secured portion of its claim. The Court concludes that the only legal outcome is that the payments are not to be credited."[251]

The first step in the court's analysis was to view the rents as a form of collateral separate from the real property. ("Foremost's secured claim consists of its subordinate interest in the value of the Building as of the commencement of the case, plus the rents as cash collateral generated thereby during the Chapter 11.")[252] ("Foremost's secured claim includes the excess rents generated and paid to Foremost during the Chapter 11").[253] "It is this additional post-petition lien on the Building rents and Flagler's continued use of such cash collateral to make the very post-petition payments at issue here, that sets this case apart [from others]."[254]

The second step in the court's analysis was its determination that the "use" of the rents for operation and payment of adequate protection constituted a decline in value that was compensable as adequate protection payments. ("Approximately $1.6 million in Chapter 11 rents have been depleted by Flagler in the operation of the Building after payment of debt service to [junior creditors] ... This cash collateral is gone, no longer available and constitutes an erosion of [mortgage lender's] security... Thus, a portion

250 *Id.* at 298.
251 *Id.* at 301.
252 *Id*. at 301.
253 *Id*. at 302.
254 *Id*. at 301.

of its collateral...has decreased in value."[255] The court thus referred to the "depletion of the post-petition rental revenues."[256]

Third, finding that the rents were a separate form of collateral, and that the use of the rents had led to a decline in value, the final question was how the payments to the lender of the adequate protection payments were to be applied. The court squarely held that the payments could not be applied to reduce the value of the secured claim as measured by the building value. Accordingly, the value of the collateral was increased by the receipt of rent, and then immediately diminished by the use, and hence a "wash."[257] The rental payments should thus have reduced the unsecured claim.

In re Union Meeting Partners[258] supports *Flagler* and illustrates how it operates. In *Union Partners*, the court had before it a motion to confirm the debtor's plan of reorganization, as well as a motion to determine the value of the secured lenders' claim ("Lincoln"). Lincoln was undersecured. The value of the property was found to be $6,800,000.[259] Lincoln's aggregate allowed claim was $9,364,186. The court determined the allowed unsecured claim by subtracting certain prior liens on the property and the "$1,442,380 total amount of Rents collected and applied" during the course of the case.[260]

As in *Flagler,* the court found that the rents were a separate form of collateral and that the collateral was being liquidated, and hence had to be applied to the claim, but did not reduce the value of the secured claim on the real property.[261] That is, the payment of the rents was seen as reducing the unsecured deficiency claim. The court did note that under the Third Circuit ruling in *Commerce Bank v. Mountain View Village Inc.*[262] the rent assignment was absolute and that Lincoln should be seen as the owner of the rents. However, the court did not find that this altered its outcome, and it expressly adopted the rulings of those cases that follow the "addition rule." ("[W]e conclude that the Rents received by Lincoln should be subtracted from the amount of its aggregate claim, but not from the amount of the secured portion of its claim.")[263]

255 *Id*. at 303.
256 *Id.* at 300.
257 *Id.* at 302.
258 178 B.R. 664 (Bankr. E.D. Pa. 1995).
259 *Id.* at 674.
260 *Id.* at 678.
261 *Id.* at 676.
262 5 F.3d 34 (3d Cir. 1993).
263 *Union Partners*, 178 B.R. at 677.

According to Judge Wedoff in *In re Addison Properties Ltd.,*[264] the proper application of the wash theory results in a decrease in the lender's unsecured claim through the liquidation of this new collateral. Thus, in describing what occurred in *Union Partners,* Judge Wedoff noted that "rents previously paid to the secured creditor were subtracted from the *unsecured* portion of the creditor's claim." *Id*. at 777 (emphasis in original).

Other cases have followed *Flagler*. For example, the court in *Mutual Life Ins. Co. v. Paradise Springs Assocs. (In re Paradise Springs Assocs.)*[265] commented:

> I disagree with the conclusion of the *Reddington/Sunarrow* and *IPC Atlanta* courts. A close reading of § 552(b) and the *dicta* in *Timbers* cited above supports the conclusion reached by the courts in *Bloomingdale, Flagler-at-First*, and *Vermont Investments*. An undersecured creditor with a security interest in post-petition rents may, pursuant to § 552(b), retain those rents as separate collateral without crediting them against the value of the real property collateral. To hold otherwise would, as noted above, render § 552(b) "a nullity."

Also, in *In re Landing Associates Ltd*.,[266] in valuing a secured claim pursuant to § 506(a) for the purposes of confirmation, the court ruled that the rents collected could not be used to reduce the allowed secured claim of the creditor.[267]

In *In re Vermont Investment Ltd. Partnership*,[268] the court's rationale in disallowing the debtor from reducing the allowed secured claim by applying the cash collateral payments against the claim was that the creditor, who had a perfected security interest in the rents of the collateral, had the right to look to the rents as separate collateral, independent of the real estate.

In *In re Birdneck Apartment Assocs. II L.P.,*[269] the court essentially followed *Vermont Avenue,* stating:

> I essentially agree with Judge Teel's reasoning in *In re Vermont Investment Limited Partnership* where he stated that: The position urged by the debtor would result in the application of the ... [creditor's] ... bargained for collateral to create an "equity cushion" from which the debtor might hope to reorganize. Aside from the obvious inequity of such a result, it would

264 185 B.R. 766 (Bankr. N.D. Ill. 1995).
265 165 B.R. 913, 926 (Bankr. D. Ariz. 1993).
266 122 B.R. 288 (Bankr. W.D. Tex. 1990).
267 *See also In re 354 East 66th Street Realty Corp.,* 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995).
268 142 B.R. 571 (Bankr. D. D.C. 1992).
269 156 B.R. 499 (Bankr. E.D. Va. 1993).

> create a dramatic incentive for any secured creditor to bring a single asset reorganization case to a halt at the earliest possible moment, and would create similar incentive on the part of the debtors to delay the case as long as possible in order to reduce the amount of the creditor's secured claim. Such a result would be contrary to the spirit and policy of the Code, which contemplates the protection of secured interests in property and that debtors should have a reasonable period of time to reorganize.[270]

3. Theory Three: Cash Collateral Can Be Used to Pay Administrative Expenses and Legal Fees and to Reduce Unsecured Claim; the "Dual Valuation Theory"

Judge Wedoff in *In re Addison Properties Limited Partnership,*[271] sought to find a middle ground between the "addition" and the "subtraction" cases (above) and to address the issue of whether debtors could use cash collateral for the purposes of paying administrative expense, such as legal fees. In *Addison,* the court essentially found an approach that was partly pro-debtor in that it permitted the use of cash collateral to be used for payment of administrative expenses, and it was partly pro-lender in that it held that payments made as adequate protection could not be used to reduce the allowed secured claim of the lender [although they could be used to reduce the unsecured portion]. This balancing was based on different views of when collateral is valued.

Addison was a single asset real estate case involving a debtor that owned seven properties. Three lenders held various levels of first-, second- and third-lien debt on both the real property and the rental income. It was undisputed that at some level, one of the creditors was undersecured. The debtors and lenders initially agreed to a consent order for the use of cash collateral, which required the use of the rental income to pay normal operating expenses, and for regular payments on the first lienholder's mortgage. The rest of the rental income had been held and segregated pending a determination of the appropriate application. The debtor then applied for authority to use $10,000 for the payment of a retainer to its lawyers. The first lienholder did not object, but the holders of the second and third liens did object.

The court in *Addison* adopted the "dual valuation" system in which property is evaluated as of the filing date in order to evaluate whether a creditor's interest has been adequately protected, but is reevaluated at plan confirmation to determine the value as of the confirmation date[272] When the dual-valuation theory is used, the claim of

270 *Id.* at 505 (citations omitted).
271 185 B.R. 766 (Bankr. N.D. Ill. 1995).
272 *Id.* at 784.

the secured creditor is fixed for adequate protection purposes, and accordingly rental income increases the collateral but not the claim. "Accordingly, if the underlying collateral is not declining in value or at risk of declining in value, the additional cash collateral may be used by the debtor to pay administrative expenses, as well as to maintain or improve the underlying collateral or to make payments on the creditor's claim."[273] Under this theory, at confirmation the property is re-valued. Any proceeds that have not been used increase the amount of the secured claim.[274] If the collateral value now exceeds the claim, the creditor is entitled to interest and costs to the extent of any surplus. Presumably the debtor can use the accumulated rents to reduce the unsecured claim, but the debtor cannot reduce the lenders' allowed secured claim.[275] This approach is fairer, said the court, because its impact on the bankruptcy process is not weighted in favor of either lender or debtor. Debtors will have funds to pay administrative expenses, but they cannot reduce the secured claim through accumulated funds and delay.[276]

Addison was followed by *In re Duval Manor Associates*.[277] When the dual-valuation theory was applied in *Duval Manor,* the court stated that it meant that if there was excess rental proceeds (apparently beyond what was required for operations and administrative expenses), then the lender could treat those as increasing its allowed secured claim and retaining them, but apparently holding that they would reduce the unsecured portion of the claim.[278]

4. Summary

The application of cash-collateral payments remains a complex subject. Most cases will begin with a consent order. Debtor's counsel will be seeking a carve-out for legal fees in most cases, and lender's counsel may want to make sure that if it receives payments, they are not reducing the allowed secured claim. *Addison* may represent a useful strategic tool for both sides to seek a middle ground.

Oddly, even if the Code requires adequate protection for the use of cash collateral, the Code now permits the debtor to use the rental income without reference to the adequate protection requirements provided that the case is a single asset case. The existing case law has not dealt with this apparent anomaly.

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273 *Id.* at 784.
274 *Id.* at 784.
275 *Id.* at 784.
276 *Id.* at 784.
277 191 B.R. 622 (Bankr. E.D. Pa. 1996).
278 191 B.R. at 634.