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From the Bankruptcy Courts: Applying Adequate Protection Payments From Postpetition Rents: Do They Reduce The Debt?

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APPLYING ADEQUATE PROTECTION PAYMENTS FROM POSTPETITION RENTS: DO THEY REDUCE THE DEBT?

When a secured creditor's collateral is depreciating after the debtor files a bankruptcy petition, and the debt exceeds the value of the collateral, the creditor is entitled to relief from the automatic stay unless the trustee or debtor in possession provides "adequate protection" of its interest in the collateral.[1] Moreover, the court, on request, must prohibit or condition the use of collateral by the trustee or debtor in possession to the extent necessary to provide adequate protection of the secured creditor's interest.[2] The trustee or debtor in possession may provide the required adequate protection of a secured creditor's interest by making periodic cash payments equal to the collateral's depreciation.[3] Such "adequate protection" payments are common in Chapter 11 cases and are often determined by negotiation and agreement approved by the court.

If a secured creditor receives the debtor's unencumbered cash as adequate protection payments, and is permitted to spend or otherwise use the cash without restrictions, such payments should reduce the balance of the outstanding debt. For example, a creditor owed $100,000 that has a security interest in depreciating equipment worth $60,000 may be receiving $1,000 each month as adequate protection payments to protect against depreciation of the collateral. If, one year later, the equipment is worth $48,000 and the creditor has received $12,000 in unrestricted adequate protection payments, at that time the creditor would have a $48,000 secured claim and a $40,000 unsecured claim. The adequate protection payments should be applied to reduce the secured portion of the debt.

However, the proper application of adequate protection payments becomes more complicated when the cash used to make the payments is also subject to the creditor's security interest. For example, suppose the creditor has a mortgage on the Chapter 11 debtor's real estate, as well as a properly recorded assignment of rents as additional collateral

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[1] See 11 USC § 362(d)(1).

[2] See 11 USC § 363(e).

[3] See 11 USC § 361(1).

for the debt. Since the postpetition rent constitutes "cash collateral,"[4] the debtor in possession may not use the rents unless the creditor consents or the court authorizes such use while adequately protecting the mortgagee's interest in the rents.[5] It is common for the mortgagee and debtor, early in the case, to agree on the use of a portion of the rents, to maintain the real estate—so that the building does not deteriorate and is able to maintain its income stream—and to pay any excess rents to the mortgagee to provide adequate protection of the mortgagee's interest in the rents as collateral. In this situation—where the debtor is using the mortgagee's own collateral to make adequate protection payments—should such payments be applied to reduce the debt at all? Should they be applied to reduce the secured portion of the claim? The unsecured portion?

These questions were recently examined by the Bankruptcy Court for the Eastern District of New York in *In re 354 East 66th Street Realty Corp.*,[6] a Chapter 11 case in which the primary asset was a building located in New York. When the petition was filed on June 22, 1993, Home Savings Bank held a mortgage on the building to secure a note obligating the debtor to repay $1,700,000. The mortgage contained an assignment to the bank of all leases, together with all rents and income of any nature derived from the property. Thus, postpetition rents constituted cash collateral. The bank filed a secured claim in the debtor's case in the amount of $2,268,755, as of the date of the filing of the petition. After the petition was filed, the mortgage was purchased by Coolidge New York Equities Limited Partnership.

Prior to the assignment of the mortgage to Coolidge, the bank and the debtor in possession negotiated a consensual "cash collateral order" that was so ordered by the court in December 1993. Several weeks later, pursuant to the cash collateral order, the debtor paid more than $39,000 to the bank. In February 1994, the debtor began to make monthly payments of $15,000 to either the bank or its successor in interest, Coolidge, as adequate protection payments. The $15,000 monthly payments constituted the approximate amount remaining after deducting the amount needed to maintain the property during the Chapter 11 case. On consent of the parties and with court approval, approximately $155,000 of cash collateral was used to pay prepetition real estate taxes.

In October 1994, the court determined at a valuation hearing that, for plan confirmation purposes, the value of the property at that time was approximately $2,069,000. The court arrived at this valuation by considering the present value of the building's future projected cash flow. The court found that Coo-

[4] See 11 USC §§ 363(a), 552(b).
[5] See 11 USC § 363(c)(2).
[6] 177 BR 776 (Bankr. EDNY 1995).

lidge's total claim exceeded the value of the collateral by approximately $220,000—if the claim is not reduced by the adequate protection payments received under the cash collateral order. However, by December 1994, the total adequate protection payments made from postpetition rents was approximately the same $220,000 amount. The court also found that the value of the property did not depreciate—and probably appreciated—since the date the petition was filed, due, in part, to an increase in the rent rolls during the case.

Because the debtor paid approximately $220,000 in adequate protection payments as of the end of 1994, which was about the same as Coolidge's unsecured deficiency claim, the debtor took the position that Coolidge's claim must be reduced by that amount so that the unsecured claim would be eliminated entirely. Consistent with this position, the plan of reorganization filed by the debtor assumed that Coolidge no longer had any unsecured claim. The plan provided for payment of the secured debt by reinstating the $1,700,000 principal amount owed on the note and paying the unpaid arrears (approximately $340,000). The plan also gave the debtor a right of first refusal on any sale of the note and mortgage. Although the plan provided for the payment in full of all unsecured claims over a two-year period, it did not include Coolidge in the unsecured creditor class.

The Mortgagee's Position: No Debt Reduction

Coolidge objected to the debtor's disclosure statement on the grounds that it did not recognize its unsecured deficiency claim that must be included in the unsecured creditor class. Coolidge argued that its lien on the rents gave it the right to treat the payments made under the cash collateral order as adequate protection payments solely to compensate it for the debtor's use of the rents. "As a result, all the rents collected by the Debtor as adequate protection payments should be added to and increase this claim, which is reduced in turn by the amount of the payments made to Coolidge, resulting in a 'wash' with respect to the amount of Coolidge's claim."[7] Therefore, Coolidge argues, the unsecured deficiency claim was not reduced by the adequate protection payments and must be included in the class of unsecured claims. This rationale would give Coolidge—as the largest unsecured creditor—the right to vote against the plan and thereby deprive the debtor of an accepting impaired class as is required by Section 1129(a)(10) of the Bankruptcy Code.

"The issue to be decided is how to apply the post-petition net rent payments made to the Secured Creditor, when the secured creditor is undersecured, but has a perfected lien on future rents."[8] If such payments reduce the allowed amount of

[7] 177 BR at 779.
[8] 177 BR at 780.

the claim, the plan could be confirmed because the unsecured class would accept the plan. If such payments do not reduce the allowed claim, then the plan could not be confirmed over the negative vote of Coolidge as the holder of the largest unsecured claim.

Noting that this issue has not been resolved in the Second Circuit, the bankruptcy court focused on Sections 506 and 552 of the Code to begin its analysis. Section 506(a) bifurcates an undersecured claim into a secured claim up to the value of the collateral, and an unsecured claim to the extent that the debt exceeds the collateral value. In general, unsecured or undersecured creditors are not entitled to an allowed claim for postpetition interest—such claims for unmatured interest are not allowable by reason of Section 502(b)(2) of the Code. In contrast, under Section 506(b), an oversecured creditor is entitled to an allowed claim for postpetition interest and any reasonable fees and costs provided under the agreement to the extent that the value of the collateral exceeds the amount of the debt. This reading of the Code was confirmed by the U.S. Supreme Court in *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*[9]

Although Section 552(a) of the Code provides, in essence, that a prepetition security interest in the debtor's after-acquired property does not attach to assets acquired postpetition, an exception is made in Section 552(b) for postpetition proceeds, product, rents, or profits that derive from collateral owned by the debtor prepetition. Therefore, a mortgagee with both a mortgage on a building and a security interest in rents from that building has a valid lien on postpetition rents. "This section of the Bankruptcy Code grants to the creditor secured by a lien on rents a separate interest in addition to the secured creditor's interest in the real property. . . . These two fundamental concepts appear to be at odds with one another in this case. On the one hand, Coolidge is not entitled to receive adequate protection payments if there is no diminution of the value of its collateral interest on its claim while it is undersecured. On the other hand, Coolidge does have a separate set of rights as a result of its perfected security interest in the rents, which rights differ from a creditor without such a perfected lien."[10]

Postpetition Rents as Separate Collateral

The bankruptcy court observed that cases on this issue "run the gamut, reflecting the possible ambiguity created by these provisions of the Bankruptcy Code."[11] The bankruptcy court looked for guidance to the Supreme Court's decision in *Timbers*, where a creditor with a mortgage on an apartment project and an assignment of rents as addi-

[9] 484 US 365, 108 S. Ct. 626 (1988).

[10] 177 BR at 780.

[11] Id.

tional collateral was undersecured. The debtor had agreed to pay the mortgagee the postpetition rents from the project less operating expenses. In response to the mortgagee's motion for relief from the automatic stay, continuance of the stay was conditioned on the receipt of certain monthly payments. The Supreme Court examined the issue of whether the undersecured creditor with a security interest in the real estate and postpetition rents was entitled to receive interest and costs accruing after the petition was filed.

The Court, in *Timbers*, reasoned that, because Section 506(b) "permits postpetition interest to be paid out only of the 'security cushion,' the undersecured creditor, who has no such cushion, falls within the general rule disallowing post-petition interest. . . ."[12] However, the Court also recognized that the rights of secured creditors with perfected liens on rent are greater than those mortgagees that do not have such liens on rents. But the bankruptcy court, in *354 East 66th Street Realty*, observed that "these additional rights were not enumerated in *Timbers*, and must be counterbalanced by the Supreme Court's further statement that one of the purposes behind Chapter 11 is to provide for the 'conscious allocation' of reorganization benefits and losses between unsecured and secured creditors."[13]

The bankruptcy court described the thrust of Coolidge's contention as follows:

> [B]y virtue of its perfected interest in the rents of the property, it is entitled to not only receive the full value of its claim as determined by the valuation of the Property, but to receive any additional net rents, thereby receiving a stream of payments during the pendency of the case above and beyond its claim. Coolidge's argument is based on an assumption that the net rents increase the value of the Property as determined by this Court. The increase in value of the Property is then reduced as Coolidge receives the net rents. This offsetting creates a "wash", having no effect on the pre-petition claim or the value of the Property.[14]

The cases cited by Coolidge in support of its position recognize, as does the bankruptcy court in *354 East 66th Street Realty*, that postpetition rents are separate collateral distinct from the real property that generates them.

> However, the Court parts ways with these courts with respect to the impact of this additional collateral where the creditor is undersecured at the time of the valuation hearing. The additional collateral does give Coolidge greater rights than those of secured creditors without the additional lien, as recognized by *Timbers*.

[12] 484 US at 373, 108 S. Ct. at 631.

[13] 177 BR at 781, quoting from 484 US at 373, 108 S. Ct. at 631.

[14] 177 BR at 781. In support of its position, Coolidge cited, e.g., In re Vermont Inv. Ltd. Partnership, 142 BR 571 (Bankr. DDC 1992); In re Birdneck Apartment Assocs. II, LP, 156 BR 499 (Bankr. ED Va. 1993).

One of these rights is the right to apply the net post-petition rents to Coolidge's claim to the exclusion of the other creditors. Coolidge's additional interest in the rents was also recognized and taken into consideration when the Court made its determination as to the value of the Property. However, the Court is hard pressed to make the leap in logic urged by Coolidge that the additional security interest entitles Coolidge to receive payment in excess of its original claim while Coolidge is undersecured. Although Coolidge argues that the Debtor's use of the rents erodes Coolidge's security, this is not the case. The rents are a component of the collateral, a portion of which is being paid to Coolidge and a portion of which is going towards maintenance of the property. When Coolidge receives the monthly net rents, it has in effect realized the benefit of the rental collateral, which payment is to be applied to reduce the debt accordingly.[15]

Defeating the Automatic Stay

The bankruptcy court found persuasive the reasoning of a decision in *In re Oak Partners, Ltd.*,[16] a similar case in which the court had to determine whether postpetition rent (net of maintenance and operating expenses) paid to a mortgagee must be applied to reduce the debt. The court, in *Oak Partners*, reasoned that the automatic stay against foreclosure would, in effect, be vitiated if the adequate protection payments do not reduce the debt:

It is important to recognize that absent bankruptcy, if a creditor such as First Union enforced its assignment of rents and took possession of the rents without foreclosing, it would still need to apply those rents to the debt as it existed at the time the rents were received. The only way First Union could collect the rents and not apply them to the debt would be to foreclose and become the owner of the property before collecting rents. However, the bankruptcy filing invokes the automatic stay which prevents the creditor from foreclosing. If (the bank) is allowed to keep the rents and not apply them to the debt, then one of the purposes of the automatic stay is defeated. In effect, allowing (the bank) to take their rents and not apply them to the debt amounts to a retroactive granting of relief from the stay.[17]

Moreover, the court in *354 East 66th Street Realty* pointed out that, if Coolidge retained the net rents without applying them to reduce the debt while Coolidge is undersecured, Coolidge's claim would never decrease to the detriment of the debtor's reorganization efforts and the remaining creditors. "The payments would drain the Debtor's estate, and the allocation of loss to the remaining creditors would amount to a windfall to Coolidge by paying them more than the amount of the original claim."[18] The bankruptcy court concluded:

[15] 177 BR at 781.

[16] 135 BR 440 (Bankr. ND Ga. 1991).

[17] 177 BR at 782, quoting from 135 BR at 450.

[18] 177 BR at 782.

> When a secured creditor has an interest in future rents, it has an interest in the collateral that arise when it is earned. This additional collateral is still only collateral for the original debt. The funds earned are not property of the secured creditor, but are its added collateral to support the secured creditor's obtaining the full benefit of its claim. In this case, the Debtor has already paid the additional net income from the rents to Coolidge so that the undersecured portion of its claim has already been repaid.[19]

The Right to Postpetition Interest

The receipt of postpetition rents having eliminated the unsecured portion of Coolidge's claim, the continuing rental payments have reached the point where they begin to reduce the secured portion of the claim. The bankruptcy court reasoned that, from that point in time, Collidge becomes oversecured. If the Debtor is permitted to apply the net rents received by Coolidge to reduce its secured claim without the payment of postpetition interest, then Coolidge would be deprived of postpetition interest to which an oversecured creditor is entitled under Section 506(b) of the Code. "This would result in a windfall to the Debtor. . . . Coolidge is now entitled to interest on the defaulted payments which it has not received."[20] The reorganization plan recognized this by proposing to pay interest on the arrears.

Conclusion

The bankruptcy court, in *354 East 66th Street Realty*, emphasized the need to apply various sections of the Code—Sections 502, 552, and 1129—together in harmony in the context of the ultimate goal of reorganization. This harmony is reached by finding that the cash collateral payments received by Coolidge must first reduce the undersecured portion of the claim, and then reduce the remaining secured claim, including interest accruing after full payment of the undersecured portion of the claim. The court stated:

> As a result, neither Coolidge nor the Debtor shall be the sole beneficiaries of the rents generated by the Property and any incentive for either party to delay the proceedings is neutralized. This approach strikes an equitable balance between the Debtor's goal of reorganization and the competing interest of adequately protecting Coolidge's rights as a secured creditor with a perfected lien on the property and on future rents.[21]

Since the proposed plan provided for the payment of interest on arrears, the court found that the plan is confirmable and that the full payment of the undersecured portion of the claim using adequate protection payments deprived the mortgagee of the right to vote as a member of the unsecured creditor class.

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[19] Id. Another recent case that supports the conclusion that postpetition rents paid to the mortgagee reduce the unsecured portion of the debt is In re Union Meeting Partners, 178 BR 664 (Bankr. ED Pa. 1995).

[20] 177 BR at 783.

[21] Id.