



Richard Levy
Latham & Watkins



James Ktsanes
Latham & Watkins

Putnal V. SunTrust May Upset Addison Precedent

Law360, New York (June 20, 2013, 2:19 PM ET) -- Bankruptcy courts are divided on whether post-petition “rents” under section 552(b)(2) of the Bankruptcy Code are entitled to adequate protection. Arising most frequently in cases in which all, or substantially all, cash collateral is generated from hotels, apartments and other lodging properties, the resolution of this issue often dictates the course of a bankruptcy case, potentially leading to dismissal of the case due to inability to pay counsel or other administrative expenses.

If a bankruptcy court rules that rents accruing post-petition are entitled to adequate protection, it typically precludes the nonconsensual use of such funds for administrative expenses not directly related to preserving and maintaining the underlying collateral.[1] If a bankruptcy court rules that such rents are not entitled to adequate protection, the debtor will have significantly greater latitude in its use of cash collateral for administrative expenses and will generally have more control over the administration of its estate.

In *Putnal v. SunTrust Bank*,[2] the bankruptcy court for the Middle District of Georgia recently held that post-petition rents were entitled to adequate protection, and thus, could not be spent to administer the bankruptcy or for other general purposes. In its opinion, the *Putnal* court leveled the most direct criticism to date against the leading case for the opposing viewpoint, *Addison Properties*. [3] In so ruling, *Putnal* joined what appears to be an emerging majority of courts holding that post-petition rents are entitled to adequate protection.

Background

While section 552(a) of the Bankruptcy Code provides that property acquired post-petition is generally not subject to a prepetition security agreement, section 552(b) provides certain exceptions to this rule. Section 552(b)(2) states:

[I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to ... amounts paid as rents of [the debtor's] property ... then such security interest extends to such rents ... acquired by the estate after the commencement of the case to the extent provided in such security agreement[4]

Thus, if a secured creditor has a prepetition assignment of rents, section 552(b)(2) acts to increase the amount of collateral, securing such a creditor's claim as rents accrue post-petition. However, bankruptcy courts have struggled with whether the secured creditor's interest in such post-petition collateral is entitled to adequate protection under sections 362 and 363 of the Bankruptcy Code.

Addison Properties

The most extensive judicial analysis of whether post-petition rents are entitled to adequate protection is contained in Judge Wedoff's opinion in *In re: Addison Properties*.^[5]

In *Addison Properties*, a single-asset real estate case, the debtor filed a motion to pay a \$10,000 retainer to its counsel, to which two creditors objected. After acknowledging that all cash held by the debtors was cash collateral, the court stated that the key question was the extent to which secured creditors were entitled to adequate protection of post-petition rents. The court reviewed different approaches, including the "single," "continuous" and "dual" valuation methods, ultimately adopting the "dual" valuation method.

Under the dual valuation method, the court determines the amount of a creditor's secured claim on the petition date for purposes of adequate protection and revalues the secured claim for confirmation purposes. Under this method, the secured creditor is not entitled to any independent adequate protection of post-petition rents, and thus, such funds may be spent by the debtor after showing that the underlying property to which the rents relate is not declining in value. In so ruling, *Addison Properties* viewed post-petition rents as mere protection against diminution in the value of the real estate, not independent collateral that is itself entitled to adequate protection.

In the nearly 18 years since the opinion was published, *Addison Properties* has been cited favorably by several courts in a variety of procedural contexts.^[6]

For example, in *In re: Homestead*, the secured creditor filed a proof of claim — including post-petition rents — as part of the secured claim.^[7] The bankruptcy court for the Northern District of Georgia overruled the debtor's objection to the proof of claim, citing *Addison Properties* for the proposition that post-petition rents should not be included in the claim for purposes of adequate protection but should be included for purposes of confirmation.

Contrary Authority

Other courts have differed from the *Addison Properties* line of cases, holding that post-petition rents are entitled to independent adequate protection.^[8]

Prior to *Addison Properties*, the bankruptcy court for the Southern District of New York ruled that the debtor could not use post-petition rents to pay its professionals.^[9] While the court noted its sympathy for the debtors, the court explained the clear need for adequate protection of the rents, stating that a professional must forego compensation and reimbursement of expenses from cash collateral absent (1) a demonstrably oversecured creditor, (2) secured creditor consent or (3) a 506(c) showing.

The Sixth Circuit also addressed the issue in *In re: Stearns Building*.^[10] In *Stearns*, the debtor sought to stay the bankruptcy court's order that prohibited the debtor from using cash collateral to pay professional fees or any other expenses unrelated to the maintenance and operation of the apartment complex. After the bankruptcy court and district court both denied the debtor's motion to stay the order, the Sixth Circuit also denied the debtor's stay motion because, among other reasons, the debtor was unlikely to succeed on appeal. The Sixth Circuit explained that the debtor could not provide adequate protection for the use of post-petition rents because it did not have any unencumbered assets and thus, was not permitted to spend such funds.^[11]

Putnal v. SunTrust Bank

In March of this year, the court in *Putnal v. SunTrust Bank*^[12] agreed with the secured lender, SunTrust, in holding that rents accruing post-petition under 552(b)(2) could not be used for general case administration. The court expressly disagreed with Addison Properties, stating that the "dual valuation" method had not been widely adopted, and challenged Addison Properties' assumption that if collateral is valued on the petition date, such valuation should disregard future income streams.

In *Putnal*, the court concluded that "SunTrust has a secured interest in each dollar in rents that accumulates, and each of those dollars is entitled to adequate protection. The debtor may not use any of the rents to administer his bankruptcy or for other general purposes because for each dollar in rents he spends, he deprives SunTrust of the adequate protection of that dollar."

Accordingly, the court limited the debtor's use of rents to expenses that directly related to the operation, maintenance and disposition of the real estate incurred primarily for the benefit of the secured creditor.^[13]

Conclusion

Whether post-petition rents are entitled to adequate protection is a critically important issue in single-asset real estate cases, as well as cases in which substantially all revenue comes from real estate rents. The determination of whether such rents may be spent on professional fees and other case administration expenses can alter, sometimes dramatically, the course of a Chapter 11 proceeding.

While Addison Properties is a thoughtful and extensive analysis of adequate protection of post-petition rents, a trend may be developing, illustrated recently by cases such as *Putnal*, that post-petition rents under section 552(b)(2) are entitled to adequate protection.^[14] Only time will tell whether *Putnal* truly represents a growing majority, or whether courts will continue to be divided.

While the matter is not settled, in most real estate cases, it may be wise for undersecured creditors to argue that post-petition rents are entitled to adequate protection, and that the court should place appropriate limitations on their use.

—By Richard A. Levy and James Ktsanes, Latham & Watkins LLP

Richard Levy is a partner and James Ktsanes is an associate in Latham & Watkins' Chicago office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] As noted below, exceptions exist when the debtor has unencumbered assets it can pledge as adequate protection, the secured creditor has a substantial equity cushion, or the court allows expenses under section 506(c) of the Bankruptcy Code.

[2] 489 B.R. 285 (M.D. Ga. 2013).

[3] 185 B.R. 766 (Bankr. N.D. Ill. 1995).

[4] 11 U.S.C. § 552(b)(2).

[5] 185 B.R. 766 (Bankr. N.D. Ill. 1995).

[6] See, e.g., *In re Farmer*, 257 B.R. 556 (Bankr. D. Mont. 2000); *In re Markos Gurnee Pshp.*, 252 B.R. 712 (Bankr. N.D. Ill. 1997); *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996).

[7] *Homestead Partners v. Condor One (In re Homestead Partners)*, 200 B.R. 274 (Bankr. N.D. Ga. 1996).

[8] See *Federal Nat'l Mortgage Ass'n v. Dacon Bolingbrook Assocs. Ltd. Partnership*, 153 B.R. 204 (N.D. Ill. 1993); *In re River Oaks Ltd. P'ship*, 166 B.R. 94 (E.D. Mich. 1994); *In re Griswold Building, LLC*, 420 B.R. 666 (Bankr. E.D. Mich. 2009); *In re Union-Go Dairy Leasing, LLC*, 2010 Bankr. LEXIS 1468 (Bankr. S.D. Ind. 2010).

[9] *In re 680 Fifth Ave. Associates*, 154 B.R. 38 (Bankr. S.D.N.Y. 1993). Addison Properties distinguished *680 Fifth Ave.*, concluding that it conflicted with the concept of adequate protection embodied in the Bankruptcy Code.

[10] 1998 U.S. App. LEXIS 22121 (6th Cir. 1998).

[11] The Sixth Circuit bankruptcy appellate panel heavily relied on Stearns in reversing a bankruptcy court's order allowing the debtors to use rents to pay professional fees, reasoning that the secured creditor was not adequately protected for such use. *In re Buttermilk Towne Center, LLC*, 442 B.R. 558 (6th Cir. BAP 2010).

[12] 489 B.R. 285 (M.D. Ga. 2013)

[13] Approximately one month after Putnal, another Georgia bankruptcy court ruled that post-petition rents were entitled to independent adequate protection. *In re Chatham Parkway Self Storage, LLC*, 2013 Bankr. LEXIS 1955 (Bankr. S.D. Ga. Apr. 25, 2013). Curiously, the Chatham Parkway court held that paying the undersecured creditor part of the post-petition rents, while using another part to pay the debtor's professional fees, constituted adequate protection. Another court has also attempted to strike an uneasy middle ground. *In re Wrecclesham Grange, Inc.*, 221 B.R. 978 (Bankr. M.D. Fla. 1997), the court held that post-petition rents were entitled to adequate protection, but only to the extent the stream of post-petition rents was declining.

[14] For purposes of this article we have only summarized published opinions, rather than court orders. A review of all bankruptcy court orders on this issue could result in different conclusions about the state of the law, although some courts have already concluded that Putnal represents the "majority view." See *In re Chatham Parkway Self Storage, LLC*, 2013 Bankr. LEXIS 1955, at * 12-13 ("The majority of courts to consider the issue have deemed a security interest in rents to be wholly separate from a creditor's security interest in property, and therefore, requiring of separate adequate protection.").

All Content © 2003-2013, Portfolio Media, Inc.