In re Putnal: Adequately Protecting Postpetition Rents

September/October 2013

Oliver S. Zeltner

Section 552(b)(2) of the Bankruptcy Code provides that if a creditor prior to bankruptcy obtained a security interest in rents paid to the debtor, that security interest extends to postpetition rents to the extent provided in the security agreement. Courts have disagreed, however, on the question of whether the debtor must provide adequate protection with respect to such postpetition rents. The resolution of this issue typically determines whether the debtor may use a portion of the postpetition rents that it receives to fund the administrative costs of its bankruptcy. Particularly in cases in which all, or nearly all, of the debtor's income comes from rental income, the debtor's ability to fund the administrative costs of bankruptcy can hinge on this issue.

Recently, the U.S. District Court for the Middle District of Georgia, in *Putnal v. SunTrust Bank*, 489 B.R. 285 (M.D. Ga. 2013), joined what appears to be a growing majority of courts in holding that a secured creditor's interest in postpetition rents is entitled to separate and independent adequate protection, even if the creditor's interest in the rent-producing real property itself is adequately protected. In so ruling, the district court expressly rejected two approaches—the "replacement lien" and "dual valuation" theories—which some courts have employed in decisions holding that no separate adequate protection with respect to postpetition rents was required.

Adequate Protection and Postpetition Rents

Section 552(b)(2) provides, with certain exceptions, that:

> [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 property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement.

Section 552(b)(2) was added to the Bankruptcy Code in 1994 to dispel confusion as to how a security interest in or assignment of hotel revenues, rents, and similar income streams needed to be perfected to protect the rights of the lender or assignee postbankruptcy. It creates an exception to the general rule, stated in section 552(a), that property acquired by a debtor after the commencement of the bankruptcy case is not subject to a prepetition security agreement. A creditor's security interest in rents, or hotel-occupancy fees, paid to the debtor thus survives the debtor's bankruptcy filing and persists, to the full extent provided in the security agreement, as the bankruptcy moves forward.

Section 363(a) of the Bankruptcy Code provides that the postpetition rents and hotel-occupancy fees described in section 552(b) constitute "cash collateral." As such, pursuant to section 363(c)(2), a debtor may use such monies only with the consent of the secured creditor or with court authorization. Section 363(e) provides that "on request of an entity that has an interest in property used . . . or proposed to be used . . . by the trustee, the court . . . shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest."

While the requirement of adequate protection for postpetition rents under these provisions appears to be straightforward, courts have struggled to define precisely what constitutes adequate

protection in this context. One line of authority, represented by the leading case, *In re Addison Properties Limited Partnership*, 185 B.R. 766 (Bankr. N.D. Ill. 1995), has applied a "dual valuation" theory. Under the dual-valuation approach, the amount of a secured creditor's claim is fixed as of the petition date for purposes of adequate protection and is recalculated later (e.g., at the chapter 11 plan-confirmation stage of the case).

As explained in *Addison*, "Section 552(b) proceeds increase the collateral securing that claim, but do not increase the claim for purposes of adequate protection." Thus, the dual-valuation approach requires no separate adequate protection for rents because, under this approach, the secured creditor is not viewed as having a distinct security interest in the rents themselves; rather, such rents serve merely to protect against a decline in value of the underlying collateral, the real property. Although some courts have adopted *Addison*'s dual-valuation theory (*see*, *e.g.*, *Homestead Partners, Ltd. v. Condor One, Inc. (In re Homestead Partners, Ltd.)*, 200 B.R. 274 (Bankr. N.D. Ga. 1996)), this approach has not been universally accepted.

Other courts have applied a "lien replacement" theory, which, like dual valuation, assumes that a security interest in rents should not be treated as an independent security interest for purposes of adequate-protection analysis. *See*, *e.g.*, *In re Mullen*, 172 B.R. 473 (Bankr. D. Mass. 1994). Under this approach, the secured creditor is viewed as having a lien on each month's rent that is replaced by another lien on the following month's rent. Thus, even if the debtor is permitted to use the rental-income stream for purposes other than maintaining the value of the real property, under the lien-replacement theory, the secured creditor remains adequately protected by virtue of the ever-renewing lien on future rents. The lien-replacement theory has come under attack in

recent years as being inconsistent with the requirements of section 552(b) and "has by now been generally discredited," according to the *Putnal* court.

Putnal

Stephen S. Putnal owned and managed various rent-producing properties, including a building in Chattanooga, Tennessee. In 2008, Putnal entered into a deed of trust with SunTrust Bank whereby Putnal granted SunTrust a security interest in, among other things, the Chattanooga property and the rents generated by that property. The security agreement characterized SunTrust's interest in the rents as an assignment of "all rents, revenues, incomes and profits of the [Chattanooga property] . . . now or hereafter due" effective upon Putnal's default. Putnal filed a chapter 11 petition in 2011 in Georgia. SunTrust filed a claim based upon its security interests in the Chattanooga property and other properties of the debtor. The parties agreed that, overall, SunTrust's claim was undersecured by more than $500,000.

Putnal leased the Chattanooga property to a pharmacy for $6,966.10 per month. Acknowledging that this rent constituted cash collateral, Putnal moved the bankruptcy court for permission to use approximately $3,000 of the monthly rent to pay for costs of administering the bankruptcy and expenses relating to the Chattanooga property, such as the costs of appraising the property and negotiating a renewal of the lease. SunTrust objected to Putnal's motion, arguing that Putnal was not entitled to use any portion of the rents because every dollar of rent paid to Putnal on the Chattanooga property was subject to SunTrust's security interests and thus was subject to the section 363 adequate-protection requirement.

The U.S. Bankruptcy Court for the Middle District of Georgia, in *In re Putnal*, 483 B.R. 799 (Bankr. M.D. Ga. 2012), granted Putnal's request to use a portion of the rents paid on the Chattanooga property to pay certain expenses related to maintaining and leasing the property, but it refused to allow Putnal to tap this revenue stream to fund the administration of his chapter 11 case. The bankruptcy court rejected Putnal's contention that SunTrust's security interests in the Chattanooga property and the rents generated by that property together constituted a "single, unified interest in the land and rents that is adequately protected so long as the value of the real property is not declining."

The bankruptcy court ruled that "[s]ection 552(b) provides SunTrust with a security interest in postpetition rents that is separate from its interest in the real property. Because the rents are separate collateral, any use of the rents results in a dollar-for-dollar reduction in the value of that collateral," meaning that any use of the rents by Putnal to pay the administrative costs of bankruptcy would constitute a failure to adequately protect SunTrust's interest. Putnal appealed to the district court.

The District Court's Ruling

The district court affirmed the bankruptcy court's ruling. On appeal, Putnal made arguments which, according to the court, "rest[ed] on the idea that SunTrust's interest in rents is subsumed by its interest in the real property, and that so long as the real property's value is not declining, all that must be protected is a *lien* in rents." Acknowledging that this argument had "some logic," but only "[i]n a very narrow and very abstract sense," the court rejected Putnal's assertion that a security interest in rents does not require adequate protection if the underlying collateral is adequately protected against a diminution in value. Putnal's argument, the court said, "ignore[d]

the nature of the interest actually assigned to SunTrust" because "SunTrust took more than [the] security necessary to maintain the value of the property; it took an interest in the cash generated by the property."

Accepting Putnal's argument, the court explained, would require the court to accept the lien-replacement theory, which would not adequately protect SunTrust's interest in postpetition rents. The court noted that while "a few courts once followed" the lien-replacement theory, "[m]ost courts [now] recognize that a prepetition security interest in rents is a special kind of collateral that, pursuant to 11 U.S.C. § 552(b), continues in full force and effect after the petition is filed." According to the court, "[T]he replacement lien theory's purported protection is seen as 'illusory' " because it "simply provides no protection for the very real interest the creditor has in accruing rents."

Having declined to adopt the lien-replacement theory, the court next turned to Putnal's argument that the court should apply the dual-valuation theory set forth in *Addison*. The court rejected this theory, for three reasons. First, the court noted that, despite its adoption by the *Addison* court, dual valuation "has not been widely adopted." Second, the court distinguished one of the *Addison* court's rationales for adopting the dual-valuation theory—the idea that one alternative to dual valuation, "continuous valuation," is flawed.

The *Addison* court explained "continuous valuation" as follows: "[A]s Section 552(b) proceeds (such as rents) come into an estate, they should first be expended to preserve the underlying collateral . . . and should then be seen as increasing the collateral used to value the creditors'

secured claims . . . .” The net effect of this approach is that “[e]ach receipt of net proceeds by the debtor results in a new secured claim, subject to adequate protection.” The *Addison* court criticized continuous valuation, finding, among other things, that “the continuous valuation approach creates highly questionable results when applied in a case where the property securing a claim fluctuates in value.”

The *Putnal* court distinguished between the continuous valuation of a rental-income stream and the continuous valuation of other types of property, finding that *Addison*’s “criticism of continuous valuation focuses on interests in property that fluctuates in value according to market forces rather than interests in rents that increase by accrual and do not decline.” Thus, by implication, the *Putnal* court appeared to favor the continuous valuation of postpetition rents subject to adequate protection.

Finally, the court rejected dual valuation because, “considering that SunTrust’s pre-petition interest in rents can technically be valued *ad infinitum*, it is of no help to the Debtor to value rents for adequate protection purposes at the time the petition is filed.” “For even then,” the court said, “the value of SunTrust’s interest is essentially unlimited.” The court thus rejected the dual-valuation doctrine without further discussion and without considering the theory’s arguable merits.

The court held that SunTrust had a security interest “in each dollar in rents that accumulates, and each of those dollars is entitled to adequate protection.” Consequently, Putnal could not divert any amount of the income stream generated by postpetition rents to fund his bankruptcy or for

"general purposes" because "for each dollar in rents he spends, he deprives SunTrust of the adequate protection of that dollar." The court further held that Putnal's use of the rents was limited to expenses "directly related to the operation, maintenance, or preservation of the Chattanooga property, or that are reasonable and necessary to preserving and disposing of such property and are incurred primarily for the benefit of the secured creditor."

Outlook

At least one court has subsequently characterized the holding of *Putnal* as the "majority view." *See In re Chatham Parkway Self Storage, LLC*, 2013 WL 1898058 (Bankr. S.D. Ga. Apr. 25, 2013). Some courts, however, may resist following *Putnal* where applying its holding would leave a debtor unable to fund the administrative costs of bankruptcy. Nevertheless, *Putnal* appears to signal a trend toward requiring debtors to adequately protect security interests in postpetition rents on a dollar-for-dollar basis.