

CASH AND RELATED PROBLEMS FOR THE REAL ESTATE DEBTOR

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I. BAPCPA Expands the Definition of Single Asset Real Estate

A. New Definition of “Single Asset Real Estate”

Following the amendments to the Bankruptcy Code enacted by BAPCPA, the term “single asset real estate” is now defined to mean “real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantial all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.” 11 U.S.C. § 101(51B). The BAPCPA amendments eliminate the prior limitation upon the definition of “single asset real estate” which required that the debtor’s real property be encumbered by liquidated secured debts in an amount less than \$4 million. Therefore, BAPCPA has greatly expanded the universe of potential single asset real estate cases.

B. Secured Creditors of Single Asset Real Estate Have Greater Rights to Relief from the Automatic Stay.

In their efforts to reorganize single asset real estate debtors face significant time limitations. Pursuant to the Bankruptcy Code, as amended by BAPCPA, the creditor holding a security interest against single asset real estate is entitled to relief from the automatic stay within thirty (30) days after the court determines that the debtor is a single asset real estate debtor, *unless*: (i) within ninety (90) days after the entry of the order of relief, the debtor files a plan that has reasonable possibility of being confirmed within a reasonable time; or (ii) the debtor has commenced monthly payments to the secured creditor which are equal to the non-default contract rate of interest. 11 U.S.C. § 362(d)(3).

II. Cash Collateral and Adequate Protection Issues Arising in the Single Asset Real Estate Case

A. Cash Collateral Issues

1. As with all bankruptcy cases, the filing of a petition for relief by the single asset real estate debtor creates an estate consisting of all property owned by the debtor at the time of the filing. In addition to the real estate owned by the debtor, the property of the estate also includes the cash belonging to the debtor. If this cash is subject to a lien or security interest, then it constitutes cash collateral.

2. Under the Bankruptcy Code, “cash collateral” is defined as:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the

estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and 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 subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

11 U.S.C. § 363.

3. In the single asset real estate case it is the rents derived from the debtor's property that constitute the "cash collateral" subject to the secured creditors lien. A mortgagee can assert a security interest in rents to the extent allowed by the security agreement and state law. *See* 11 U.S.C. § 552(b); Butner v. United States, 440 U.S. 48 (1979).

B. Debtor's Use of Cash Collateral

A debtor cannot use cash collateral unless the creditor holding an interest in that cash collateral consents or the court authorizes its use. 11 U.S.C. § 363(c)(2). If cash is not subject to a security interest or lien (and therefore is not cash collateral), then a debtor can use its cash in the ordinary course of its business without obtaining court or lender approval. 11 U.S.C. § 363(b).

C. Consent to Use of Cash Collateral (Implied v. Expressed Consent)

1. It is not uncommon for a creditor having a security interest in cash to consent to the use of its cash collateral during a chapter 11 proceeding. However, in most cases, the debtor's use of cash collateral is the subject of a negotiated and agreed upon cash collateral order for which the parties seek court approval. The consenting creditor will desire court approval of the agreed cash collateral order because as part of his negotiated agreement with the debtor, the creditor will extract various benefits which he wants the court to approve such that he can be insured of the benefit of his bargain. Furthermore, such court approval is required before the agreement can become valid. F.R.B.P. 4001(d).

2. Despite the Bankruptcy Code's prohibition upon the debtor's use of cash collateral without the consent of the secured party or a court order, some debtors continue to consume cash without fulfilling these requirements. In some cases the debtor will use cash collateral and later contend that the secured creditor gave its implied consent to such use. Necessarily, this raises two issues: (i) is implied consent sufficient as a matter of law to satisfy the requirements of § 363(c)(2)(A); and (ii) if implied consent is sufficient, then what actions or inactions by a secured creditor constitute "implied consent?"

3. The Ninth Circuit Court of Appeals has definitively ruled that implied consent is insufficient as a matter of law to satisfy the requirements of §363(c)(2)(A). *Freightliner Market Development v. Silver Field Freight*, 823 F.2d 362, 368-369 (9th Cir. 1987). Therefore, in the Ninth Circuit, a creditor's consent to the debtor's use of cash collateral must be expressly authorized by the creditor(s) with an interest in such cash. *Id.*

4. Outside the Ninth Circuit, courts have held that a debtor's consensual use of cash collateral may be implied from the creditor's actions or inactions. These courts have held that if a secured creditor knows that a debtor is spending cash collateral without the consent of the secured creditor and such secured creditor does nothing to prevent such use, then the secured creditor shall be deemed to have impliedly consented to such use. *Matter of Nat'l Save NE, Inc.*, 76 B.R. 896, 907 (Bankr. D.Conn. 1987) ("secured creditor on notice may not choose to ignore unauthorized use of cash collateral"); *In re Unity Foods*, 75 B.R. 222 (Bankr. N.D.Ga. 1987) (equities do not favor a creditor who knowingly allows debtor to use cash collateral and which creditor later claims such use was unauthorized).

D. Court Authorized Use.

If a secured creditor having an interest in cash refuses to consent to the debtor's use of cash collateral, then the debtor has no choice but to seek court approval for such use. Before a court can approve the debtor's use of cash collateral, the court must find and conclude that the secured creditor's interest in such cash collateral is "adequately protected." See 11 U.S.C. § 363(e) ("on request of an entity that has an interest in property used" by the debtor, "the court, with or without a hearing, shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest").

III. Requirements of Adequate Protection

A. What is Adequate Protection?

1. In its simplest form, "adequate protection" requires that for every dollar of cash collateral consumed by the debtor, it must earn a dollar of cash to replace the dollar consumed. See *In re C.F. Simonin's Sons, Inc.*, 28 B.R. 707, 712 (Bankr. E.D.N.C. 1983) (requiring the high-risk debtor to provide one dollar of protection for every eighty-five cents used).

2. The concept of "adequate protection" also requires that a debtor protect its lender from any depreciation in its collateral during the pendency of the case. *United Savings Assoc. of Texas v. Timbers of Inwood Forest Assoc. Ltd.*, 484 U.S. 365, 108 S.Ct. 626 (1988).

3. If a debtor fails to provide adequate protection for a secured creditor's interest in the debtor's property, then the secured creditor is entitled to relief from the automatic stay. 11 U.S.C. § 362(d)(1).

B. Methods of Providing Adequate Protection.

1. The Bankruptcy Code provides certain non-excessive methods for providing adequate protection to a secured creditor. First, a debtor can make periodic cash payments to the extent that the stay results in a decrease in the value of a secured creditor's interests in the property. 11 U.S.C. §361(1). Alternatively, a debtor can provide an additional or replacement lien to the extent that such stay, use, sale or lease results in a decrease in the value of such entity's interest in such property. 11 U.S.C. §361(2). Lastly, a debtor may grant such

other relief as will result in the realization by such creditor of the indubitable equivalent of such entity's interest in the debtor's property. 11 U.S.C. § 361(3).¹

2. A number of cases have found different types of situations provide indubitable equivalent. One form of adequate protection providing this indubitable equivalent is often referred to as an "equity cushion." An equity cushion exists if the value of the collateral available to the creditor exceeds the creditor's claim by a margin sufficient to protect the creditor during the bankruptcy proceedings. *In re Monnier Brothers*, 755 F.2d 1336 (8th Cir. 1985).

3. What amounts to an adequate equity cushion varies. Courts generally find equity cushions greater than 20% to be adequate, and find equity cushions of less than 11% to be inadequate. *In re Kost*, 102 B.R. 829, 831 (D.Wyo. 1989). Most questions arise in the range from 12% to 20%. An equity cushion provides adequate protection if it is sufficiently large to ensure that the secured creditor will be able to recover its entire debt from the security at the completion of the case. *In re Elmira Litho, Inc.*, 174 B.R. 892, 904 (Bankr. S.D.N.Y. 1994).

C. Interests Which Are Not Entitled To Adequate Protection.

1. The over-secured creditor's interest in the property is protected to the extent of the decline in the value of collateral only. The ratio of collateral to debt is not protected. *In re Delta Resources, Inc.*, 54 F.3d 722 (11th Cir. 1995). If the collateral consists of consumables such as inventory or receivables, then the stay may be conditioned upon a continued accounting to the creditor, and the segregation of cash proceeds along with a replacement lien in new inventory and accounts. *In re T.H.B. Corp.*, 85 B.R. 192. (Bankr. D.Mass. 1988).

2. A creditor is only entitled to adequate protection of *its* interest in the collateral; therefore, the adequate protection of subordinate liens is not a consideration. *In re Mellor*, 734 F.2d 1396 (9th Cir. 1984).

IV. **Application of Adequate Protection Payments**

A. Adequate Protection Payments.

In most cases, the single asset debtor and its primary secured lender will agree on the method of adequate protection to be made in exchange for the debtor's continued use of the creditor's cash collateral and the debtor's continued possession of the real estate. Often the debtor and creditor will agree that the debtor will only use its cash for purposes of maintaining the debtor's real estate business and that any excess cash will be paid over to the creditor in the form of adequate protection payments. See 11 U.S.C. § 361(1). If the debtor and creditor are unable to agree, then the above-described method of adequate protection is generally the type ordered by the court. See *In re Morning Star Ranch Resorts*, 64 B.R. 818 (Bankr. D.Colo. 1986); *In re Gunnison Center Apartments, LP*, 320 B.R. 391 (Bankr. D.Colo. 2005).

¹ In chapter 12 cases, adequate protection has its own definition and the normal rules of § 361 do not apply. 11 U.S.C. § 1205.

B. How are the Adequate Protection Payments Applied.

After the adequate protection payments are made by the debtor to its secured creditor, the issue then becomes: how are these payments to be applied? This issue is particularly acute in the case of an undersecured creditor (i.e. the value of the real estate securing the loan is less than the secured creditor's claim). If the undersecured receives adequate protection payments from its cash collateral during the bankruptcy case, are those payments applied to the secured portion of the claim or the unsecured portion of the claim? Unfortunately, the case law fails to provide a clear answer to this question.

C. "Subtraction" v. "Wash" Cases.

1. There are generally two approaches to analyzing the application of adequate protection payments made by a debtor to its secured creditor. The first approach is often referred to as "subtraction." The second approach is often referred to as "wash." An excellent and detailed discussion of the subtraction and wash approaches in determining the application of adequate protection payments is contained in the ABI presentation: Moore and Silfen, *Subcommittee on Real Estate Law Deconstructing Timbers-Application of Adequate Protection Payments to Undersecured Creditors in Single Asset Bankruptcy Cases*, ABI Winter Leadership Conference, December 2000 ("Moore and Silfen").

2. Under the "subtraction" approach, the adequate protection payments made by a debtor are applied to reduce the secured claim of the creditor. This assumes that the real estate serving as collateral for the secured loan is not depreciated in value during the pendency of the bankruptcy case. If the value of the real estate is depreciating, then the secured creditor is entitled to apply the adequate protection payments to compensate it for such reduction in value. 11 U.S.C. § 361(1); *Timbers of Inwood Forest, supra.*, 101 S.Ct. 626 (1988). Cases applying the subtraction approach are as follows: *In re Club Associates*, 107 B.R. 385 (Bankr. N.D. Ga. 1989), *In re Spacek*, 112 B.R. 162, (Bankr. W.D.Tex. 1990); *Matter of IPC, Atlanta Limited Partnership*, 142 B.R. 547 (Bankr. N.D.Ga. 1992); *Confederation Life Insurance Co. v. Beau Rivage Limited*, 126 R.B. 632 (Bankr. N.D.Ga. 1991); *In re Reddington/Sunarrow, Ltd. Partnership*, 119 B.R. 809 (Bankr. D.N.M. 1990); and *In re Kalian*, 169 B.R. 502 (Bankr. D.R.I. 1994).

3. Under the "wash" analysis, the creditor convinces the court that the adequate protection payments received by the creditor are to be added to the value of its collateral thereby creating a wash between asset value and payments received by the creditor. As described by *Moore and Silfen*, the wash cases can be broken down into three (3) major categories:

- (a) First, there are "wash" cases that add the dollar value of post-petition adequate protection payments to the undersecured creditors' collateral base and then turn around and subtract that same amount right out resulting in a true "wash." *In re Columbia Office Associates Limited Partnership*, 175 B.R. 199 (Bankr. D.Md. 1994); *In re Flagler-at-First Associates, Ltd.*, 114 B.R. 297 (Bankr. S.D.Fla. 1990); *In re Landing Associates, Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex 1990); *In re Johansen, Thackeray, MacKenzie Properties, Ltd.*, 166 B.R. 962 (D. Utah 1994); *In re Bloomingdale Partners*, 155 B.R. 961 (Bankr. N.D. Ill. 1993); and *In re*

Vermont Investment Limited Partnership, 142 B.R. 571 (Bankr. D.Dist. Col. 1992).

(b) Second, there is a subset of the above mentioned true “wash” cases which add each of the payments received by the undersecured creditor during the case to the total collateral package and then subtract the payments received from the aggregate claim. *In re Gramercy Twins Associates*, 187 B.R. 112 (Bankr. S.D.N.Y. 1995); and *In re Union Meetings Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995).

(c) Finally, there are the “wash” cases which consider the rents as a completely separate collateral and treats them neither as added to nor subtracted from the undersecured creditor’s collateral or claim. *In re Paradise Springs Associates*, 165 B.R. 913 (Bankr. D.Ariz 1993); and *In re Woodmere Investors Limited Partnership*, 178 B.R. 346 (Bankr. S.D.N.Y. 1995).

Moore and Silfen, supra. at pgs. 3-4,

D. Application or Payments Determined by Cash Collateral Order.

In negotiating the terms of an agreed upon cash collateral order, it would seem that the debtor and the secured creditor would agree upon the application of adequate protection payments to be made under such an order. However, in most of the reported decisions, the cash collateral order appears to be silent as to the application of adequate protection payments. It can only be assumed that this silence is intentional. It seems that both the debtor and the creditor want to reserve for a later date their arguments regarding how the adequate protection payments should be applied.