

# Client Alert

April 2014

## Tenth Circuit Affirms Order Allowing Debtor to Use Oversecured Creditor's Cash Collateral to Pay Professionals

The Tenth Circuit Court of Appeals recently considered the question of how much protection is required for a secured creditor to be adequately protected. *Banker's Bank of Kansas, N.A. v. Bluejay Properties, LLC (In re Bluejay Properties, LLC)*, Bankr. No. 12-22680 (10<sup>th</sup> Cir. Mar. 12, 2014)(unpublished). In affirming the decision by the Bankruptcy Court for the District of Kansas, the Tenth Circuit held if a creditor is adequately protected as a result of the value of its collateral exceeding the amount of its claim by a reasonable margin, then the creditor is not entitled to separate adequate protection for each category of its collateral including cash collateral.

### Case Background

Bluejay Properties ("Bluejay" or the "Debtor") filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code on September 28, 2012 (the "Petition Date"). Bluejay owned a 192-unit apartment complex called Quinton Point (the "Property") located in Junction City, Kansas.<sup>1</sup> In 2009, the Debtor built the Property using a \$15 million construction loan from University National Bank ("UNB"). The Debtor's obligation to UNB was later assigned to Banker's Bank of Kansas, N.A. (the "Bank"). The promissory note was secured by a first lien mortgage and an assignment of the Property's rents.

Within days after the Petition Date, the Debtor filed a motion in the bankruptcy court seeking authority to use the Property's rents in accordance with a proposed budget.<sup>2</sup> Since the rents were encumbered by a lien in favor of the Bank, the rents were considered "cash collateral" within the meaning of section 363(a) of the Bankruptcy Code.<sup>3</sup> The Bank objected to the use of its collateral to pay Debtor's legal expenses and management fees.<sup>4</sup> The Bank, however, did not object to the Debtor using its cash collateral to pay the Property's operating expenses in accordance with a court-approved budget. After an evidentiary hearing on the Debtor's motion to use cash collateral, the bankruptcy court issued an order permitting the Debtor to use Property rents in accordance with the proposed budget and granting a replacement lien in favor of the Bank in future rents (the "Cash Collateral Order"). The bankruptcy court reasoned that the

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<sup>1</sup> Bluejay was a single asset real estate entity as that term is defined in 11 U.S.C. § 101(51)(B) and 11 U.S.C. § 362(d)(3).

<sup>2</sup> The Debtor's proposed budget for the first four months of the bankruptcy allocated less than \$10,000 a month—less than 10 percent of its total proposed operating expenses—to the payment of its professional fees and management fees.

<sup>3</sup> "Cash collateral" is defined in section 363(a) of the Bankruptcy Code to mean "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 522(b) of this title, whether existing before or after the commencement of a case under this title." 11 U.S.C. §362(a).

<sup>4</sup> The Property was being managed by the majority owners of the Debtor.

Bank's interest in its cash collateral was adequately protected due to the significant equity cushion in its total collateral package.<sup>5</sup> Additionally, the bankruptcy court required, as further adequate protection, the Debtor to make single asset real estate payments to the Bank on a monthly basis at the contract rate of interest under the loan — 6.5 percent. The Bank timely filed a notice of appeal of the Cash Collateral Order and the parties consented to appellate review by the Tenth Circuit.

### **The Tenth Circuit Decision**

In appealing the entry of the Cash Collateral Order, the Bank asserted that the bankruptcy court made two primary errors: (1) the Cash Collateral Order did not account for the independent security interest the Bank had in the Property's rents in addition to the security interest it had in the Property itself and (2) the Cash Collateral Order allowed the Debtor to use rents from the Property to pay expenses that do not directly benefit the Property. The Tenth Circuit found both of these arguments unavailing.

A debtor is required to provide adequate protection to a creditor for the debtor to use certain estate property, including cash collateral, during the bankruptcy case.<sup>6</sup> Adequate protection can consist of cash payments to a creditor, additional or replacement liens granted in favor of a creditor or providing a creditor with the indubitable equivalent of its interest in the secured assets.<sup>7</sup>

The bankruptcy court determined that the value of the Property alone was almost \$3 million greater than the amount of the Bank's secured claim and that the value of the Property was stable or increasing in value. As a result of this finding that the Bank's claim, including interest and costs, was oversecured solely by the Property, the bankruptcy court allowed the Debtor to use the Bank's cash collateral in accordance with the proposed budget. The bankruptcy court held, and the Tenth Circuit affirmed, that the Bank was not entitled to additional adequate protection for its separate lien on the Property's rents because the Bank's entire claim was adequately protected by the Property.<sup>8</sup>

Furthermore, in analyzing the Cash Collateral Order the Tenth Circuit concluded that "whether a creditor's interest in rents is separate from an interest in real property only matters when the creditor is undersecured and/or the property is declining in value ... [a]nd if its debt is adequately protected by less than all of the creditor's security interests, the creditor is not entitled to insist that each type of collateral be maintained 'as is' in order to provide adequate protection."<sup>9</sup> Consequently, the Tenth Circuit rejected the Bank's argument that the bankruptcy court erred in failing to provide additional adequate protection to the Bank for its separate security interest in the Property's rents when authorizing the use of cash collateral and affirmed the bankruptcy court's ruling that because the value of the Property was greater than the Bank's claim, the Bank was not entitled to additional adequate protection in connection with the rental income.

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<sup>5</sup> At an evidentiary hearing on the value of the Property and the amount of the Bank's claim, the bankruptcy court determined that the Property was worth \$16,945,000 and generated approximately \$167,000 a month in rental income; the bankruptcy court also determined that the Bank's claim was a little less than \$14 million.

<sup>6</sup> Section 363(c)(2) of the Bankruptcy Code makes the use, sale or lease of cash collateral contingent upon consent of creditors with a secured interest in the collateral or court approval. See 11 U.S.C. § 363(e)(2). Furthermore, pursuant to section 363(e) of the Bankruptcy Code, the court is required to restrict such use, sale, or lease of property "as is necessary to provide adequate protection" of a creditor's interest. See 11 U.S.C. § 363(e).

<sup>7</sup> See 11 U.S.C. § 361.

<sup>8</sup> The Tenth Circuit also noted that in addition to the Bank being adequately protected by the value of the Property, the bankruptcy court provided the Bank further adequate protection by granting the Bank a replacement lien in future Property rents and ordered the Debtor to make contract rate interest payments to the Bank post-petition.

<sup>9</sup> *Banker's Bank of Kansas, N.A. v. Bluejay Properties, LLC (In re Bluejay Properties, LLC)*, Bankr. No. 12-22680 (10<sup>th</sup> Cir. Mar. 12, 2014)(unpublished).

The Bank also argued that the Cash Collateral Order improperly allowed the Debtor to use rents from the Property to pay administrative expenses, such as professional and management fees, which do not directly benefit the Property or the Bank. In disposing of this argument, the Tenth Circuit relied on its holding that the Bank's claim was oversecured and precedent allowing the use of encumbered assets to pay administrative expenses where the secured creditor is oversecured or fully secured.<sup>10</sup>

## Conclusion

Whether a secured creditor's claim is adequately protected is an issue that is frequently addressed in bankruptcy cases. Often secured creditors have liens in most or all of the debtors' assets, including real property, personal property, rents and accounts receivable. The Tenth Circuit in *Bluejay Properties* confirmed that adequate protection is not required for each independent source of a creditor's collateral, rather if a creditor's secured claim is adequately protected, the secured creditor is not entitled to adequate protection for each separate piece of collateral. Therefore, if a secured creditor is fortunate enough to find itself oversecured by certain of its collateral, that secured creditor will not be able to seek additional adequate protection for each category of its collateral.

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<sup>10</sup> "A secured creditor is not to be deprived of the benefit of its bargain and will be protected in bankruptcy to the extent of the value of its collateral. Only surplus proceeds are available for distribution to creditors of the estate and administrative claimants. Therefore, *absent equity in the collateral*, administrative claimants cannot look to encumbered property to provide a source of payment for their claims." *In re Am. Res. Mgmt. Corp.*, 51 B.R. 713, 719 (Bankr. D. Utah 1985) (emphasis added) (citations omitted).