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Article 9: UCC Security Interests in Proceeds of Collateral

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"PROCEED" WITH CAUTION: NAVIGATING 11 U.S.C. § 552'S EFFECT ON PREPETITION SECURITY INTERESTS IN PROCEEDS OF VARIOUS ASSETS

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"PROCEED" WITH CAUTION: NAVIGATING 11 U.S.C. § 552'S EFFECT ON PREPETITION SECURITY INTERESTS IN PROCEEDS OF VARIOUS ASSETS.

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INTRODUCTION

Uniform Commercial Code Section 9-102(a)(64) defines "Proceeds" as:

> (A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
>
> (B) whatever is collected on, or distributed on account of, collateral;
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> (C) rights arising out of collateral;
>
> (D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or
>
> (E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

U.C.C. § 9-102(a)(64). In essence, whatever replaces the economic value of a secured party's collateral constitutes proceeds.

Section 552 of title 11 interrupts a secured creditor's interest in post-petition property of the estate unless certain exceptions apply. Section 552 reads as follows:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
>
> (b) (1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if 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 proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
>
> (2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if 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, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(a) and (b)(1), (2).

I. The purpose of 11 U.S.C. § 552 and how it balances the Code's interests with the secured creditor's interest

As articulated by the Ninth Circuit, "the purpose of § 552 is to permit a debtor 'to gather into the estate as much money as possible to satisfy the claims of all creditors'; but § 552(b) 'balances the Code's interest in freeing the debtor of prepetition obligations with a secured creditor's rights to maintain a bargained-for interest in certain items of collateral.'" *Financial Sec. Assurance v. Days Cal. Riverside Ltd. P'ship. (In re Days Cal. Riverside Ltd. P'ship)*, 27 F.3d 374, 375 (9th Cir. 1994).

Generally, modern security agreements extend the secured creditor's security interest to cover proceeds, products, offspring, or profits generated by the collateral. Further, in reading U.C.C. § 9-203(f)[1]

[1] U.C.C. § 9-203(f) provides "[t]he attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9-315 and is also attachment of a security interest in a supporting obligation for the collateral."

together with U.C.C. § 9-315(a),[2] a creditor's security interest in proceeds automatically attaches.

II. Section 552's elements

Consistent with other sections of the Bankruptcy Code, the secured creditor has the burden of proving that its lien survives 11 U.S.C. § 552. *See, e.g. Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (In re Residential Capital, LLC)*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

As such, secured creditors must establish two requirements under 11 U.S.C. § 552(b): (1) the parties entered into a prepetition security agreement extending to after-acquired property, and (2) the after-acquired property must fit within the enumerated categories of proceeds, products, offspring, profits, or rents under § 552(b). *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance (In re T-H New Orleans Ltd. P'ship)*, 10 F.3d 1099, 1104 (5th Cir. 1993).

III. Section 552 dismissal and Section 349(b)

There is a split in authority on the issue of whether a creditor's lien in after-acquired property cut off under § 552(a) reattaches upon dismissal. This split relates to how the courts interpret 11 U.S.C. § 349. *Compare Kucera v. Bank of Brainard (In re Kucera)*, 123 B.R. 852, 855 (Bankr. D. Neb. 1990) (concluding under § 349 that § 552 does not operate after dismissal; if it did debtors would receive "property free and clear of liens"), with *Citizens First Nat'l Bank v. Rumbold & Kuhn, Inc. (In re Newton)*, 64 B.R. 790, 793 (Bankr. C.D. Ill. 1990) (Section 349(b) operates to reattach liens voided under § 506(d), but does not reinstate a security interest cut off by § 552); *see also Gulf Ins. Co. v. Glasbrenner*, 343 B.R. 47, 55-56 (S.D.N.Y. 2006) (same).

In *Newton*, the Debtor, a farmer, sold his 1984 crops to defendant. Plaintiff, a bank, held a first-priority prepetition lien against Debtor's crops "to be planted, grown, matured, harvested, and stored during the 1984 crop year." *In re Newton*, 64 B.R. at 791. Prior to Debtor filing bankruptcy, plaintiff served upon defendant notice of its security interest on Debtor's 1984 crop. *Id.* Following advice from counsel, Debtor delayed planting the 1984 crop until after he filed Chapter 11. *Id.* The parties

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[2] U.C.C. § 9-315(a) provides "[e]xcept as otherwise provided in this article and Section 2-403(2):

(1) a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien; and

(2) a security interest attaches to any identifiable proceeds of collateral.

initially agreed that while Debtor's case was pending, § 552 cut off the bank's security interest. *Id.* at 792. Debtor harvested the crop in fall of 1984, obtained a certificate from the bankruptcy court stating he had filed a Chapter 11 bankruptcy, and sold the crops to the defendant after presenting it with the certificate. *Id.* Instead of paying down his loan, "Debtor used the proceeds of the check to operate his farm." *Id.* However, the court dismissed Debtor's case for failure to prosecute. *Id.* A few months later, Debtor filed Chapter 7, and the bank brought an adversary proceeding against defendant to recover the amount the defendant paid Debtor for the 1984 crop. *Id.*

Defendant argued § 552 barred attachment of the bank's security interest in the 1984 crops. The bank countered that when the court dismissed Debtor's Chapter 11, § 349 reinstated the bank's lien. *Id.*

The court interpreted § 349(b) and concluded the omission of § 552 from § 349(b) was telling, finding § 349(b) did not restore the bank's lien. *Id.* at 793. However, after analyzing § 349(b)'s legislative history, the court reasoned § 349(b) does not unwind sales of property from the estate to a good faith purchaser. Finding the bank's lien was not in place at the time of purchase, the court held the sale of crops was in the ordinary course of business to a good faith purchaser as defined under Illinois law. *Id.* at 793-95.

In *Kucera*, the bankruptcy court addressed the extent of a creditor's lien in $3,917.02 of proceeds from the sale of corn. 123 B.R. at 853. In that case, Debtor filed a Chapter 11 plan. He moved to dismiss, only to file a second Chapter 11 petition twenty-five days later. *Id.* The defendant, a bank, held possession of the $3,917.02 in proceeds, and asserted a first-priority security interest in the Debtor's stored grain and all proceeds derived therefrom. *Id.*

The Debtor argued the bank's security interest did not attach to the proceeds because "the corn was planted, harvested and sold during the pendency of the predecessor bankruptcy case." *Id.* The court concluded § 552(b) did not apply since the planted corn constituted after-acquired property. *Id.* at 853-84. This finding did not resolve the issue before the court since Debtor dismissed his prior case. The court then turned to the effect of dismissal. *Id.* at 854. The bank argued § 349(b) re-vested all property of the estate back to the Debtor, and its lien subsequently reattached to the proceeds. Contrary to *Newton*, the *Kucera* court reasoned § 349(b) effectively restores parties to the position they would have been in had the bankruptcy not occurred. *See id.* at 854.

IV. Difference between "after-acquired property" and "proceeds"

There exists a distinction between "after-acquired property" obtained by the bankruptcy estate post-petition and proceeds of the kind excepted from § 552(a)'s reach. This distinction remains in a nebulous state.

To navigate between the concepts of "after-acquired property" and "proceeds" courts have traveled down a variety of paths. Some courts have looked to the United States Supreme Court's holding in *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934), where the Court barred "the creation of an enforceable lien upon a subject not existent when the bankruptcy became effective or even arising from, or connected with, preexisting property, but brought into being solely as the fruit of the subsequent labor of the bankrupt." *Id.* at 243; *see Smoker v. Hill & Assocs.,* 204 B.R. 966 (N.D. Ind. 1997) (affirming bankruptcy court's finding debtor's post-petition insurance commissions subject to creditor's lien pursuant to 11 U.S.C. § 552(b)(1)). Moreover, "[t]he passage of § 552 broadened the scope of the *Local Loan* holding to extinguish all liens on after-acquired property, subject to certain exceptions." *In re Cafeteria Operators, L.P.*, 299 B.R. 400, 405 (Bankr. N.D. Tex. 2003).

As illustrated in *In re Inman*, 95 B.R. 479 (Bankr. W.D. Ky. 1988), the court concluded that while a lender held a pre-petition security interest in a debtor's inventory, the money generated by the operation of the restaurant converting the inventory into sale of food was a service. *Id.* at 480-81. Accordingly, the court held restaurants sell services, and profits generated by converting the inventory into food fit for human consumption constituted after-acquired property, rather than proceeds of the restaurant's inventory. *Id.* at 481.

Utilizing the "equities of the case" approach under § 552, the court in *In re Cafeteria Operators, L.P.*, both agreed and disagreed with the *Inman* court. 299 B.R. at 409. In that case, the CEO and Chief Restructuring Officer of the Debtors (Debtors operated several family-style restaurants) testified convincingly that the Debtors' cash derived primarily from the services provided by its employees. *Id.* at 408. The CEO testified that the food component of a meal made up less than one-third of the price the Debtors charged per plate. *Id.*

As a result, the court concluded that the lender had a security interest in the Debtors' food and beverage inventory to the extent the "portion of the revenues acquired as a result of the disposition of the food and beverage inventory" was attributable to the food and beverage component of a meal. *See id.* at 409.

In *In re James Cable Partners, L.P. v Citibank, N.A.*, 141 B.R. 772 (Bankr. M.D. Ga. 1992), the bankruptcy court used Congress' expanded definition of "proceeds" under § 552. In that case, Plaintiff/Debtor, James Cable, a cable television business, provides communities with cable television service by purchasing franchise rights from those communities' governments. *Id.* at 773. In essence, the Debtor acts as "'a conduit for the signal.'" *Id.* To receive these signals, subscribers pay a monthly fee. *Id.* On the petition date, Debtor had approximately 77,567 subscribers. *Id.* Following the petition date, Debtor had acquired 16,500 new subscribers. *Id.*

Debtor agreed that Citibank held a validly perfected pre-petition security interest in "all of [Debtor's] assets," but argued its post-petition revenues were not subject to the Bank's lien. *Id.* at 774. Debtor generated its revenue from a combination of cable installation, monthly cable service, and advertising. *Id.* at 775. In particular, Debtor argued under § 552(b) Citibank's security interest extended to subscriber proceeds, but accounts receivable generated post-petition fell outside of the Bank's lien. *Id.*

The *James Cable* court concluded Citibank had a continuing security interest in the Debtor's revenues generated by pre-petition subscribers, but found the Bank's security interest did not extend to post-petition subscribers Debtor acquired through post-petition advertising efforts. *Id.* at 776-77. Payments received from the latter subscribers constituted "after-acquired" property of the Debtor not subject to Citibank's security interest by operation of § 552(a). *Id.* at 777.

V. Section 552, Hotel Room Revenue and Perfection

A majority of courts hold that hotel room revenues are not interests in real property. Instead, those courts find hotel room revenues constitute personal property, and that any lien attaching thereto must be perfected by filing an Article 9 U.C.C. The minority of courts conclude hotel room revenues are in fact interests in real property and may be perfected by that state's real property recording statutes. *See In re Old Colony, LLC*, 476 B.R. 1, 20 (Bankr. D. Mass. 2012)

In *In re Old Colony, LLC*, the court found hotel room revenues constituted "rent" under Wyoming law. The Debtor, Old Colony, LLC, owned and operated an 83-room hotel located in Teton Village, Wyoming. To finance the hotel's construction, Debtor borrowed $19.5 million from a combination of lenders. *Id.* at 3. Debtor borrowed $16.5 million from Jackson Bank. Wells Fargo later purchased Jackson Bank following the 2008 financial meltdown. *Id.* Debtor financed the remaining $3.5 million

with a loan through Johnson Resort Properties, Inc. The $3.5 million note contemplated a one-year term. *Id.* During this time, Debtor was unable to find an institutional lender willing to advance funds needed to pay off the one-year note, and was "'forced' to obtain financing through a private lender . . . which came with an interest rate of 15%." *Id.* at 3-4.

To secure the $16.5 million loan, Debtor granted Wells Fargo a mortgage on the property. *Id.* at 8. The mortgage also contemplated that Wells Fargo would have a lien on "all of the Debtor's 'right, title, and interest in and to all present and future leases of the Property and all Rents from the Property.'" *Id.* Wells Fargo recorded the mortgage, but did not file a U.C.C. with the state of Wyoming. *Id.*

Unable to service its debt, Debtor sought Chapter 11 relief. And a dispute ensued between Wells Fargo and the Debtor over whether the Bank's security interest in the hotel's room revenues was an interest in real property perfected by the mortgage, or whether the room revenues constituted personal property, which can only be perfected by the filing of a U.C.C. *Id.*

The *Old Colony* court addressed the split in authority regarding whether a hotel's room revenues constitute "rent" that flows from the real property and may be perfected via a mortgage, or whether the room revenues are personal property interests that require a U.C.C. filing. *Id.* at 19-20.

The majority of courts conclude hotel room revenues are not interests in real property.[3] As such, a lender needs to file a U.C.C. in those states to perfect its interest in the room revenues. These courts reject the theory that "payment for use of a hotel room is an interest in real property because they are persuaded that hotel guests are 'mere licensees and not tenants.'" *Id.* at 20. Consequently, the hotel guests have only a personal contract with hotel management, and no interest in the realty. *Id.*

On the other hand, the minority of courts find that hotel room revenues are, in fact, rents flowing from the realty, and may be perfected by recording the appropriate land documents. *Id.* at 21. These courts define "rent" broadly; as one court reasoned, a hotel charges guests based on that person's "use of the underlying real estate and hence are an interest in real estate." *Travelers Ins. Co. v. First Nat'l Bank*, 250 Ill. App. 3d 641, 647, 621 N.E.2d 209, 214 (1993) (citing *In re Schaumburg Hotel Owner Ltd. P'ship*, No. 87 B 14301, 1989 Bankr. LEXIS 2750 (Bankr. N.D. Ill. January 12, 1989)).

[3]Depending upon the underlying real estate law in each state.

The *Old Colony* court concluded hotel room revenues are "rent" and held Wells Fargo had a validly perfected pre-petition security interest that captured room rent derived from the real estate post-petition. As a result, § 552(b)(2) did not disrupt its security interest. *In re Old Colony, LLC,* 476 B.R. at 26-28.

VI. Section 552 and FCC licenses

While lenders are unable to take a security interest in a Federal Communications Commission ("FCC") license itself for public policy reasons, it may take a security interest in the economic value that a debtor generates from such license. As articulated in *In re Ridgely Communications, Inc.*, 139 B.R. 374 (Bankr. D. Md. 1992) (citing *In re Merkley*, 94 F.C.C.2d 829, 830-31 (1983)):

> [A] broadcast license, as distinguished from the station's plant or physical assets, is not an owned asset or vested property interest so as to be subject to a mortgage, lien, pledge, attachment, seizure, or similar property right. . . . [S]uch hypothecation endangers the independence of the licensee who is and who should be at all times responsible for and accountable to the Commission in the exercise of the broadcasting trust.

Id. at 376.

In essence, there exists a debtor's "private" right to receive proceeds or the economic value derived by the FCC license, as opposed to the FCC's "public" right to assign FCC licenses and regulate public airwaves. *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n (In re TerreStar Networks, Inc,),* 457 B.R. 254, 262-63 (Bankr. S.D.N.Y. 2011). Consequently, a debtor may grant a security interest in the "private" right, but not in the license itself since a lender's ability to foreclose on the license infringes upon the FCC's authority to regulate and transfer licenses. *Id.* at 263.

In *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n*, Debtor TerreStar is a mobile satellite service provider. *Id.* at 257 As such, it requires an FCC license to operate. *Id.* In 2004, the FCC transferred to TerreStar a license to use 20 MHz of a 2 GHz S-Band spectrum. Four years later, TerreStar issued $500 million in 15% Notes. *Id.* U.S. Bank served as the Noteholders' indentured trustee and collateral agent. *Id.* As collateral, TerreStar granted the 15% Noteholders a security interest in "all proceeds of the FCC Licenses, and the right to receive all monies, consideration and proceeds derived from or in connection with the sale, assignment, transfer, or other disposition of the FCC Licenses. . . ." *Id.* at

258. Importantly, the parties explicitly carved out the FCC license itself from the Noteholders' security interest.

Sprint Nextel enters the fold following certain pre-petition FCC declaratory rulings concluding that TerreStar had reimbursement requirements to Sprint. In lieu of compensating Sprint, TerreStar filed Chapter 11, and Sprint filed a proof of claim in the amount of $104 million. Sprint then brought an adversary complaint against U.S. Bank and filed a motion with the court to declare the 15% Noteholders' security interest in TerreStar's FCC license as either invalid or subordinated to Sprint's claim. *Id.* at 257.

Sprint argued the Noteholders' lien lacked attachment under § 552 because no sale or transfer of the underlying assets occurred before the bankruptcy, and thus honoring the lien would violate § 552's prohibition against liens on after-acquired property. *Id.* at 266.

The court held the 15% Noteholders' liens were valid, and consistent with the FCC's policy in permitting a lien on a license's economic value, but not in the license itself. *Id.* at 265.

Sprint Nextel Corp. v. U.S. Bank Nat'l stands as an excellent case for explaining how a lender should "proceed" in securing an interest in a debtor's FCC license. Indeed, following this ruling, the Tenth Circuit Court of Appeals overturned a decision from the U.S. Bankruptcy Court for the District of Colorado, which held a bank's lien on an FM radio station's "general intangibles (and their proceeds)" was invalid. *In re Tracy Broad. Corp.*, 696 F.3d 1051 (10th Cir. 2012).

In *Tracy Broad. Corp.*, Valley Bank & Trust Co. held a security interest in an FM radio station's assets including its "general intangibles and [ ] proceeds." 696 F.3d at 1052. Following an adverse ruling in federal court in favor of Spectrum Scan, the radio station filed Chapter 11. *Id.* In its schedules, the radio station listed its broadcasting license, and reported Valley Bank held a security interest in the license's proceeds. *Id.* Spectrum Scan brought an adversary complaint against Valley Bank to determine the extent of the bank's security interest. *Id.*

The bankruptcy court found Valley Bank's security interest did not attach to the radio station's proceeds generated by its broadcasting license. *Id.* The bankruptcy court relied on the Federal Communications Act, which bars the transfer or assignment of an FCC license without the FCC's permission. *Id.* at 1052-53. Under this bar, the bankruptcy court found Valley Bank's lien did not extend to the radio station's proceeds

derived from its FCC license. *Id.* at 1053. The United States District Court for Colorado affirmed, and the Tenth Circuit reversed. *Id*. at 1052.

The Tenth Circuit began its discussion by parsing out the inherent private and public interests that flow from an FCC license. *Id*. at 1054. In reviewing the decisions in *MLQ Investors, L.P. v. Pac. Quadracasting, Inc.*, 146 F.3d 746, 749 (9th Cir. 1998), *In re Ridgely Communications, Inc.*, 139 B.R. 374 (Bankr. D. Md. 1992), and Nebraska state law, the *Tracy* court concluded the radio station had sufficient rights in the license to grant Valley Bank a security interest in the proceeds. *See id.* at 1063-66.

VII. Section 552 and Non-Assignable Intangibles

In a similar vein as the anti-assignment issue with FCC licenses, non-assignable contracts, leases, franchises, and software licenses also distinguish between the intangible's non-economic rights, and the proceeds generated therefrom.

In *SJR Enters., Inc.*, a Chapter 11 Debtor, a Nissan dealer, sold all of its dealership assets to another car dealer. *NBD Park Ridge Bank v. SRJ Enters., Inc.*, 150 B.R. 933, 934 (Bankr. N.D. Ill. 1993). As part of the sale proceeds, the Debtor received $125,000 from the buyer to voluntarily terminate its franchise agreement. The *SJR Enters.* court addressed whether the voluntary termination "fee" of $125,000 constituted "proceeds" derived from the franchise agreement Debtor entered into with NBD Park Ridge Bank. *Id*. at 935.

NBD held a security interest in Debtor's "'accounts receivable . . . contract rights and any other personal property of Debtor now owned or hereafter acquired, and in all of the proceeds thereof.'" *Id*. Debtor also granted a security interest to another bank, Success National Bank of Lincolnshire ("Success") in "'(a) all Accounts, Accounts Receivable and Contract Rights of Debtor, whether now or hereafter existing or acquired; ...; (d) all general intangibles; and (e) all proceeds and products of the foregoing.'" *Id*. "Section 17.1 of the Debtor's franchise agreement . . . provides that the Debtor 'shall not transfer or assign any right . . . under this Agreement without the prior written approval of [Nissan].'" *Id*. at 938.

The Debtor, NBD, and Success each posited different theories as to whether the $125,000 termination fee constituted "after-acquired property" or "proceeds." In finding the termination fee existed pre-petition as an intangible property interest, the court recognized automobile dealership lenders are generally barred from taking a security interest directly in the franchise agreement itself. *Id* at 939. Recognizing the "no-

lien" policy in FCC licenses, the court analyzed *In re Tak Communications, Inc.*, 138 B.R. 568 (Bankr. W.D. Wis. 1992) (holding proceeds generated by FCC license were unencumbered), and *In re Ridgely Communications, Inc.*, 139 B.R. 374 (Bankr. D. Md. 1992) (holding lender had a valid security interest in FCC license proceeds), and followed the approach in *Ridgely* concluding the termination fee was a proceed generated by the franchise agreement. *Id.* at 940-41. Thus, the termination fee was encumbered by Success and NBD's security interest. *Id.* at 941. However, the court did not parse out which secured creditor had priority over the termination fee. *Id.*

In re SRJ Enters. Inc. illustrates how some bankruptcy courts are willing to recognize the distinction between a non-assignable intangible and the proceeds generated therefrom. *See also Freightliner Market Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 369 (9th Cir. 1987) (reasoning whether or not a license is transferable is immaterial when a creditor has a lien on the general intangible proceeds; "[i]f the rights produce proceeds, those rights are in fact 'property'").