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CONCURRENT SESSION

Navigating § 552: Pre-Petition Security Interests in Proceeds

Christopher A. Ward, Moderator
Polsinelli PC; Wilmington, Del.

Hon. Laurel M. Isicoff
U.S. Bankruptcy Court (S.D. Fla.); Miami

Robert J. Miller
Bryan Cave LLP; Phoenix

Paul H. Zumbro
Cravath, Swaine & Moore LLP; New York

2018

NAVIGATING § 552: PRE-PETITION SECURITY INTERESTS IN PROCEEDS

How and when is a secured creditor's rights affected by § 552? This session will examine typical scenarios so you can learn all you need to know about this difficult area of the law.

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NB: This unofficial compilation of the U.S. Code is current as of Jan. 4, 2012 (see http://www.law.cornell.edu/uscode/uscprint.html).

TITLE 11 - BANKRUPTCY
CHAPTER 5 - CREDITORS, THE DEBTOR, AND THE ESTATE
SUBCHAPTER III - THE ESTATE

§ 552. Postpetition effect of security interest

(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.

(Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2602; Pub. L. 98–353, title III, § 466, July 10, 1984, 98 Stat. 380; Pub. L. 103–394, title II, § 214(a), Oct. 22, 1994, 108 Stat. 4126; Pub. L. 109–8, title XII, § 1204(2), Apr. 20, 2005, 119 Stat. 194.)

Historical and Revision Notes

legislative statements

Section 552 (a) is derived from the House bill and the alternative provision in the Senate amendment is rejected. Section 552 (b) represents a compromise between the House bill and the Senate amendment. Proceeds coverage, but not after acquired property clauses, are valid under title 11. The provision allows the court to consider the equities in each case. In the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party. Although this section grants a secured party a security interest in proceeds, product, offspring, rents, or profits, the section is explicitly subject to other sections of title 11. For example, the trustee or debtor in possession may use, sell, or lease proceeds, product, offspring, rents or profits under section 363.

senate report no. 95–989

Under the Uniform Commercial Code, article 9, creditors may take security interests in after-acquired property. Section 552 governs the effect of such a prepetition security interest in postpetition property. It applies to all security interests as defined in section 101(37) of the bankruptcy code, not only to U.C.C. security interests.

As a general rule, if a security agreement is entered into before the commencement of the case, then property that the estate acquires is not subject to the security interest created by a provision in the security agreement extending the security interest to after-acquired property. Subsection (b) provides an important exception consistent with the Uniform Commercial Code. If the security agreement extends to proceeds, product, offspring, rents, or profits of the property in question, then the proceeds would continue to be subject to the security interest pursuant to the terms of the

security agreement and provisions of applicable law, except to the extent that where the estate acquires the proceeds at the expense of other creditors holding unsecured claims, the expenditure resulted in an improvement in the position of the secured party.

The exception covers the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors, but is limited to the benefit inuring to the secured party thereby. Situations in which the estate incurs expense in simply protecting collateral are governed by 11 U.S.C. 506 (c). In ordinary circumstances, the risk of loss in continued operations will remain with the estate.

house report no. 95–595

Under the Uniform Commercial Code, Article 9, creditors may take security interests in after-acquired property. This section governs the effect of such a prepetition security interest in postpetition property. It applies to all security interests as defined in section 101 of the bankruptcy code, not only to U.C.C. security interests.

As a general rule, if a security agreement is entered into before the case, then property that the estate acquires is not subject to the security interest created by the security agreement. Subsection (b) provides the only exception. If the security agreement extends to proceeds, product, offspring, rents, or profits of property that the debtor had before the commencement of the case, then the proceeds, etc., continue to be subject to the security interest, except to the extent that the estate acquired the proceeds to the prejudice of other creditors holding unsecured claims. "Extends to" as used here would include an automatically arising security interest in proceeds, as permitted under the 1972 version of the Uniform Commercial Code, as well as an interest in proceeds specifically designated, as required under the 1962 Code or similar statutes covering property not covered by the Code. "Prejudice" is not intended to be a broad term here, but is designed to cover the situation where the estate expends funds that result in an increase in the value of collateral. The exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors. The term "proceeds" is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted.

Amendments

2005—Subsec. (b)(1). Pub. L. 109–8 substituted "products" for "product" in two places.

1994—Subsec. (b). Pub. L. 103–394 designated existing provisions as par. (1), struck out "rents," after "offspring," in two places, and added par. (2).

1984—Subsec. (b). Pub. L. 98–353 inserted "522," after "506(c),", substituted "an entity entered" for "a secured party enter", and substituted "except to any extent" for "except to the extent".

Effective Date of 2005 Amendment

Amendment by Pub. L. 109–8 effective 180 days after Apr. 20, 2005, and not applicable with respect to cases commenced under this title before such effective date, except as otherwise provided, see section 1501 of Pub. L. 109–8, set out as a note under section 101 of this title.

Effective Date of 1994 Amendment

Amendment by Pub. L. 103–394 effective Oct. 22, 1994, and not applicable with respect to cases commenced under this title before Oct. 22, 1994, see section 702 of Pub. L. 103–394, set out as a note under section 101 of this title.

Effective Date of 1984 Amendment

Amendment by Pub. L. 98–353 effective with respect to cases filed 90 days after July 10, 1984, see section 552(a) of Pub. L. 98–353, set out as a note under section 101 of this title.

NAVIGATING SECTION 552 OF THE BANKRUPTCY CODE: PREPETITION SECURITY INTERESTS AND CUT-OFF ISSUES

I. Section 552 of the Bankruptcy Code in General.[1]

Section 552 is statutory balancing act between the pre- and post-petition rights of a secured creditor in property of a debtor's estate. Primarily because debtors and senior lenders often stipulate to section 552 waivers in the context of cash collateral or debtor-in-possession financing orders, the courts have infrequently addressed the application of section 552.

Section 552(a) provides the general rule that a secured creditor's rights under an after-acquired property clause in a security agreement is terminated with respect to property acquired by the debtor or estate after the petition date.[2] The purpose of section 552 is "to allow a debtor to gather into the estate as much money as possible to satisfy the claims of all creditors," and to "balance[] 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. It provides a narrow exception to the general rule of 552(a)." *In re Bering Trader, Inc.*, 944 F.2d 500, 502 (9th Cir. 1991).

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[1] 11 U.S.C. § 552—Postpetition Effect of Security Interest.

(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.

[2] The statute requires a security agreement. *See* 11 U.S.C. § 552(b). The security agreement also must have an after-acquired property clause.

Section 552(b)'s narrow exception applies to two kinds of collateral. Subsection 552(b)(1) contains an exception with respect to the post-petition "proceeds, products, offspring, or profits" of the secured creditor's prepetition collateral. Subsection 552(b)(2) specifically addresses the dispute that used to exist with respect to hospitality properties, until the Bankruptcy Code was amended in 1994. Under subsection 552(b)(2), a secured creditor retains its liens over post-petition "rents . . . 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 . . ." so long as such property is covered by a proper security agreement.

Subsections 552(b)(1) and (2) both contain an "equities of the case" exception. While it has been rarely tested by the courts, the principal purpose of the "equities of the case" exception is to prevent secured creditors from "reaping unjust benefits from an increase in the value of collateral during a bankruptcy case resulting from the (usually) reorganizing chapter 11 debtor's use of other assets of the estate or from the investment of non-estate assets," *In re Endresen*, 548 B.R. 258, 274 (B.A.P. 9th Cir. 2016) (summary of case law). *See, e.g.*, *In re Tower Air, Inc.*, 397 F.3d 191, 205 (3d Cir. 2005).

II. Alignment of the Parties' Interests.

Debtors:

Chapter 11 debtors stand to receive an obvious benefit from section 552(a). If a secured creditor's lien is cut-off under section 552(a) and is not subject to an exception under section 552(b), then the debtor may, in the ordinary course of business, use, sell, or lease after-acquired post-petition property covered by a prepetition security agreement without obtaining either consent from creditors or a court order under section 363. 3-53 COLLIER BANKRUPTCY PRACTICE GUIDE P 53.03 (2017); *see also Practice Note*, *Treatment of Prepetition Liens in Postpetition Property*, Practical Law: Bankruptcy (2018). Section 552(a) assists a debtor seeking a "fresh start," as additional unencumbered property provides a debtor with increased flexibility in the reorganization process. Nevertheless, as noted above, debtors often waive the protections provided under section 552. They also usually grant replacement liens on pre- and post-petition property to secured lenders as part of DIP financing or a cash collateral order.

Secured Creditors:

The section 552(b) exceptions give secured creditors some comfort that their bargained-for rights will be protected in bankruptcy. Secured creditors that successfully avail themselves to a section 552(b) exception often have significant leverage over a debtor, since a debtor almost always needs to use cash proceeds to maintain post-petition operations. Michael L. Bernstein & George W. Kuney, BANKRUPTCY IN PRACTICE, American Bankruptcy Institute (Charles J. Tabb, ed., 5th ed. 2015). While a typical lender with a lien in accounts receivable and inventory may be given a conditional replacement lien as adequate protection, a debtor would find it more difficult to provide

adequate protection for the usage of post-petition property when a secured creditor has a continuing lien under section 552(b).[3]

Unsecured Creditors:

Unsecured creditors will almost universally be aligned with a debtor on issues under section 552. To the extent a secured creditor's liens are cut-off under lenders 552(a), unsecured creditors are more likely to be "in the money" from a recovery perspective. Because issues arising under section 552 in commercial cases are normally addressed very early in the case, unsecured creditors' committees do not often have the opportunity to "draw lines" on section 552(b) issues.

Trustees:

A number of the cases in this area arise in trusteeships. Trustees, of course, will almost always be aligned with the debtor and unsecured creditors, although early-stage waivers and stipulations entered into by the debtor in commercial cases will often bind a subsequently appointed trustee. In smaller cases, however, section 552 issues may arise, especially when the estate receives an unexpected windfall through litigation. (*See* cases discussed below.)

III. Obvious Areas of Litigation.

The nature, extent and validity of a prepetition security interest is generally defined by state law (typically the U.C.C.)—state law therefore determines whether property constitutes proceeds, products, offspring or profits of collateral. The treatment of "proceeds"[4] is a nuanced topic. States may have non-uniform versions of the U.C.C., with different requirements or scope. Courts may exclude post-petition revenue generated as compensation for labor or services provided by the debtor after filing. *See, e.g.*, *In re Cafeteria Operators, L.P.*, 299 B.R. 400, 409 (Bankr. N.D. Tex. 2003); *In re Skagit Pac. Corp.*, 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004) ("revenue generated by the operation of a debtor's business, post-petition, is not considered proceeds if such revenue represents compensation for goods and services rendered by the debtor in its everyday business performance"). Precise wording in loan documents also is critical. *See, e.g.*, *Misdescription of Collateral in Security Agreement Ruins Lender's Claim to Postbankruptcy Proceeds*, CLARKS' SECURED TRANSACTIONS MONTHLY, Nov. 2012 (discussing Nevada bankruptcy case holding loan document granting a security interest in

[3] Stated differently, a debtor cannot simply provide a conditional replacement lien on rents, for example, when a lender has a prepetition lien on accumulated rents and a continuing lien on post-petition rents. Theoretically, the debtor would struggle to find new or different (unencumbered) collateral on which to grant the creditor a replacement lien.

[4] The U.C.C. defines "proceeds" as including "whatever is acquired on the sale, lease, license, exchange, or other disposition of collateral." U.C.C. § 9-102(a)(64)(A). Courts interpreting section 552, however, have repeatedly held that "proceeds" under section 552(a) is to be given the "broadest possible definition . . ." *See In re Endresen*, 548 B.R. at 267.

"payments" or "future payments" did not give the lender a security interest in post-petition payments that would survive section 552(a)).

IV. Post-Petition Enhancement to a Creditor's Collateral Package.

The subsection 552(b)(1) exception was intended to cover after-acquired property directly attributable to prepetition collateral, without addition of estate resources. 5-552 COLLIER ON BANKRUPTCY P 552.02[2][a] (16th 2017). The ABI Commission to Study the Reform of Chapter 11 specifically commented on this point—that an estate should benefit in a material way when a secured creditor's collateral is enhanced during the pendency of a reorganization case. (*See* attached Report.) A bellweather case on this issue is *In re Residential Capital, LLC*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013). In *Residential Capital*, the Judge held: (1) the section 552(b) exception was intended to cover after-acquired property that is directly attributable to prepetition collateral, without addition of estate resources; (2) work performed by the debtor during chapter 11 to increase goodwill qualified as estate resources; and (3) since the lenders could not provide evidence on what portion of goodwill was attributable to their collateral, their lien did not extend to the sale value attributable to goodwill.

Residential Capital is one of the few cases that have applied the "equities of the case" exception in favor of the estate. This statutory exception built into section 552(b) is intended to prevent secured creditors from receiving windfalls and to give the courts discretion in balancing the interests of secured creditors against the general policy of the Bankruptcy Code. Sally McDonald Henry, *Paying-to-Play in Chapter 11*, 17 , J. BUS. & SEC. L. 113, 129 (2016). While this exception has been rarely tested in litigation, the courts tend to consider: (1) the time and estate funds expended, at the expense of unsecured creditors, to enhance the value of the collateral; and (2) the value of the creditor's collateral.[5] Courts are not inclined to apply the exception when there are other remedies that have not been exhausted. *See, e.g.*, *Delbridge v. Prod. Credit Ass'n & Fed. Land Bank,* 104 B.R. 824, 826 (E.D. Mich. 1989) ("equities of the case" relief denied, debtor failed to seek relief under sections 363 or 506 of the Bankruptcy Code).

V. Adequate Protection and "First Day" Financing Issues.

In most commercial cases, post-petition proceeds, profits and rents of pre-petition collateral are almost automatically treated as cash collateral under section 363(a). A practical effect of section 552(b) is that the secured party often ends up with a lien on property acquired by the estate post-petition, notwithstanding section 552(a), because a debtor will grant a replacement lien in favor of the secured party on accounts or inventory generated post-petition as a condition to using the secured party's cash collateral or to obtain critical debtor-in-possession financing.

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[5] It should not be surprising that, when a secured creditor is arguably oversecured, the "equities of the case" exception is more easily applied by courts. *See, e.g.*, *In re Airport Inn Assocs., Ltd.*, 132 B.R. 951, 959 (Bankr. D. Colo. 1990).

The real question here, however, is whether a debtor in the appropriate case has the ability to identify a material issue under section 552, so that it could be "flagged" at the onset of a chapter 11 case. In most cases, it seems likely that any benefit to the estate that might be preserved by "carving out" section 552 issues might be outweighed by a debtor's need to use cash collateral or (even more compelling) new advances critical to survival under a debtor-in-possession financing package. This issue really can only be addressed and evaluated on a case-by-case basis. Moreover, a debtor might need to tender this issue to a committee, if the circumstances warrant it.

VI. Security Interests in Cash.

The law in many jurisdictions provides that a security interest in a deposit account may only be perfected by control, and once the funds leave the deposit account and are transferred, the creditor no longer has any "control" of the funds and its interests become unperfected. While section 552(b) preserves a secured creditor's pre-petition perfected secured interest, a secured creditor without the proper degree of "control" over deposit accounts may not be able to avail themselves of the benefits of section 552(b).

Lenders typically perfect a lien on a deposit account in which the cash is held through a Deposit Account Control Agreement ("DACA"). Often, as a matter of expediency or to manage expenses, a lender may decide not to enter into a DACA. Lenders need to be aware of the risk this creates under section 552. This risk may be minimal if (again) cash collateral and/or DIP financing issue would make this issue immaterial. Likewise, a DACA should not be necessary when the debtor has a deposit relationship with the secured lender.

VII. Chapter 9—Section 928 Exception.

Section 928(a) provides another exception to section 552(a) for post-petition "special revenues" acquired by debtor (*i.e.*, a subset of municipal bonds). Similar to secured creditors in chapter 11 cases, a chapter 9 holder of special revenue bonds or other secured creditor who opposes the debtor's use of pledged revenues may seek adequate protection to ensure that its collateral interests in such special revenues remains protected. Other provisions that affect special revenue bonds include: (i) section 922(d): pledged special revenue is also exempted from the automatic stay under section 922(d); (ii) under section 927, special revenue bondholders are denied the ability to be treated as holders of recourse or general obligation debt pursuant to section 1111(b). An open question is the scope of "necessary operating expenses" under section 928(b).[6]

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[6] 11 U.S.C. § 928(b) ("Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system shall be subject to the necessary operating expenses of such project or system, as the case may be.").

VIII. Recent Noteworthy Cases.

In re Roselli Moving & Storage Corp., 568 B.R. 592 (Bankr. E.D.N.Y. 2017). Bank asserted lien in settlement funds recovered by chapter 7 trustee at the final report stage, after failing to object to a settlement in which debtor and affiliates paid $125,000 in exchange for release of estate claims. Noting the lender provided no legal authority for the proposition that it retained a pre-petition lien of funds in the control of the transferee, court found the bank's pre-petition lien does not extend to the settlement funds under section 552.

In re Endresen, 548 B.R. 258 (9th Cir. Bankr. 2016). Construction defect claims settled by chapter 7 trustee remained the collateral of secured party, due to the language in the trust deed and broad definition of "proceeds" under subsection 552(b)(1). However, trial court reversed in applying "equities of the case" exception to terminate lien of additional secured party even though that party defaulted by failing to respond to trustee's properly served, amended complaint.

In re Johnson, 554 B.R. 448 (Bankr. S.D. Ohio 2016).[7] Lender's attempt to argue payments to hockey player under player contract were proceeds protected under subsection 552(b)(1) rejected by the court for numerous reasons. Court provides exhaustive analysis of California law applicable to employment contracts and liens, as well as thorough application of section 552(a) and (b).

[7] Affirmed by *In re Johnson*, 16-8035, 2017 WL 2399453, at *1 (B.A.P. 6th Cir. June 2, 2017).

4. Section 552(b) and Equities of the Case

Recommended Principles:

- The trustee should not be able to waive, or to enter into any agreement affecting, a court's ability to limit or alter a secured creditor's interest in the debtor's or the estate's property based on the equities of the case under section 552(b) of the Bankruptcy Code.
- A trustee should not be required to establish an actual expenditure of funds to show that the estate enhanced the value of a secured creditor's collateral for purposes of the equities of the case determination under section 552(b). Rather, the trustee should be able to make such a showing with evidence of any value provided, obligation incurred, or other actions taken with respect to the collateral. With this clarification, the court should continue to determine the scope and meaning of the term "equities of the case" based on the facts of, and evidence presented in, the particular case.
- The Commission considered and declined to adopt a federal definition of the term "proceeds" for purposes of chapter 11 cases.

826 If approved in connection with postpetition financing, courts generally enforce the waivers. *See, e.g.*, Weinstein, Eisen & Weiss v. Gill (*In re* Cooper Commons LLC), 512 F.3d 533, 535–36 (9th Cir. 2008) (denying section 506(c) claim by debtor's former counsel, who represented the debtor in negotiating postpetition financing agreement including the waiver, based on *res judicata*).

Section 552(b) and Equities of the Case: Background

Section 552 of the Bankruptcy Code addresses the postpetition effect of prepetition liens on the debtor's property.[827] Section 552(a) establishes the general rule that the bankruptcy filing cuts off a creditor's rights under any after-acquired property clause in a prepetition security agreement with the debtor.[828] Section 552(b) sets forth two exceptions to this general rule, one dealing with proceeds of prepetition collateral,[829] and the other dealing with rents and similar payments relating to prepetition collateral.[830] The exceptions basically allow the secured creditor's prepetition lien to continue in postpetition proceeds of, or postpetition rents relating to, prepetition collateral. Each exception in turn is subject to an exception: the court, after notice and a hearing, may treat the secured creditor's prepetition lien differently "based on the equities of the case." The language of section 552(b) represents a compromise between the House and Senate versions of the 1978 bankruptcy bill: The final version allowed prepetition liens to continue in postpetition proceeds, but cabined such liens when necessary to protect the estate based on the equities of the case.[831]

The equities of the case exception allows a court to limit, alter, or terminate the extension of a secured creditor's prepetition lien to postpetition property of the estate. Although the Bankruptcy Code does not define "equities of the case," the legislative history suggests that the exception was intended to compensate the estate for use of unencumbered property or expenditures that enhanced the value of the secured creditor's lien and to protect the rehabilitative purposes of the Bankruptcy Code. For example, the legislative history provides: "[T]he 'equities of the case' provision . . . is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally."[832] The Fourth Circuit has explained: "It appears clear from the legislative history related to § 552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code."[833]

In applying the equities of the case exception, courts generally consider three factors: (i) the amount of time and estate funds expended on the collateral; (ii) the relative position of the secured party

827 11 U.S.C. § 552.

828 Section 552(a) provides: "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." 11 U.S.C. § 552(a).

829 Section 552(b)(1) provides:

> 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.

11 U.S.C. § 552(b)(1).

830 11 U.S.C. § 552(b)(2). The language of section 552(b)(2) is similar to that of section 552(b)(1) except that it applies "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." *Id.*

831 Section 552(b) represents a compromise between the House bill and the Senate amendment. Proceeds clauses, but not after-acquired property clauses, are enforceable under the Bankruptcy Code. The provision allows the court to consider the equities of the case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in the secured party's position.

832 140 Cong. Rec. H. 10,768 (Oct. 4, 1994).

833 United Va. Bank v. Slab Fork Coal Co. (*In re* Slab Fork Coal Co.), 784 F.2d 1188, 1191 (4th Cir. 1986), *cert. denied*, 477 U.S. 905 (1986).

following the expenditure of estate time and money (*i.e.*, whether the collateral has been enhanced); and (iii) the rehabilitative nature of the bankruptcy case.[834] Neither the language of the statute nor the legislative history requires the estate to have devoted money or unencumbered assets to the improvement of the secured creditor's position, but some courts have applied the equities of the case exception in this manner. For example, in *Laurel Hill*, the court held that when a postpetition financing facility was repaid from proceeds that were subject to the security interests of various secured claimants whose liens had been transferred to the sale proceeds, the payments were not *at the expense of the estate* and thus did not support an equities of the case award to the unsecured creditors.[835] Nevertheless, in *Residential Capital*, the court invoked the equities of the case exception under section 552(b)(1) to cut off the secured creditor's lien in postpetition goodwill when "time, effort, and expense by the Debtors' estates" enhanced the value of the assets sold in the case.[836]

Similar to section 506(c), the trustee[837] often waives its right to assert the equities of the case exception under section 552(b), or stipulates that no such equities exist, in connection with postpetition financing or the use of cash collateral.[838] Perhaps because of these waivers, relatively little case law exists on section 552(b).

Section 552(b) and Equities of the Case: Recommendations and Findings

Section 552 represents a basic compromise: Prepetition secured creditors can maintain their interests in the debtor's prepetition property, including proceeds, but the trustee can use property acquired by the estate unencumbered by any prepetition liens. This balance provides the trustee with resources to help facilitate the debtor's reorganization. Nevertheless, to the extent the trustee expends any of these or other estate resources in a manner that enhances the value of a secured creditor's collateral, section 552(b) permits the court to assess the equities of allowing the secured creditor to retain that enhancement.

The Commissioners observed the relationship between sections 506(c) and 552(b) of the Bankruptcy Code in that both seek to give the secured creditor the value of its allowed secured claim while preventing the secured creditor from receiving any windfalls in the case. These sections are also tied in certain respects to the valuation of a secured creditor's collateral for purposes of adequate protection requests and ultimate distributions in the case. Accordingly, the Commission considered the appropriate scope and use of section 552(b) in the context of the recommended principles relating to section 506(c), foreclosure value, and reorganization value.[839]

834 *See In re* Laurel Hill Paper Co., 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008).

835 *Id.*

836 *See* Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

837 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model.*

838 For example, the court made the following finding in its final order approving postpetition financing in the *General Growth Properties* chapter 11 case:

> In light of the Lenders' agreement to subordinate their liens and superpriority claims to the Carve-Out, the Lenders are entitled to a waiver of (i) the provisions of section 506(c) of the Bankruptcy Code and (ii) any "equities of the case" claims under section 552(b) of the Bankruptcy Code, in each case, in respect of the DIP Documents.

In re Gen. Growth Props., Inc., 09-11977 (ALG) (May 14, 2009).

839 *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value.*

The Commissioners identified several issues in the application of section 552(b), including defining the scope of the secured creditor's prepetition collateral package and the broad interpretation of "proceeds" and related terms under applicable state law. With respect to collateral identification, the Commission reviewed the *Residential Capital* decision and its discussion of postpetition goodwill by the Honorable Martin Glenn of the U.S. Bankruptcy Court of the Southern District of New York.[840] In that case, Judge Glenn rejected the prepetition secured creditor's claim to postpetition goodwill on several grounds. Specifically, he determined that the prepetition secured creditors failed to show that their collateral was converted into postpetition goodwill and that, even if the secured creditor's collateral "was used to generate goodwill (either by maintaining or improving the value of assets or by diminishing liabilities), Debtor resources were used as well."[841] Judge Glenn concluded that the use of the debtor's resources, at least in part, to transform the collateral into postpetition goodwill precluded the goodwill from being characterized as proceeds for purposes of section 552(b).

The Commissioners debated the facts and holding in *Residential Capital* and the potential approaches to resolving those issues. Some of the Commissioners supported excluding all postpetition goodwill from a prepetition secured creditor's collateral package. They reasoned that the value generated postpetition by the debtor in possession's efforts and resources, as well as value associated with costs and obligations avoided through the chapter 11 process, should be available to support the debtor's reorganization. The Commissioners discussed the impact of such a bright-line rule regarding goodwill on credit markets and the challenge of allocating value between prepetition and postpetition goodwill. The Commission agreed that the treatment of goodwill was best determined through a case-specific inquiry based on the facts of the case and the evidence presented at the hearing.

Similarly, the Commissioners examined the scope of the term "proceeds" under state law. Several of the Commissioners noted the significant expansion of the definition of proceeds under state law since the enactment of the Bankruptcy Code in 1978. They discussed how these kinds of amendments arguably allowed state commercial law to restrict the resources available to support a debtor's reorganization under chapter 11. They provided examples of parties litigating the scope of proceeds and reflected on two articles by Professor Ray Warner concerning the continued expansion of the concept under state law.[842] Professor Warner posits that certain amendments to Article 9 of the Uniform Commercial Code, including the expanded definition of proceeds, "had little or no nonbankruptcy function, but were designed primarily to alter bankruptcy law outcomes in favor of secured creditors."[843] Several of the Commissioners supported a federal definition of proceeds that would scale back the definition to the replacement or substitution of collateral concept originally assigned to proceeds of collateral. Other Commissioners suggested that a federal definition of proceeds that conflicted with state law would create uncertainty and increase costs in secured credit transactions. The Commission ultimately declined to adopt a federal definition of proceeds.

840 Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

841 *Id.*

842 *See, e.g.*, G. Ray Warner, *Article 9's Bankrupt Proceeds Rule: Amending Section 552 Through the UCC's "Proceeds" Definition*, 46 Gonzaga L. Rev. 521 (2011); G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 Am. Bankr. Inst. L. Rev. 3, 5–6 (2001). *See also* Moringiello, *When Does Some Federal Interest Require a Different Result?*, *supra* note 280 ("The Code recognizes the secured creditor's entitlement to the value of its collateral, and also recognizes that the creditor's security interest extends to proceeds of its collateral, even if those proceeds are realized after the debtor has filed for bankruptcy. The 2001 Amendments to Article 9 of the Uniform Commercial Code expanded the definition of proceeds to include 'rights arising out of the collateral' a definition that could so expand the idea of proceeds as to deprive unsecured claimants of any recovery at all.").

843 Warner, *Article 9's Bankrupt Proceeds Rule*, *supra* note 842, at 521.

The Commissioners then considered whether section 552(b) strikes the appropriate balance between the rights of secured creditors and the estate. The Commissioners generally agreed with the continuation of a secured creditor's lien in proceeds subject to the equities of the estate exception, but several of the Commissioners expressed discomfort with the kinds of expenditures and evidence required for the trustee to establish the exception. These Commissioners commented that, if the section is concerned with enhancements of value and promoting rehabilitation, the trustee should be able to satisfy the equities of the case exception with evidence of the estate contributing value, whether through time, effort, money, property, other resources, or cost savings. The basic premise should be that, if the estate creates value through any means during the chapter 11 case and such value enhances the secured creditor's collateral, the estate should receive the benefit of such value. The extent of value attributed to the estate would be determined by the court based on the evidence presented under the equities of the case exception. The Commission agreed that so long as the evidence establishes the estate's expenditures (in whatever form), this clarification to the scope of the equities of the case exception would be beneficial and aligned with the objectives of the related principles.

Finally, as with section 506(c) and for similar reasons, the Commission voted to recommend that parties not be permitted to waive the equities of the case exception under section 552(b) or to stipulate that no equities exist to invoke the exception. The Commission agreed that such determinations should be made *ex post* based on the circumstances of the case and the evidence presented by the parties.

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2017

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

24TH ANNUAL CENTRAL STATES BANKRUPTCY WORKSHOP
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Kay S. Kress, Esq.
Shelly A. DeRousse, Esq.

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

Hon. Catherine J. Furay
Shelly A. DeRousse, Esq.
Kay S. Kress, Esq.
Deanne M. Koll, Esq.

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;
>
> (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'").