

# Navigating the Bankruptcy Court's Power to Modify A Secured Creditor's Lien

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As a borrower approaches bankruptcy, secured creditors often believe that their existing liens and collateral packages will be respected by the bankruptcy court, absent a basis to challenge priority, perfection or some misconduct to justify equitable subordination. On the contrary, bankruptcy courts have the power to modify the scope of validly perfected liens. This article focuses on the impact of section 552 of the Bankruptcy Code, which addresses the effect of a bankruptcy filing on property acquired by the debtor after the filing of the bankruptcy case (referred to as "after-acquired property") and proceeds of pre-bankruptcy collateral.

The extent of a secured creditor's lien on collateral is critical to determining a host of secured creditor rights, including: 1) the extent of credit bid rights for a sale of collateral under section 363 of the Bankruptcy Code because a secured creditor can only credit bid

on its collateral; 2) the entitlement to post-petition interest because only an over-secured creditor is entitled to post-petition interest under section 506(b) of the Bankruptcy Code; 3) the entitlement to "adequate protection"; and 4) the allocation of value in a sale and plan context.

## **PRE-BANKRUPTCY LIEN ON AFTER-ACQUIRED PROPERTY AND COLLATERAL PROCEEDS**

The principal purpose of Article 9 of the Uniform Commercial Code (UCC) is to bring simplicity and certainty to financial transactions, which both reduces transactional costs and the cost of credit. To accomplish this, secured creditors may obtain a lien in substantially all of a borrower's personal property, including its after-acquired property. UCC § 9-204.

Commercial lending transactions typically include the grant of a lien on the borrowers' after-acquired property, and also include a lien on proceeds of collateral. In fact, the UCC automatically provides for a lien on collateral proceeds pursuant to UCC §§ 9-203(f) and 9-315. The term "proceeds" is broadly defined under the UCC to include "whatever is acquired upon the sale, lease, license, exchange or other disposition of collateral."

UCC § 9-102(64)(A). A secured creditor's lien, however, attaches only to "identifiable" proceeds of its collateral. UCC § 9-315(a)(2).

## **INVALIDATING LIENS ON AFTER-ACQUIRED PROPERTY**

When a borrower files for bankruptcy (whether under Chapter 11 or Chapter 7), the extent of the secured creditors' lien on after-acquired property and proceeds of prepetition collateral is affected by section 552 of the Bankruptcy Code, titled "Post-Petition Effect of Security Interest." Section 552(a) seeks to advance one of the primary purposes of the Bankruptcy Code to provide a debtor with a fresh start. To that end, section 552(a) establishes a general rule that a debtor's after-acquired property is not subject to a secured creditor's pre-bankruptcy lien. Effectively, section 552(a) of the Bankruptcy Code invalidates a valid lien on after-acquired property contained in prepetition security agreements. By severing a secured creditor's lien in after-acquired property on the petition date, the bankruptcy court seeks to create unencumbered assets that can be monetized, thus improving the debtors' chance of a successful reorganization.

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## PRESERVING LIENS ON PROCEEDS OF PREPETITION COLLATERAL

The Bankruptcy Code recognizes the tension between providing a secured creditor with the benefit of its bargain and giving the debtor a fresh start. Thus, while the general rule is that a lender's lien in after-acquired property is cut off on the petition date by section 552(a) of the Bankruptcy Code, section 552(b) creates a critical exception: subject to certain limitations, a secured creditor retains its lien in proceeds of its prepetition collateral. 11 U.S.C. § 552(b)(1). Thus, if a debtor sells inventory subject to a prepetition lien after the petition date, the lender will retain its lien in identifiable sale proceeds. It should be noted that Section 552(b) contains a second exception, which is beyond the scope of this article. The second exception allows a secured creditor to retain its prepetition lien on rents and hotel room revenues generated post-bankruptcy. 11 U.S.C. § 552(b)(2).

The term "proceeds" is not defined under the Bankruptcy Code. Courts have applied the meaning of proceeds used in the UCC and have expanded that definition to include "any property into which property subject to the security interest is converted." *In re James Cable Partners L.P.*, 141 B.R. 772, 775 (Bankr. M.D. Ga. 1992) ("It is clear that the coverage of section 552 is broader than that of the UCC."), citing H.R. 595, 95th Cong., 1st Sess. 376-77 (1977). Nevertheless, the burden of proving that a prepetition lien survives post-petition rests with the secured creditor. 11 U.S.C. § 363(p)(2).

## AFTER-ACQUIRED PROPERTY VERSUS COLLATERAL PROCEEDS

It is not always easy to distinguish between after-acquired property

and collateral proceeds. The distinction, however, is critically important because it will determine whether the assets are collateral available solely to satisfy the secured creditor's claim or available to be shared pro rata with general unsecured creditors. An example of this dispute is found in *James Cable*, 141 B.R. 772.

In that case, the debtor asserted that the post-petition fees paid by the debtors' cable subscribers were after-acquired property and, thus, excluded from the lender's pre-petition lien under section 552(a). After a trial, the bankruptcy court held against the debtor, holding that the secured creditor, which had an all-asset lien, had a security interest in the post-petition accounts receivable generated by subscribers existing on the petition date because such fees were proceeds of its collateral (*i.e.*, the existing subscription agreement). *Id.* at 777. There was a wrinkle, however, for the secured creditor.

After the bankruptcy case was filed, the debtor had signed up approximately 2,000 new subscribers. The bankruptcy court held that the new post-petition accounts were after-acquired property and payments by those new subscribers made were after-acquired property and not proceeds of the lender's prepetition collateral. *Id.* Thus, the lender no longer had a lien on all of the debtor's accounts receivable, but only accounts receivable payable by prepetition subscribers.

Another case highlighting the impact of section 552 is *In re SJR Enterprises, Inc.*, 150 B.R. 933 (Bankr. N.D. Ill. 1993). In that case, the debtor operated a car dealership and sold its assets in a section 363 sale. As part

of the sale price, the buyer paid a fee so the debtor would exercise its contractual right to terminate its franchise agreement with Nissan, which would enable the buyer to operate its own Nissan franchise. The debtor asserted that this termination fee was after-acquired property not subject to its prepetition lenders' all-asset liens because the fee was payable under a post-petition sale contract.

The bankruptcy court disagreed, holding that the termination fee represented proceeds of the prepetition lenders' collateral. To hold otherwise, the bankruptcy court said, would be to elevate "form over substance," because the debtor's exclusive right to operate in its territory and its contractual right to terminate its franchise agreement existed pre-bankruptcy. *Id.* at 938. According to the bankruptcy court, these rights, and the value attributable to them, constituted goodwill (*i.e.*, the excess of the purchase price over the value of the debtors' hard assets). Goodwill is a "general intangible" under the UCC on which the lenders had a perfected lien; thus, monetizing those pre-bankruptcy rights constituted proceeds of the lenders' collateral. *Id.* at 941.

## THE 'EQUITIES OF THE CASE' EXCEPTION

Section 552(a) provides the general rule of invalidating prepetition liens on after-acquired property, and section 552(b)(1) is the exception to that rule preserving liens on post-petition proceeds of pre-petition collateral. Secured creditors, however, also have to deal with another provision in section 552 that may affect their liens. The last clause of section 552(b)(1) provides that the bankruptcy court

has the power to limit a lien on post-petition proceeds from prepetition collateral “based on the equities of the case.” 11 U.S.C. § 552(b).

The phrase “equities of the case” is not defined in the Bankruptcy Code and courts have applied the exception narrowly. *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n (In re Terrestar Networks, Inc.)*, 457 B.R. 254, 271 (Bankr. S.D.N.Y. 2011) (collecting cases). The legislative history suggests that the “equities of the case” exception was intended to compensate a debtor’s estate for the use of unencumbered property or expenditures that enhance the value of the secured creditor’s collateral. *All Points Capital Corp. v. Laurel Hill Paper Co. (In re Laurel Hill Paper Co.)*, 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008) (citation omitted). The U.S. Court of Appeals for the Seventh Circuit, for example, has posited that if a creditor had a lien in raw materials worth \$1 million and the debtor invested \$100,000 from general estate funds to convert those material into a manufactured goods worth \$1.5 million, it may be inequitable to let the secured creditor benefit from the entire proceeds of the sale because the general creditors contributed to the appreciated value. *J. Catton Farms v. First National Bank of Chicago*, 779 F.2d 1242, 1247 (7th Cir. 1985) (J. Posner).

In *In re Residential Capital Funding*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013), the bankruptcy court rejected the secured creditor’s argument that its “all asset” lien attached to a portion of the sale proceeds attributable to the goodwill of a business line the debtors sold under section 363 of the Bankruptcy Code. It did so on the basis that no goodwill existed

on the date of the bankruptcy filing. The value of the business line and related assets on the filing date were “seriously impaired, subject to steep reductions in the value by litigation risks, potential seizure of certain assets, and termination of rights and setoff by various parties in interest.” *Id.* at 611.

At the time of the filing, the buyer had not committed to pay anything for the business division, let alone a purchase price above the fair value of the hard assets. *Id.* The bankruptcy court found that it was the debtors’ efforts over many months after the Chapter 11 filing to stabilize the business, placate the business’ counter-parties and mitigate litigation risk that ultimately facilitated the sale at a price that reflected goodwill. *Id.* Based on these facts, the court used the “equities of the case” doctrine to limit the secured lenders’ lien on goodwill generated after the petition date, despite the lenders’ all asset lien. *Id.* at 612.

The American Bankruptcy Institute Commission to Study the Reform of Chapter 11, however, has recommended to Congress numerous proposals to reform Chapter 11 of the Bankruptcy Code, including expanding the scope of the “equities of the case” exception. See Am. Bankr. Inst. Comm’n to Study Reform of Chapter 11, Final Report And Recommendations (ABI Report), 230-234 (2014). According to the Commission, “[t]he basic premise should be that, if the estate creates value through *any means* during the [C]hapter 11 case and such value enhances the secured creditor’s collateral, the estate should receive the benefit of such value.” *Id.* at 234 (emphasis added).

The Commission’s proposal is inconsistent with — and far broader

than — the legislative history of section 552, which states that the equities of the case exception “is designed to cover the situation where the estate expends funds that result in an increase in the value of collateral.” See H.R. 595, 95th Cong., 1st Sess. 376-77 (1977). The Commission’s proposal would not require the debtor to expend actual funds and, instead, would include any value enhancement “though time, effort ... or cost savings.” ABI Report at 234. If adopted, this proposal would lead to increased litigation and greater risk for secured creditors in recovering the value of their collateral in bankruptcy cases.

## CONCLUSION

Secured creditors should understand that that blanket liens may have some holes and out-of-the money stakeholders will continue to use Section 552 of the Bankruptcy Code as a weapon in their arsenal to extract value from them. While the statutory exceptions are relative narrow, they do exist.



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