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The Pre-Petition Right to Post-Petition Income Streams and the Misinterpretation of § 552

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When an asset-based lender takes a security interest in every conceivable type of collateral under revised Article 9 and real property law, the reasonable expectation of the parties is that pre-petition liens attach to all post-petition sale considerations under § 552 of the Bankruptcy Code. Cash-flow lenders similarly take blanket pre-petition liens, basing loans not on the value of hard assets but on the present value of future income streams. Value is not divided up by asset, but is supported by the economic capacity of the assets taken as a whole. Therefore, whether an asset-based or cash-flow loan, the value of the interest in collateral subject to a pre-petition blanket lien is commonly regarded as the “enterprise value,” or 100 percent of the value of the debtor’s business, up to the amount of the lender’s claim.



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Viewing the value of a secured claim as the amount a purchaser would pay for a business, theoretically one could allocate a purchase price on an asset-by-asset basis. Under those circumstances, a significant portion of the purchase price often would be allocable to the “catch-all” category known as “general intangibles,”¹ and in many cases, a purchaser simply pays the amount equal to the net present value of the future earning capacity of the

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business, or a “multiple of EBITDA.”² Post-petition earnings before interest, taxes, depreciation and amortization (EBITDA), therefore, represents component parts of the value of the cash-flow lender’s secured claim. Accordingly, just as § 552(b) protects the liens of asset-based lenders on post-petition proceeds of pre-petition inventory and receivables, it should similarly protect cash-flow

and disagreements flare among scholars and courts. Those narrowly interpreting the definition of “proceeds” would view future accounts as property that did not exist as of the petition date, constituting “new” value,

to which all creditors are entitled to share ratably under § 552(b).³ However, where a pre-petition lender takes security in the “right to future accounts” and predicates its loans on the value of future income streams, those streams are no different

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lenders’ liens on post-petition income streams as proceeds of the pre-petition right to future EBITDA.

Correcting Narrow Interpretations of “Proceeds”

As an example, take a situation where pre-petition collateral consists of accounts. No one would have difficulty concluding that the post-petition revenues from the collection of the accounts are “proceeds” under § 552(b), but change the pre-petition collateral from “accounts” to “right to future accounts,”

from the income-producing capacity of the pre-petition blanket lien.⁴

In real estate contexts, future income streams are labeled “rents” and are protected under § 552(b) whether or not they arose from leases in effect on the filing date.⁵ Hotel revenues once presented a conflict among those who argued that such revenues were not “rents” entitled to protection under § 552(b). Hotel lending, predicated on a pre-petition lien on future income streams, was jeopardized as a result until

¹ “General intangibles” as defined in Article 9 is a residual category of personal property that is not included in other types of collateral. See 9-102(a)(42) and Official Comment 5(d). As Grant Gilmore pointed out when this term was invented, “general intangibles” is simply a general label for property not otherwise described, such as rights not arising under existing contracts. Gilmore, *Security Interests in Personal Property* § 12.5 p.382 (1965). The present right to earn profit in the future is a current interest in property encompassed within the term “general intangibles.” *Id.* Vol. 2, § 45.5 p. 1306 (1965) (“[f]uture ‘contract rights’ (no contract having yet been ‘made’) may be present ‘general intangibles.’”).

² See, e.g., *In re ION Media Networks Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009); *In re Nellson Nutraceutical Inc.*, No. 06-10072 (CSS), 2007 WL 201134 (Bankr. D. Del. Jan. 18, 2007).

³ *In re SRJ Enterprises Inc.*, 150 B.R. 933, 941 (Bankr. N.D. Ill. 1993) (“Section 552 preserves to a great extent the status quo and protects state law property entitlements that existed as of the date of the filing. New, post-petition value is unencumbered. Old value is subject to perfected, pre-petition security interests in that value.”).

⁴ Steven L. Schwarcz, “The Impact on Securitization of Revised UCC Article 9,” 74 *Chi-Kent L. Rev.* 947, 958 (1999) (“Revised Article 9’s expanded definition of proceeds will expand the universe of future assets that can be sold to SPVs without the fear of the SPV’s interest in those assets being cut off [by § 552(b)] in the event of the originator’s bankruptcy.”).

⁵ See generally R. Wilson Freyermuth, “Modernizing Security in Rents: The New Uniform Assignment of Rents Act,” 71 *Mo. L. Rev.* 1, 2 (2006) (“[B]ecause rents are ‘proceeds’ of the land in an economic sense... most commercial mortgage lenders require the mortgagor to deliver a separate ‘assignment of rents.’”).

§ 552(b) was amended to specifically cover post-petition “rents.”⁶ Thereafter, courts uniformly recognized post-petition rents and hotel revenues—including revenues generated by occupants who did not exist as of the filing date—as the continuation of a pre-petition lender’s security interest in the underlying property and right to future income streams. Perhaps because Article 9 developed under a different regime, or perhaps because the concept of “proceeds” has been less accepted as encompassing income-producing capacity in the same manner as real estate, courts and commentators have been more reluctant to recognize a post-petition security interest in cash flows if the pre-petition security interest simply covers the intangible right to future income streams.⁷

Progressive Thinking on “Proceeds”

This reluctance has not been universal. An article by Prof. Wilson Freyermuth⁸ persuasively argued that “proceeds” under the old Article 9 should be interpreted to include income-producing capacity of collateral, whether collateral is sold or otherwise disposed of. Seventh Circuit Chief Judge Frank Easterbrook concluded that while a lender with only an interest in inventory may be limited to wholesale value, a lender with a security interest in general intangibles can capture post-petition business “profit.”⁹ Other courts have taken comparable approaches, endorsing the notion that a pre-petition security interest in general intangibles would capture the “going-concern” or “market-share” value of an automobile franchise (even if the franchise agreement itself were not subject to a security interest).¹⁰ Similarly, in *Media Properties*,¹¹ a pre-petition lien on general intangibles (but not on the Federal Communications Commission license) encompassed the enterprise

value of a television station when realized upon a sale post-petition.¹²

As the discourse on these issues continued, Article 9 was revised, and the term “proceeds” was expanded and is now broad enough to encompass proceeds from the lease of equipment (even though the equipment has not been sold),¹³ dividends from stock,¹⁴ and presumably tipping fees from the utilization of landfill capacity.¹⁵ These developments, while welcome, should not be a surprise given the early development of Article 9.

Grant Gilmore readily embraced the notion that future contract rights are present “general intangibles.” Sections of his legendary treatise are devoted to the concept of future interests and the ability to lien the same under what were then-state common laws that resisted granting a security interest in future expectancies.¹⁶ As asset-based lending flourished, requiring vast changes to state law and accommodations under bankruptcy law (such as under what circumstances after-acquired collateral would be trapped as preferential), Gilmore took over the task force responsible for harmonizing the Bankruptcy Code and the Uniform Commercial Code (UCC). Section 552(b) resulted, bifurcating “new” value from “old” pre-petition value. A secured creditor would no longer be permitted to keep after-acquired collateral subsequent to the intervention of bankruptcy unless the property were “proceeds” of the pre-petition collateral. This provision protected asset-based lending: Proceeds generated from the post-petition sale of pre-petition inventory and collection of receivables would constitute § 552(b) “proceeds.”

The collateral that served to support the loan would continue to do so regardless of the form taken. Any diminution in the value of that collateral would be entitled to adequate protection. Any costs incurred by the estate to protect, preserve or dispose of that collateral

would be subject to surcharge under § 506(c) or deduction from the scope of the liens under the “equities of the case” exception of § 552(b). One cannot know whether Gilmore believed that cash-flow lenders would be similarly protected under § 552(b), but one can guess. Future income streams, when realized, are proceeds of some type of pre-petition collateral, whatever the label may be. Whether characterized as “general intangibles,” as in *SRJ* and *Media Properties*, or as all now existing and hereafter arising “profits,” this future income, or enterprise value, is the source of the security for the cash-flow loan.

Las Vegas Monorail

These issues were recently addressed in the unpublished opinion *In re Las Vegas Monorail Co.*¹⁷ Secured lenders had better hope that “what happens in Vegas stays in Vegas.” Hon. **Bruce Markell** considered pre-petition liens on post-petition income streams and ruled against the cash-flow lender. He did so in much the same way as the *Hastie* court ruled against stock dividends, the *Cleary* court ruled against equipment lease proceeds and as many of the courts have ruled in hotel-revenue cases.

Las Vegas Monorail Company (LVMC) owned and operated a monorail connecting nine hotels along the Las Vegas strip and financed its operations through a series of various industrial revenue bonds. LVMC executed a financing agreement that granted a security interest in all of LVMC’s existing and future contract rights under LVMC’s franchise agreement, “net project revenues” and all proceeds thereof. In other words, among other collateral, the bondholders parted with cash in exchange for a security interest in LVMC’s interest in future cash flows.

While LVMC’s revenues far exceeded its operating costs, its positive cash flow barely covered 10 percent of its scheduled debt service. After commencing its chapter 11 case, LVMC sought use of its cash collateral on a nonconsensual basis. The trustee of the senior bonds objected, arguing that all money derived from the monorail operation was “proceeds” of its pre-petition collateral for purposes of § 552(b). In the context of considering these cash-collateral motions, Judge Markell ruled that the trustee did not have a lien on the profits

⁶ According to the legislative history, the amendment to § 552(b) “clarifies the bankruptcy treatment of hotel revenues.” (emphasis added). Similarly, the legislative history to § 928(a), a section that protects post-petition income streams for “special revenue” bonds in municipal bankruptcy cases, describes the enactment as necessary to avoid the “interpretation” that § 552(b) may otherwise cut off the lien on post-petition revenue streams. Both provisions, therefore, guard against narrow interpretations of § 552(b). Compare H.R. Rep. 103-834, 103rd Cong., 2d Sess 27-29 (Oct. 4, 1994); 140 Cong. Rec. H10768 (Oct. 4, 1994), with S. Rep. No. 506, 100th Cong., 2d Sess 5-7 (Sept. 14, 1988).

⁷ Prior to legislative rescue, hotel revenues could have been interpreted as “proceeds” within § 552(b). See Randall Klein and Alan Solow, “The Hotel Revenues Paradox: Taking a Pre-Petition Lien on Future Income Streams,” *Critical Issues in Chapter 11 Bankruptcies*, American Bar Association Division for Professional Education (1994).

⁸ “Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306,” 69 *Tul. L. Rev.* 645 (1995).

⁹ *In re Ebbler Furniture and Appliances Inc.*, 804 F.2d 87, 93 (7th Cir. 1986) (Easterbrook, J., concurring) (pre-petition lender not entitled to “going-concern” value where it did not contract for security interest in borrower’s “name, reputation, customer list, staff, and so on”).

¹⁰ *SRJ*, 150 B.R. 933.

¹¹ *In re Media Properties Inc.*, 311 B.R. 244 (Bankr. W.D. Wis. 2004).

¹² *SRJ* and *Media Properties* involved sales of entire businesses. If a purchaser simply pays a lump sum for the net present value of future EBITDA, each portion of EBITDA realized post-petition and prior to the sale of the enterprise is simply a component part of the proceeds.

¹³ *Gen. Elec. Credit Co. Inc. v. Cleary Bros. Constr. Co. Inc.* (*In re Cleary Bros. Constr. Co. Inc.*), 9 B.R. 40 (S.D. Fla. 1980), criticized in “Rethinking Proceeds” at n.65-73.

¹⁴ *In re Hastie*, 2 F.3d 1042 (10th Cir. 1993), criticized in “Rethinking Proceeds” at n.19-39.

¹⁵ *In re West Chestnut Realty of Haverford Inc.*, 166 B.R. 53 (Bankr. E.D. Pa. 1993). See generally Klein and Solow, “Section 552: Postpetition Liens on Future Income Streams,” *Norton’s Annual Survey of Bankruptcy Law* 1011(1995) (criticizing *Hastie*, *West Chestnut Realty* and others).

¹⁶ Gilmore cites favorably to the *dictum* from Justice Brandeis who assumed the validity, under New York law, of a present security interest in future accounts. See *Benedict v. Ratner*, 268 U.S. 353, 359 (1925) (“It may be assumed that...the original assignment of future acquired accounts became operative under the state law, both as to those paid over to [lienholder] before the bankruptcy proceedings and as to those collected by the receiver”).

¹⁷ No. 10-10464 (Bankr. D. Nev. Feb. 17, 2010) (Markell, J.), available at http://scholar.google.com/scholar_case?case=5901276149939110770&q=%22las+vegas+monorail%22+%26+%22cash+collateral%22&hl=en&as_sdt=400002.

of LVMC generated post-petition and therefore did not have an interest entitled to adequate protection.

Judge Markell spent the majority of his ruling parsing the granting clause in the security agreement. With respect to the grant of security on contract rights in the franchise agreement, he ruled that a security interest in “contract rights” is not the same as a security interest in all of the entitlements and privileges represented by the franchise agreement. If contract rights were connected in some way to revenues from monorail operations, fares would be the product of use of the monorail trains and track, to which the trustee held no security grant, not the proceeds of the “intangible right to run the business.” In his view, a grant of security in “contract rights” is a grant of security in a “limited subset of rights” and is not the same as a security interest in the franchise agreement itself.

As for the grant of security in “net project revenues,” Judge Markell noted that this was not a grant of security in gross revenues because it could not be calculated until after the payment of operation and maintenance costs from gross revenues. The trustee could not satisfy the burden of establishing the extent of its interest where it did not introduce evidence of any such costs. At the end of a long and scathing opinion, the only amounts Judge Markell found to constitute cash collateral of the trustee were pre-petition funds on deposit.

He blamed the language of the security documents, stating that the financing agreement is “somewhat convoluted,” “confuses more than it clarifies,” has a “continuous blob” of the security grant and is “not a model of clarity.” He pointed out collateral that the financing agreement does not cover, including intangible rights, gross revenues, the franchise agreement itself, and trains and track. Judge Markell even criticized the placement of the security grant in “contract rights” in the franchise agreement. Because the grant is found last in a list of other agreements, the “intent that emerges” is that these security interests were intended only for a contingency situation where the trustee wanted to take over the monorail if a planned extension of the monorail did not occur.

One might conclude that Judge Markell is saying that this case could have been decided differently had the financing agreement contained the correct magic words to describe the trustee’s security. For example, what

if the security grant had included general intangibles, the franchise agreement¹⁸ and all present and future rights to income generated by the franchise agreement? Behind the semantics, the intent of LVMC and the trustee is manifest. LVMC obtained financing for the monorail by granting liens in the future net profits to be generated by the monorail, which the parties did describe in numerous ways, including all currently owned and after-acquired contract rights stemming from the franchise agreement and all other operating contracts, “net project revenues,” all money, funds and balances, revenues, income and profits added to, earned or accrued on any net project revenues, all proceeds of the foregoing and all rights to payment, and every other kind and other forms of obligations and receivables and other property that at any given time constitute proceeds of the foregoing. None of these satisfied Judge Markell. Instead, he artfully construed the financing agreement and the trustee’s assertions as to avoid more difficult arguments such as those addressed in *Rethinking Proceeds, SRJ* and *Media Properties*.

Conclusion

The danger of a narrow opinion is that it may be relied on for the wrong propositions in connection with more consequential debates. Cash-flow lenders that lend on future income streams want assurances that those streams constitute proceeds of their pre-petition collateral and are entitled to adequate protection. Had the trustee in *Monorail* moved to sell LVMC’s business on either the first day or the last day of LVMC’s bankruptcy case, the trustee would have received all sale proceeds, which would have been equal to the net present value of the future income streams. The *Monorail* decision and others like it¹⁹ have emboldened those who wish to misinterpret § 552(b) as cutting off a lender’s security in post-petition profits. It took the hotel-lending industry years of litigation and ultimately legislative intervention to protect and preserve pre-petition hotel loans. One would hope that similar legislative efforts will not be necessary to preserve the value of pre-petition liens on future income streams. Section 552(b) and the definition of “proceeds” are already broad enough to capture pre-petition

liens on future income streams and the proceeds thereof—just as Gilmore would have wanted it. ■

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¹⁸ In this respect, *Monorail* is consistent with *In re HRC Joint Venture*, 175 B.R. 948 (Bankr. S.D. Ohio 1994).

¹⁹ *In re Cafeteria Operators LP*, 299 B.R. 400 (Bankr. N.D. Tex. 2003). See generally Bruce H. White and William L. Medford, “Section 552’s Hidden Threat to Secured Creditors: There Goes Your Equity Cushion,” *ABI Journal*, Vol. XXV, No. 4, p.28, May 2006.