

# Income Streams: An Economic Analysis of Rents as Proceeds

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In a previously published article<sup>1</sup> the authors posited that, just as U.S. Bankruptcy Code Section 552(b) protects asset-based lenders' liens on post-petition proceeds of prepetition inventory and receivables, it should similarly protect cash-flow lenders' liens on post-petition income streams as proceeds of the prepetition capacity to generate future EBITDA.

The article argued that the *In re Las Vegas Monorail Company*<sup>2</sup> decision and others like it misinterpret § 552(b) as cutting off a lender's security in post-petition profits. A growing body of scholarship and case law—including the recent *Bloomfield State Bank v. U.S.*<sup>3</sup> decision penned by Judge Richard A. Posner of the 7th U.S. Circuit Court of Appeals—support the proposition that § 552(b) and the Article 9 definition of "proceeds" are broad enough to capture liens on post-petition income

streams as proceeds of the prepetition earning capacity of assets.<sup>4</sup>

This result is consistent with the economic reality of the underwriting and syndication of cash-flow loans. Cash-flow lenders that lend based on enterprise value should have assurance that their security interest includes a lien with priority over subsequent competing interests, including the bankruptcy estate and the IRS, on future profits generated by all existing collateral.

### ***Bloomfield State Bank***

The facts of *Bloomfield* are straightforward. Bloomfield State Bank made a mortgage loan secured by the borrower's real property and all existing and future rents. The borrower failed to pay its lender and the IRS. The federal taxing agency filed a tax lien against all of the borrower's property, including the real estate. A receiver appointed to administer the real estate then entered into new leases and collected \$82,675 in rents. The IRS claimed that its tax lien primed Bloomfield's lien on these rents because the leases were entered into and the rents were received after

the tax lien was filed. The district court granted summary judgment in favor of the IRS. On appeal, the 7th Circuit reversed and remanded, directing that judgment be ordered for Bloomfield.

Under the Federal Tax Lien Act (FTLA), IRS tax liens have priority on certain "after-acquired" property. The issue in *Bloomfield* was whether the rents collected by the receiver were proceeds of the underlying real estate subject to the preexisting mortgage lien or were unencumbered after-acquired property. In tax law parlance, the issue was whether the property securing the bank lien was "in existence" prior to the IRS tax lien. The IRS argued that the "property" at issue was the rental income, which did not exist at the time of the tax lien. Bloomfield argued, and the 7th Circuit agreed, that the relevant "property" was the real estate and that the rents were simply proceeds of the preexisting real property.

The district court found no basis to distinguish rents from accounts, citing prior 7th Circuit authority that granted the IRS priority in accounts

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receivable arising after the filing of a tax lien. This authority relied on the “choateness doctrine” to define the “existence” requirement for a creditor’s lien to trump a federal tax lien.<sup>5</sup> However, to the extent the choateness doctrine provided the foundation for such precedent, Posner soundly dismantled it. “The word ‘choate,’ used as it is in law to mean ‘in existence’... is a barbarism, albeit a venerable one.”<sup>6</sup> Despite the fact that it is essentially an invented term, it is ingrained in the legal vernacular and widely used. “Not used by us! For the law’s use of ‘choate’ is not only a sign of ignorance but also a source of confusion.”<sup>7</sup>

After correcting the widespread misunderstanding attached to the term “choate,” Posner reviewed both the language of the FTLA and Supreme Court case law and found that “[t]he ‘property’ that must be in existence for a lender’s lien to take priority over a federal tax lien is the property that, by virtue of a perfected security in it, is a source of value for repaying a loan in the event of a default....”<sup>8</sup> In this case, “the real estate that generated the rental income at issue...existed when the mortgage was issued and thus before the tax lien attached; the rental income was proceeds of that property, which pre-existed the tax lien.”<sup>9</sup>

The IRS argued that the rents were not “proceeds” of the real estate because the real estate had not been sold. The 7th Circuit disagreed, noting that no one would dispute the priority among the creditors had the real estate been sold rather than rented. “Whether the proceeds from the enforcement of a lender’s lien take the form of sale income or rental income is a detail of no significance. To say that a parcel of land is ‘sold’ rather than ‘rented’ just means that the owner sells the use of the land forever rather than for a limited period. Sale income and rental income are just two forms of proceeds from land (or improvements on it).”<sup>10</sup>

Posner went on to explain that if the rule were as the district court held, with a secured lender unable to capture those proceeds, the effect would be to skew incentives. For example, to avoid a tax lien, a mortgagee in possession would sell instead of renting the real property even if renting would yield the higher value. The court pointed out that no one would benefit from such a curtailment of opportunities to maximize the value of assets.

**From Bloomfield to Bankruptcy**

While *Bloomfield* is not a bankruptcy case, the analogy to § 552(b) is fitting. Both the FTLA and § 552(b) are designed to cut off the priority of a security interest on after-acquired property but not on proceeds of existing property. Both are designed to avoid windfall recoveries for secured lenders with respect to property that was not “in existence” at the time of the intervening tax lien or bankruptcy case. But when a secured lender underwrites and prices its loan based on the value of the borrower’s business (including the earning power of the collateral package) and seeks repayment from its security in that “source of value,” there is no windfall.

When a mortgage lender makes a loan to support an apartment complex, a shopping mall, or a hotel, that loan is based on the present value of the earning power of that property. Although it took legislative action to amend § 552(b) to protect a prepetition lender’s interest in post-petition hotel revenues, the economic argument at the heart of each of these examples is the same as set forth in *Bloomfield*. This concept is similarly applicable in the context of income streams of FCC licenses,<sup>11</sup> broadcast licenses,<sup>12</sup> and liquor licenses.<sup>13</sup>

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While some may continue to equate future income streams to future accounts, as the district court did in *Bloomfield*, that analogy breaks down. Posner pointed out in *Bloomfield* that the account example would be more akin to a situation in which a lender only had a lien on leases, with the cash generated specifically from rentals, which differs from a situation in which a lender has a mortgage on a borrower's real property. "The sort of receivable to which the statute denies priority over a federal tax lien is one that does not match an existing asset; a month's rent is a receivable that matches the value of the real property for that month."<sup>14</sup>

A mortgage lender with a lien on all of a borrower's real property is like a cash-flow lender with a blanket lien on the entirety of a business. Both real property lending and cash-flow lending are based on the net present value of future income streams generated from the use of existing collateral. In the case of real property, it is irrelevant whether leases generating rents are in existence or whether the rent is paid at the time of the IRS lien or commencement of a bankruptcy case. Rents are proceeds realized from the use of the income-producing real property. A cash-flow

loan is made based on the enterprise value of the commercial borrower's assets, which often include not just hard assets, but also intangible assets such as goodwill, customer lists, and a sales force bound by non-compete agreements.

It is similarly irrelevant whether contracts giving rise to accounts exist as of the filing date. When the fully encumbered assets of a cash-flow borrower are sold as a going concern, assuming no new assets (other than proceeds) were acquired by the business after the IRS lien or commencement of a case, all sale proceeds would be subject to a lien in favor of the secured creditor. In a sale during bankruptcy, these proceeds would be subject to surcharge under § 506(c) for the costs of preservation and disposition, and in the case of enhancement of value, would be subject to an allocation in favor of the estate based on the "equities of the case" exception to § 552. But just as "[s]ale income and rental income are just two forms of proceeds from land,"<sup>15</sup> post-petition sale proceeds and post-petition EBITDA are just two forms of proceeds from the property of the estate existing as of the filing date.

#### Economic Reality

The *Bloomfield* opinion is based on straightforward economic reality. When a mortgage lender has a lien

on real property, that lender should be able to look to the proceeds of its collateral (i.e., the real estate) to repay its claim. Allowing others to prime the mortgage lender for certain subsets of proceeds generated by the real estate based on the name given to those proceeds or the timing of when they are generated would create incentives to avoid those priming liens by using or disposing of the property in ways other than its highest and best use. Similarly, a cash-flow lender making a loan to a business wants confidence in its security. If these lenders believed that they were in jeopardy of getting primed with respect to certain proceeds, it would become more difficult to underwrite cash-flow loans, and the loans that were made would be priced at higher rates to justify the risk.

Narrow interpretations of proceeds and a secured lender's security will cause not only inefficient uses of collateral, but also a tightening of the cash-flow lending market.<sup>16</sup> These are the same concerns that led to the creation of Article 9 in Grant Gilmore's day to allow for perfection of liens in future interests and later revision of Article 9 to expand the definition of "proceeds" to protect commercial expectations and to expand previously rigid court rulings concerning rights to proceeds under §552(b). In each instance, had revisions

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not been made, the lending industry (and its borrowers) would have suffered.

Legislative intervention should not be necessary where Article 9 and §552(b) are already broad enough to cover a cash-flow lender's interests in cash flows generated post-petition by assets that were encumbered by a lender prepetition. The economic justification is the same as succinctly stated by Posner in *Bloomfield*— semantics should not deprive lenders of the source of value for repayment of a loan in the event of a default. ■



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<sup>1</sup> "The Pre-Petition Right to Post-Petition Income Streams and the Misinterpretation of § 552," 29-Jan *Am. Bankr. Inst. J.* 58 (2011).

<sup>2</sup> 429 B.R. 317 (Bankr. D. Nev. 2010).

<sup>3</sup> No. 10-3939, 2011 WL 1773953 (7th Cir. May 11, 2011) (Posner, J.).

<sup>4</sup> See the authorities referenced in "Misinterpretation of § 552," see also Steven L. Schwarcz, "Protecting Rights, Preventing Windfalls: A Model for Harmonizing State and Federal Laws on Floating Liens," 75 N.C. L. Rev. 403 (1997).

<sup>5</sup> See *J.D. Court, Inc. v. U.S.*, 712 F.2d 258, 262-63 (7th Cir. 1983) ("[T]his court, as recently as 1979, recognized the continued viability of the 'choateness doctrine' under the Tax Lien Act of 1966....").

<sup>6</sup> *Bloomfield* at \*2.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at \*3 (emphasis added).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> See *MLQ Investors, L.P. v. Pacific Quadracasting, Inc.*, 146 F.3d 746 (9th Cir. 1998) (holding that proceeds from the sale of an FCC license constituted general intangibles in which the secured creditor held a lien perfected prior to the IRS tax lien and therefore the secured creditor's interest in sale proceeds prevailed over the IRS). *MLQ* was cited in *Bloomfield*. See *Bloomfield* at \*3.

<sup>12</sup> See *Continental Bank, N.A. v. Everett, et al.*, 964 F.2d 701, 704 (7th Cir. 1992) (Easterbrook, J.) (stating where a secured party could not take a lien on a broadcast license, "A broadcast license is not a tangible asset. It can't be melted down, sold as scrap, or packed up and sent to Alaska.... The value of the license...lay in the income stream from those advertisers. Continental wanted, and got, a security interest in that income....").

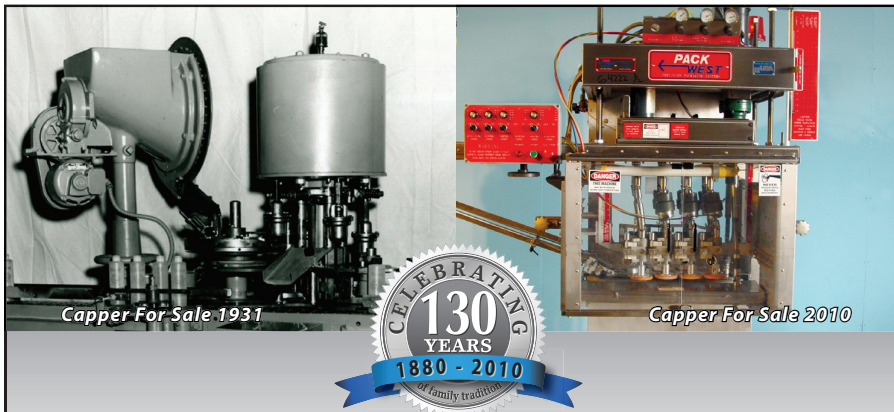
<sup>13</sup> See the progression of recent bankruptcy decisions relating to proceeds of New Jersey liquor licenses. *Straffi v. New Jersey (In re Chris-Don, Inc.)*, 308 B.R. 214 (D. N.J. 2004) (holding that despite state law providing that liquor licenses are not "property," a lender's security interest in general intangibles includes a security interest in a liquor license and proceeds from the sale of the liquor license); compare *In re Main Street Beverage Corp., et al.*, 232 B.R. 303 (D. N.J. 1998) (holding that lender did not have a valid security interest in the right to receive payment of the proceeds of the sale of a liquor license, noting that while, as a matter of commercial law, the economic value of the liquor license should perhaps be able to be utilized, it is for the state legislature to choose to redefine the nature of a liquor license under state law).

<sup>14</sup> *Bloomfield* at \*4. In addition, where precedent underlying the account-analogy argument is based on the choateness doctrine, reliance on such precedent should be reevaluated in light of the *Bloomfield* court's discrediting of that doctrine.

<sup>15</sup> *Id.* at \*3.

<sup>16</sup> For a more analytically inflexible view of proceeds, see G. Ray Warner, "Article 9's Bankrupt Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC 'Proceeds' Definition," 46 *Gonzaga L. Rev.* 541 (2010/11)

(arguing that the "generation of value" theory of proceeds as incorporated in revised Article 9 undermines § 552). See also *Spectrum Scan LLC, et al. v. Valley Bank and Trust Co. (In re Tracy Broadcasting Corp.)*, 438 B.R. 323, 330-31 (Bankr. D. Colo. 2010) (disagreeing with *In re Media Properties, Inc.*, 311 B.R. 244 (Bankr. W.D. Wisc. 2004), which held that a prepetition lien on general intangibles (but not on an FCC license) encompassed the enterprise value of a television station when realized upon post-petition sale).



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