Cash is King: Determining the Extent of a Secured Lender's Liens Over Revenues Generated During a Bankruptcy Case

Julian I. Gurule

Julian I. Gurule
Julian Gurule is an associate in the Los Angeles office of Milbank, Tweed, Hadley & McCloy and a member of the firm's Financial Restructuring Group.

I. Introduction

In business bankruptcy cases, a debtor's viability and the potential recoveries for the debtor's various creditors often depend on who gets (or who gets to use) the debtor's cash. Cash generated by the debtor's business post-petition is a consistent source of conflict among the debtor and its secured and unsecured creditors. Secured pre-petition lenders with liens over substantially all of the debtor's pre-petition assets often assert liens over the debtor's post-petition revenues, while the debtor and unsecured creditors often contend that the cash is unencumbered and therefore available to finance the debtor's post-petition business operations and fund unsecured creditor recoveries.

When litigated, the outcome of this dispute will likely play a critical role in the overall resolution of a bankruptcy case. Aside from impacting relative recoveries, from an operational perspective, the Bankruptcy Code provides that a debtor cannot use its lender's cash collateral[1] without either the lender's consent or a bankruptcy court order authorizing cash collateral use.[2] Thus, the question of whether the secured lender possesses liens over post-petition cash (i.e., whether the cash is the lender's cash collateral) may, in turn, determine whether the debtor can use such post-petition cash to move forward towards reorganization or be forced to liquidate for lack of cash.

The issue of pre-petition liens asserted over post-petition revenues lays bare a tension between foundational, yet competing, policy objectives embodied in the Bankruptcy Code. Numerous Bankruptcy Code provisions affirm or supplement the rights of secured creditors, reflecting congressional intent to largely honor in bankruptcy the rights a secured lender bargained for when extending a loan.[3] A faithful adherence to this policy objective would allow the secured lender's liens to continue to encumber the debtor's revenues after the commencement of the bankruptcy case to the extent provided in the parties' security agreement. Allowing a secured lender's liens to extend to post-petition revenues would also, in theory, encourage lending and lower financing costs for borrowers, particularly in industries where future revenue streams are a major component of collateral packages.[4]

Certain fundamental policy concerns, however, weigh in favor of severing a lender's liens over post-petition cash. For example, chapter 11's most basic purpose is to enable the debtor to reorganize its business affairs and continue to provide its stakeholders and society with all the benefits attendant to its continued operation as a going concern.[5] If the secured lender's liens on post-petition revenues were cut off, the debtor would have access to a source of unencumbered cash with which to fund its restructuring expenses and business operations in bankruptcy, thereby increasing the likelihood of a successful reorganization. Unencumbered cash would also help achieve the policy objectives of providing the debtor with a "fresh start" and increasing any potential recoveries for other constituents, including for general unsecured creditors and equity holders.[6] As discussed in the following section, Bankruptcy Code section 552 attempts to achieve a compromise between these varied policy interests.

II. Overview of Section 552

Section 552 is the starting point for determining whether a secured lender will maintain a lien over post-petition revenues. Section 552(a) establishes the general rule that the property that the debtor or it's estate acquires after the commencement of the bankruptcy case is not subject to any lien granted by the debtor pre-petition.[7]

Section 552(a), however, is subject to the exceptions set forth in section 552(b), which blur the bright-line rule and often lead to litigation between secured lenders and competing stakeholders. Section 552(b)(1) provides that, subject to certain other Bankruptcy Code provisions,[8] if a debtor and a secured lender entered into a security agreement that granted the lender liens over the debtor's pre-petition property as well as the proceeds, products, offspring or profits of such property, then the lender's liens extend to any such proceeds, products, offspring or profits acquired by the estate during the bankruptcy case to the extent provided by the security agreement and applicable non-bankruptcy law.[9] Section 552(b)(2) provides a similar exception for rents of pre-petition collateral and fees, charges, accounts, or other payments for the use or occupancy of hotel and motel rooms.[10] [11] [12]

The Bankruptcy Code places the burden of proof on the secured creditor asserting an interest in cash collateral, including any revenues that the lender believes would fall within the section 552(b) exceptions.[13]

III. Case Law Treatment of Section 552 and Post-Petition Revenues

The decision of the Ninth Circuit Bankruptcy Appellate Panel (the "BAP") last year in *Far East National Bank v. United States Trustee (In re Premier Golf Properties, LP)*,[14] discussed in detail the application of section 552(b) to post-petition revenues, and held that the lender's liens were severed with respect to greens fees and driving range fees generated by the debtor's post-petition operation of a golf course and driving range.

In *Premier Golf*, Far East National Bank (the "Bank") loaned the debtor $11.5 million and received security interests in, among other things, the debtor's personal property, including general intangibles, license fees and "all proceeds thereof," and real property and all rents, profits, issues, and revenues from the real property.[15]

The debtor filed a chapter 11 petition in May 2011 and opened a cash collateral account into which it deposited its pre-petition cash and the cash generated from the sale of pre-petition goods and inventory over which the Bank had a lien.[16] The debtor did not, however, deposit into the cash collateral account post-petition revenue received as greens fees or driving range fees.[17]

The Bank filed a motion to terminate the debtor's use of cash collateral, arguing that the greens fees and driving range fees fell into section 552(b)'s exceptions for "rents" derived from the use of its real property collateral or, alternatively, as "proceeds" of its personal property collateral.[18] The debtor argued that the cash was generated by the post-petition operation of its business, rather than as rents or proceeds of the Bank's collateral, and therefore the cash was not subject to the Bank's liens pursuant to section 552(a).[19]

The Bankruptcy Court denied the Bank's motion, holding that the greens fees and driving range fees were not rents or proceeds of the Bank's collateral and, therefore, not its cash collateral. The Bank appealed to the BAP.[20]

The BAP began its analysis by noting the basic policy tension between the parties' respective arguments. The court observed that the Ninth Circuit has held that the general purpose of section 552(a) is "to allow a debtor to gather into the estate as much money as possible to satisfy the claims of all creditors."[21] In keeping with this goal, the BAP reasoned that, although the section 552(b) exceptions permit secured lenders "to maintain a bargained-for interest in certain items of collateral," the exceptions nevertheless are "narrow."[22]

Turning to the Bank's arguments, the BAP considered whether the greens fees and driving range fees constituted "rents" of the Bank's real property collateral. The BAP based its analysis on *Zeeway Corp. v. Rio Salado Bank (In re Zeeway Corp.)*,[23] a previous BAP decision that established a test to determine whether post-petition revenues qualify as "rents" for purposes of section 552(b). In *Zeeway Corp.*, the BAP held that (a) income produced from the real property is considered rents and that (b) revenues generated from services rendered or that are the result of specific business conducted on the property are not rents.[24] Applying this test, the *Zeeway Corp.* court held that post-petition revenues—in that case, gate receipts received by the debtor in the operation of a racetrack—were not rents because they were not generated by the use or occupancy of the land, but rather by the services that the debtor provided to its customers.[25]

In *Premier Golf*, the BAP referenced the Bankruptcy Court's findings that "the key to a golf club's generation of income is due to the regular planting, seeding, mowing, repositioning holes, watering, fertilizing, and maintaining the golf course."[26] The BAP reasoned that in light of the debtor's efforts, the revenues from greens fees and driving range fees were not produced from the real property collateral "as much as generated by other services that are performed on the Land"[27] and therefore did not qualify as rents under the *Zeeway Corp.* test.

The BAP also rejected the Bank's alternative argument that the cash constituted proceeds of the Bank's pre-petition personal property collateral, namely the licenses that the debtor granted to golfers to use the golf course and driving range.[28] The BAP observed that proceeds of licenses are personal property governed by the UCC. Under the UCC, the BAP reasoned that the relevant question was "whether the revenue from the Golf Club's green fees and driving range fees was acquired on the disposition of, or collected on, the Golf Club's general intangible property, making them proceeds of the Bank's collateral."[29]

The BAP, however, does not seem to have applied this UCC analysis in reaching its conclusion. Instead, the court adopted a different standard (similar to the *Zeeway Corp.* test for rents), which required that "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…. Revenue generated post-petition solely as a result of a debtor's labor is not subject to a creditor's pre-petition interest."[30] Applying this standard, the BAP found that the cash generated was not simply in consideration for a license to use the real property, but "largely the result of the Golf Club's labor and own operational resources, which make the license valuable to golfers."[31] Thus, the BAP concluded, although the green fees and driving range fees were "collected on" the licenses, they were not proceeds generated from the Bank's collateral for purposes of section 552(b) and therefore not the Bank's cash collateral.[32]

The *Premier Golf* court's conclusion is consistent with much of the case law that addresses the extent of a lender's liens over post-petition revenues. The analyses often boil down to determining whether the revenues are better considered as (a) a recovery on pre-petition collateral or (b) compensation for labor or services rendered by the debtor post-petition.

The Ninth Circuit Court of Appeals' reasoning in *Philip Morris Capital Corp. v. Bering Trader, Inc. (In re Bering Trader, Inc.)*, for example, touched on this distinction in rejecting a secured lender's argument that its pre-petition security interest in "accounts" (but not "rents") was sufficient for the lender's liens to extend to rental income received by the debtor post-petition pursuant to section 552(b).[33] In *Bering Trader*, the court observed that "[e]ach of the excepted types of property enumerated in section 552(b) is derivative. That is, it necessarily derives from the sale, exchange or other disposition of other encumbered property. Accounts are not necessarily derivative. Accounts could include, for example, a right to payment for services rendered."[34] Thus, in its analysis of what was and was not included in section 552(b), the Ninth Circuit underlined the distinction between revenues generated through the disposition of collateral and revenues generated through services provided.

The Ninth Circuit BAP's decision in *Arkison v. Frontier Asset Management, LLC (In re Skagit Pacific Corp.)*, further clarified that "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."[35] In *Skagit Pacific*, the debtor manufactured and sold modular office trailers. The secured creditor held a lien on the debtor's accounts receivable and their proceeds.[36] The creditor asserted that, pursuant to section 552(b), this security interest extended to a payment received by the debtor for a contract that was originated and completed post-petition as "proceeds" of the creditor's accounts receivable collateral.[37]

The BAP rejected the secured creditor's argument, reasoning that:

> Revenue generated post-petition solely as a result of a debtor's labor is not subject to a creditor's pre-petition interest…. Thus, any portion of the DOT Account Receivable attributable to the Debtor's services as part of the manufacturing or production of the modules would not be considered proceeds under § 552(b). And what is produced by the debtor's added value by its labor (or the value added by others' labor) throughout the process of the reorganization effort will likewise not be subject to a creditor's pre-petition interest.[38]

The BAP also noted that where post-petition acts create an account receivable, such post-petition receivable could not be proceeds since no underlying collateral existed pre-petition.[39]

These results, however, are not universal. In some cases, even in some of the most service-oriented industries, the courts struggle with severing the secured lender's lien. For example, in *T-H New Orleans Ltd. Partnership v. Financial Security Assurance, Inc. (In re T-H New Orleans Ltd. Partnership)*, which involved a secured lender's asserted lien over post-petition revenues generated by the debtor's operation of its hotel, the Fifth Circuit Court of Appeals reasoned that:

> [T]he physical condition of the Hotel and its location are more essential to the Hotel's ability to generate revenue than the services it provides. Take away the land and the bricks and mortar, and there is nothing upon which the collateral services of entertainment, food, recreational activities, laundry and cleaning could exist. The converse is not true, for many chains of motels have been successful in providing "simply a good night's rest at the most economical price." Therefore, we reject the notion that a hotel's revenues are so intertwined and dependent on the hotel's service that one cannot conclude the revenues are rent for purposes of § 552(b).[40]

Although the debate over lenders' liens on hotel revenues was largely resolved by Congress's enactment of section 552(b)

(2) (which expressly allowed pre-petition liens to extend to post-petition hotel receipts), the underlying logic articulated by the *T-H New Orleans* court remains viable and directly contrary to the reasoning in cases like *Premier Golf*.

Lastly, in contrast to the foregoing cases, some courts adopt a less absolutist and more practical approach in determining the various stakeholders' interests in post-petition revenues and cash. In *In re Cafeteria Operators, L.P.*, the court found that post-petition revenues generated from the operation of the debtor's restaurant largely resulted from the debtor's provision of food services to customers,[41] but the court recognized that, to an extent, the restaurant revenues also represented a disposition of the food and beverage inventory that was the lender's collateral.[42] As a compromise, the court held that the lender would maintain its liens over the debtor's cash in an amount equal to the cost of the inventory used in each post-petition sale.[43]

This pragmatic approach, however, is not workable in every case. In *Cafeteria Operators*, the court benefitted from being presented with identifiable and readily valued collateral that was disposed of during the bankruptcy case. In many other cases, such as in *Premier Golf,* where the collateral in dispute was real property, the *Cafeteria Operators* solution would likely be unavailable because the collateral is not disposed of as part of the generation of post-petition revenues.

IV. Conclusion

Although the diversity of businesses that file bankruptcy cases, each with its own model for generating revenue, prevents any single statute or body of case law from fully resolving the issue of liens over post-petition cash, the basic distinction between realization on collateral versus compensation for labor or services provides substantial initial guidance for courts and attorneys that are faced with this question in a given case. ■

Endnotes

1 "Cash Collateral" is broadly defined in 11 U.S.C. § 363(a) to include "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest."

2 *See* 11 U.S.C. § 363(c). In practice, the debtor and its secured lender often negotiate an agreement, subject to bankruptcy court approval, that provides for the secured lender's consent to the debtor's cash collateral use (subject to various conditions and limitations) in exchange for certain adequate protection, including, among other things, a lien on cash generated post-petition (notwithstanding § 552's bar) to the extent that the debtor's use of the cash results in a diminution in the value of the lender's collateral. This basic arrangement helps avoid potential disputes and litigation over the debtor's use of post-petition cash.

3 *See, e.g.*, 11 U.S.C. § 362(d) (providing secured creditors with relief from the automatic stay under certain circumstances); 11 U.S.C. § 363(c)(2) (prohibiting use of secured creditor's cash collateral absent consent or court authorization); 11 U.S.C. § 364(d) (allowing priming or equivalent priority post-petition financing only if secured creditor's interest is adequately protected); 11 U.S.C. § 1129(b)(2) (heightened standard for cram-down of secured claims in Chapter 11 plan relative to unsecured claims); *see also In re SI Grand Traverse LLC*, 450 B.R. 703, 705 (Bankr. W.D. Mich. 2011) (stating that "Congress has expressed in the strongest terms the federal policy of protecting a secured creditor's interest in collateral generally, cash collateral more specifically, and even more specifically, hotel rents . . . .")

4 *See Fin. Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. P'ship (In re Days Cal. Riverside Ltd. P'ship)*, 27 F.3d 374, 377 (9th Cir. 1994) (holding that terminating liens over post-petition revenues for hotel borrowers "runs counter to a major premise of hotel financing," in which the value of the property is largely determined by the cash flow it generates).

5 *See, e.g.*, *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 808 F.2d 363, 373 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988).

6 *See Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (holding that "[o]ne of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.'")

7 *See* 11 U.S.C. § 552(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.")

8 The referenced provisions are: 11 U.S.C. § 363 (use, sale or lease of property); 11 U.S.C. § 506(c) (surcharge against secured creditor's collateral); 11 U.S.C. § 522 (bankruptcy exemptions); 11 U.S.C. § 544 (trustee's strong arm powers);

11 U.S.C. § 545 (avoidance of statutory liens); 11 U.S.C. § 547 (preference actions); and 11 U.S.C. § 548 (fraudulent transfer actions).

9 *See* 11 U.S.C. § 552(b)(1).

10 *See* 11 U.S.C. § 552(b)(2). Note, however, that section 552(b)(2) does not contain the limitation set forth in section 552(b)(1) that the lien has to be otherwise enforceable under applicable non-bankruptcy law.

11 Sections 552(b)(1) and (2) also provide the Bankruptcy Court with the authority, based on the "equities of the case," to limit a secured creditor's liens otherwise allowed under § 552(b).

12 A useful summary of the test for whether a security interest survives § 552(a) was stated by the court in *Am. President Lines, Ltd. v. Lykes Bros. Steamship Co. (In re Lykes Bros. Steamship Co.)*, 216 B.R. 856, 863-64 (Bankr. M.D. Fla. 1996) (holding that the secured party must show each of: "(1) The security agreement by its terms must extend to the after-acquired property specified in § 552(b), i.e. 'proceeds, product, offspring or profits of such property.' (2) The after-acquired property itself must fit within one of the categories enumerated in § 552(b). (3) The statutory 'exceptions to the exception' (i.e., §§ 363, 544, 545, 547 and 548) do not apply. (4) The equities do not require otherwise.")

13 *See* 11 U.S.C. § 363(p)(2).

14 477 B.R. 767, 777 (B.A.P. 9th Cir. 2012).

15 *See id.* at 770.

16 There was no dispute that cash generated from the sale of pre-petition goods and inventory was the Bank's cash collateral.

17 *See id.*

18 *See id.* at 770-71.

19 *See id.* at 770.

20 *See id.* at 771.

21 *See id.* at 771-72 (citations and internal quotation marks omitted).

22 *See id.* at 772 (citations and internal quotation marks omitted).

23 71 B.R. 210 (B.A.P. 9th Cir. 1987).

24 *See Golf Properties, supra,* 477 B.R. at 772-75.

25 *See id.* at 772-73; The *Premier Golf* court also noted that a number of bankruptcy courts in other circuits have adopted and applied the *Zeeway Corp.* test to greens fees in golf course bankruptcies and concluded that greens fees were not rents. *See id.* at 773; *see In re GGVXX, Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991); *In re Everett Home Town Ltd. P'ship*, 146 B.R. 453 (Bankr. D. Ariz. 1992).

26 *See Golf Properties,supra,* 477 B.R. at 774.

27 *See id.*

28 *See id.* at 775.

29 *See id.* at 775. Here, the BAP was paraphrasing the test for what constitutes proceeds under the UCC, which 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 . . . ." UCC § 9-102(a)(64).

30 *See Golf Properties, supra,* 477 B.R. at 776 (quoting *Arkison v. Frontier Asset Mgmt., LLC (In re Skagit Pac. Corp.)*, 316 B.R. 330 (B.A.P. 9th Cir. 2004)).

31 *See id.*

32 *See id.*

33 944 F.2d 500, 502 (9th Cir. 1991).

34 *See id.* at 502.

35 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004) (citation omitted).

36 *See id.* at 333.

37 The secured creditor also made a tracing argument, which was rejected by the court. *See id.* at 337-40.

38 *Id.* at 336 (internal citations omitted).

39 *See id.*

40 10 F.3d 1099, 1106 (5th Cir. 1993).

41 299 B.R. 400, 409 (Bankr. N.D. Tex. 2003) ("If consumers were solely purchasing the food component, they would look to the local grocery store, for example, to make such a purchase. Clearly, restaurant customers are paying some premium to have the food prepared prior to consumption and served to them.").

42 *Id.; see also Bus. Bank v. White (In re Timothy Dean Rest. & Bar)*, 342 B.R. 1 (Bankr. D.D.C. 2006) (stating that secured lender could have asserted lien over room service revenues to the extent attributable to encumbered food and beverage inventory, but that lender failed to produce any evidence that the revenues could be identified as proceeds of its collateral); *See In re Las Vegas Monorail Co.*, 429 B.R. 317, 344-45 (Bankr. D. Nev. 2010) (noting that the "equities of the case" limitation in section 552(b) may serve as basis for allocation of revenues between those generated by collateral versus operations).

43 *See Cafeteria Operators, supra,* 299 B.R. at 410.