

THE LIMITS ON PROCEEDS

by

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PROBLEMS FOR DISCUSSION

Problem 1

Bank has a security interest in the Degas Museum's paintings. Will Bank's security interest attach, as proceeds, to the revenue Degas Museum receives from selling museum daily passes, special exhibit passes, or annual memberships?

Problem 2

Digger is a farmer who grows vegetables and raises cows. Bank has a security interest in Digger's cows and crops.

- A. Will Bank's security interest attach, as proceeds, to the calves born to Digger's cows?
- B. If Digger participated in a federal soil conservation program under which Digger receives money for taking acreage out of cultivation, will Bank's security interest attach, as proceeds, to Digger's rights under that federal program? *See In re Kingsley*, [865 F.2d 975](#) (8th Cir. 1989).

Problem 3

Bank has a security interest in all of Doubloon Casino's equipment and general intangibles.

- A. Will Bank's security interest attach to the money that customers put in Doubloon Casino's slot machines, as proceeds of the slot machines? *See In re Value-Added Communications, Inc.*, [139 F.3d 543](#) (5th Cir. 1998); *In re Northeastern Copy Services, Inc.*, [175 B.R. 580](#) (Bankr. E.D. Pa. 1994); *In re S & J Holding Corp.*, [42 B.R. 249](#) (Bankr. S.D. Fla. 1984). *But cf.* G. Ray Warner, *Proceeds in Bankruptcy Under Revised Article 9*, [20 AM. BANKR. INST. J. 22](#), 23 (March 2001).
- B. Will Bank's security interest attach to the money as proceeds of the casino's gaming license? *In re Las Vegas Monorail Co.*, [429 B.R. 317](#) (Bankr. D. Nev. 2010).

Problem 4

Bank has a security interest in Designer's equipment and software. Will Bank's security interest attach, as proceeds, to Designer's rights in any designs created using that equipment and software?

Problem 5

Bank has a security interest in Dealership's inventory of automobiles. The payments that Dealership receives from its customers include amounts for: (i) automobiles purchased; (ii) sales taxes; (iii) registration and titling fees; and (iv) extended warranties. In addition, Dealership occasionally receives from automobile manufacturers incentive payments based on the number of cases sold. To which, if any, of these payments will Bank's security interest attach as proceeds of the inventory? See *In re EEE Auto Sales, Inc.*, [2011 WL 2078544](#) (Bankr. E.D. Va. 2011); *In re Greg James Ventures LLC*, [2008 WL 4829952](#) (Bankr. N.D. Cal. 2008).

Problem 6

Diversified Farm Supply sells fertilizer and seed to farmers. Supplier has a purchase-money security interest in chemicals and fertilizer it has sold to Diversified.

- A. Diversified has commingled Supplier's collateral with other chemicals and fertilizer. Will Supplier's security interest attach, as proceeds, to the payments Diversified receives for the commingled inventory? See *Van Diest Supply Co. v. Shelby County State Bank*, [425 F.3d 437](#) (7th Cir. 2005).
- B. Diversified kept Supplier's collateral segregated from other inventory but has not maintained records that allow it to determine which supplier's inventory went to each customer. Will Supplier's security interest attach, as proceeds, to the payments Diversified receives for any of Diversified's inventory?

Problem 7

Downtown Manufacturing manufactures widgets. In return of a loan, Downtown authenticated a security agreement in favor of Bank. The security agreement describes the collateral as "all existing and after-acquired inventory, equipment, accounts, chattel paper, general intangibles, and commercial tort claims. Some time later, Downtown acquired a tort claim against a utility company for equipment damage and business losses resulting from a fire that destroyed one of Downtown's facilities. Will Bank's security interest attach or all or any portion of that tort claim? See *In re American Cartage, Inc.*, [656 F.3d 82](#) (1st Cir. 2011); *Helms v. Certified Packing Corp.*, [551 F.3d 675](#) (7th Cir. 2008).

RECENT CASES DEALING WITH PROCEEDS

ATTACHMENT ISSUES

PROCEEDS OF COLLATERAL

Property Qualifying as Proceeds

In re K-Ram, Inc.,

[451 B.R. 154](#) (Bankr. D.N.M. 2011)

Funds paid into court registry in connection with debtor's slander of title claim were proceeds of a commercial tort claim. Bank that previously received an Assignment of Any and All Excess Proceeds held a security interest in the commercial tort claim and, because the bank never filed a financing statement, its interest was unperfected and avoidable in the debtor's bankruptcy.

In re Chalmers,

[2011 WL 6217373](#) (Bankr. W.D. Mo. 2011)

Bank with a security interest in all of an insurance agency's assets was entitled to payments from buyer of agency's book of business even though the owner of agency agreed to stay on as an employee of the agency, thereby maintaining the value of the book of business. The payments were by the buyer to the seller agency, not by the agency to the owner, and hence were proceeds of the assets sold, not compensation for post-sale services.

In re HSF Holding, Inc.,

[421 B.R. 716](#) (Bankr. D. Del. 2010)

Creditor's perfected security interest in debtor's rights as buyer under shipbuilding contract covered spare engine delivered with the vessel because the engine was proceeds of that contract.

Bank Rhode Island v. Mixitforme, Inc.,

2007 R.I. Super Lexis (R.I. Super. Ct. 2007)

Funds paid out of collateralized deposit account into court registry were free of the depository's security interest, but debtor's residual interest in the registry was proceeds of the deposit account and the depository's security interest could and did attach to that beneficial interest.

Price v. Nationwide Mutual Insurance Co. of Des Moines,

[152 P.3d 1274](#) (Kan. Ct. App. 2007)

Money received from insurer in settlement of insurance claim resulting from theft of tractor was proceeds of tractor and therefore covered by security interest in tractor.

In re Tower Air, Inc.,

[397 F.3d 191](#) (3d Cir. 2005)

Insurance payable by reason of damage to the collateral is proceeds under old Article 9, even though the original collateral still exists.

Tracing Issues

McCourt v. Triplett,

[2010 WL 3422458](#) (Ark. Ct. App. 2010)

Secured party did not meet its burden in attempting to establish that deposit account contained identifiable proceeds of collateralized accounts and inventory because its only evidence was testimony of the debtor's president that most of the deposits came from such sources. Accordingly, judgment creditor was entitled to all the funds.

444 W. Ocean, LLC v. Simmax Energy (CA), LLC,

[2010 WL 310775](#) (Cal. Ct. App. 2010)

Security interest in debtor's deposit account was perfected by a filed financing statement without evidence that the deposit account contained proceeds of collateralized accounts. Even if evidence of tracing were required, the secured party provided that through the testimony of the debtor's office manager that the recent deposits were proceeds of accounts receivable.

In re NETtel Corp.,

[2008 WL 1932075](#) (Bankr. D. Del. 2008)

Lenders did not show that deposits on hand on the date of the petition were proceeds of collateral because some may have been funds they had loaned and under old Article 9 they could not have a security interest in a deposit account as original collateral. Lenders could also not show that postpetition deposits into a lock box were proceeds of its collateral because, even though the debtor acted as DIP for only 25 days, some of the deposits may have been for postpetition services.

Madisonville State Bank v. Citizens Bank of Texas,

[184 S.W.3d 835](#) (Tex. Ct. App. 2006)

Deposits were not identifiable as proceeds of accounts despite evidence that \$1.3 million of the \$5.3 million deposited during the relevant period were derived from accounts.

In re Furr's Supermarkets, Inc.,

[378 B.R. 418](#) (10th Cir. BAP 2007)

Consignor's inability to trace proceeds of consigned inventory rendered the proceeds unidentifiable and thus not subject to the consignee's security interest.

In re QMECT, Inc.,

[373 B.R. 100](#) (Bankr. N.D. Cal. 2007)

While an account receivable generated by the sale of a piece of inventory may constitute the proceeds of the inventory and the cash collected in payment of an account receivable may constitute the proceeds of the account receivable, new inventory acquired and new accounts generated postpetition are not necessarily proceeds of prior assets of the same type produced in the operation of the debtor's business even if the secured party holds a blanket lien – debtor's electroplating business involved the creation of accounts primarily through the provision of services.

Van Diest Supply Co. v. Shelby County State Bank,
[425 F.3d 437](#) (7th Cir. 2005)

Proceeds from intermingled inventory were not identifiable.

NON-PROCEEDS OF COLLATERAL

In re Wright Group, Inc.,
[443 B.R. 795](#) (Bankr. N.D. Ind. 2011)

Transactions in which patrons of miniature golf course pay for use of the course and receive permission to use a golf club, ball, scorecard, and pencil, are licenses to use the facility; they do not generate proceeds of the equipment and, because they are cash transactions, do not generate accounts. Any security interest in money received from patrons prepetition was not perfected due to a lack of possession. Any security interest in post-petition receipts is cut off by § 552.

In re Premier Golf Properties, LP,
[2011 WL 4352003](#) (Bankr. S.D. Cal. 2011)

Prepetition security interest in accounts and revenues generated by debtor's golf courses, including membership initiation fees, green fees, and driving range fees, did not extend to post-petition receipts because they were not proceeds of prepetition collateral.

In re EEE Auto Sales, Inc.,
[2011 WL 2078544](#) (Bankr. E.D. Va. 2011)

Amounts auto dealer collected from buyers for sales taxes and registration fees were not proceeds of the dealer's inventory.

In re Greg James Ventures LLC,
[2008 WL 4829952](#) (Bankr. N.D. Cal. 2008)

Lender's security interest in debtor's inventory of motor vehicles did not attach as proceeds to postpetition receipts for the sale of extended warranties, fees paid by customers' lenders for originating loans, incentive payments from the manufacturer, or charges for servicing vehicles under warranty, but it did attach as proceeds to receipts for amounts charged for preparing vehicles for sale and to proceeds of parts provided to repair vehicles.

Searcy Farm Supply, LLC v. Merchants & Planters Bank,
[256 S.W.3d 496](#) (Ark. 2007)

Seed supplier with PMSI in farmer's seed did not have priority over bank with earlier perfected security interest in farmer's future crops because crops were not proceeds of the seed and because the jurisdiction had not enacted the alternative provisions of revised Article 9 on production-money security interests.

Insurance Company of the State of Pennsylvania v. HSBC Bank of USA,
[829 N.Y.S.2d 511](#) (N.Y. App. Div. 2007)

Secured party with blanket lien who seized all of the assets of the debtor, a cigarette wholesaler, had to account to the state's subrogee for the commingled but traceable tax proceeds of cigarette sales because no security interest could attach to such funds.

In re Young,
[2011 WL 3799245](#) (Bankr. D.N.M. 2011)

Debtors' member withdrawals from LLC – a form of distribution on account of their equity interests– were not proceeds of their LLC interests and hence Bank's security interest in those membership interests did not attach to the withdrawals. The court treated as dispositive the ruling in *In re Hastie*, 2 F.3d 1042 (10th Cir. 1993), without considering subsequent enactment of § 9-102(a)(64)(B).

In re Las Vegas Monorail Co.,
[429 B.R. 317](#) (Bankr. D. Nev. 2010)

Revenues generated from the operation of a monorail were not proceeds of the debtor's franchise agreement permitting it to operate the monorail. The security interest of the bond trustee in the debtor's "net revenue" subordinated it to operating expenses and left it with a security interest only in the funds deposited with the trustee, not in cash on hand held by the debtor's agent or funds previously diverted into a different deposit account. This security interest in net revenue is not proceeds of other collateral, and therefore to the extent arising postpetition, is cut off by § 552(a).

In re Magnacom Wireless, LLC,
[503 F.3d 984](#) (9th Cir. 2007), *cert. denied*, [128 S. Ct. 2076](#) (2008)

Funds generated by the FCC's sale of new broadcast licenses after it cancelled the bankruptcy debtor's licenses for nonpayment were not proceeds of the debtor's licenses and thus the funds were not property of the estate; the FCC's actions were based on its regulatory authority, not on its status as a secured creditor.

PROCEEDS OF NON-COLLATERAL

Liquor Licenses

Concorde Equity II, LLC v. Bretz,
[2011 WL 5056295](#) (Cal. Ct. App. 2011)

Although state law prohibits the granting of a security interest in a liquor license, the lender's security interest could and did attach to the proceeds of the a liquor license sold by a court-appointed receiver.

In re S & A Restaurant Corp.,

[2010 WL 3619779](#) (Bankr. E.D. Tex. 2010)

Because New Jersey law prohibits liens on liquor licences, landlord that had advanced \$100,000 to tenant to finance the acquisition of liquor licenses did not in fact acquire a security interest in the tenant's liquor licences. Transaction would not be re-characterized as a joint venture or partnership because there was no sharing of profits and losses, merely a loan. Landlord was not entitled to an equitable lien on the proceeds of the liquor licenses.

Tort Claims

In re American Cartage, Inc.,

[656 F.3d 82](#) (1st Cir. 2011)

Security agreement's after-acquired property clause cannot encompass commercial tort claims that did not exist when the security agreement was entered into. While the right to a tort recovery can be proceeds of other collateral, the commercial tort claim itself – and hence standing to pursue a commercial tort claims – cannot be proceeds of other collateral.

Algonquin Power Income Fund v. Christine Falls of New York, Inc.,

[2011 WL 6178802](#) (N.D.N.Y. 2011)

Claim for engineering malpractice could not be assigned under Connecticut law (prior to enactment of revised Article 9) and, even if it could be, security agreement describing the collateral as “any interest in any kind of property or asset, whether real, personal or mixed, and whether tangible or intangible,” while sufficient to cover a chose in action, was not sufficiently specific to cover the existing malpractice claim. Subsequent agreement covering “actions and rights in action . . . arising from or relating to any of the property described” also did not cover the malpractice claim because the claim did not involve damage to property. Moreover, no security interest attached when the malpractice action transformed to a judgment, bond, and contract claim because if a security agreement does not grant a security interest in a tort claim or its proceeds, no subsequent transformation will “magically” result in an automatic attachment of those proceeds.

Inliner Americas, Inc. v. MaComb Funding Group, LLC,

[348 S.W.3d 1](#) (Tex. Ct. App. 2010)

Security agreement that described the collateral to include now owned and hereafter acquired “causes of action” and “[a]ll products and proceeds” thereof did not include a later-accruing legal malpractice claim against the debtor's attorneys because public policy prohibits the assignment of legal malpractice claims. The settlement proceeds of the malpractice claims were also not collateral because the creditor had not argued that the security agreement listed them as a distinct asset independent of such claims, but merely as proceeds of the claim. No discussion of § 9-204(b)(2).

Helms v. Certified Packing Corp.,
[551 F.3d 675](#) (7th Cir. 2008)

Although tort and insurance claims for loss or damage to collateral are proceeds of the collateral (limited by the collateral's value), neither debtor's claim against insurance broker for negligent failure to list the debtor's destroyed facility on a business-losses insurance policy nor debtor's tort claim against utility company for business losses arising from fire were proceeds of secured lender's collateral.

In re Zych,
[379 B.R. 857](#) (Minn. Ct. App. 2007)

Creditor's security interest does not attach to a commercial tort claim that was neither described in the security agreement nor existing when the security agreement was executed, even though the commercial tort claim might be proceeds of other collateral.

LLC Interests

In re McKenzie,
[2011 WL 2118689](#) (Bankr. E.D. Tenn. 2011)

No security interest attached to the debtor's LLC interest because the operating agreement required the prior written consent of the LLC's Board of Governors, and no such consent was obtained. The court asked for more briefing on whether § 9-408 allows a security interest to attach to the proceeds of the LLC interest despite a restriction on assignment in the operating agreement.

PERFECTION ISSUES

In re Hall,
[2011 WL 4485774](#) (9th Cir. BAP 2011)

Attorney's charging lien on proceeds of lawsuit was unperfected because attorney failed to comply with Nevada statute requiring service of notice of the claimed lien on both the client and the opposing party.

In re Royal West Properties, Inc.,
[441 B.R. 158](#) (Bankr. S.D. Fla. 2010)

The real property reacquired by the debtor through foreclosure or receipt of a deed in lieu of foreclosure was proceeds of the mortgage receivables to which the creditors' security interests attached, but those interests were not perfected beyond 20 days.

PRIORITY ISSUES

DEPOSIT ACCOUNTS

Platte Valley Bank v. Tetra Financial Group, LLC,
[2011 WL 335595](#) (D. Neb. 2011)

Even if deposit account funded in connection with sale-leaseback of equipment in which lender had a first priority security interest was proceeds of the equipment, lender's security interest was junior to that of the depositary bank, which had control.

First Dakota National Bank v. First National Bank of Plainview,
[2011 WL 4382147](#) (D.S.D. 2011)

Pursuant to § 9-341, bank's unperfected security interest in proceeds of debtor's livestock was subordinate to the setoff rights of the depositary bank in which the proceeds were deposited. The prior common law regarding special deposits is no longer applicable and, even if it were, the deposits were not special deposits, even though resulting from sales of livestock purportedly owned by the bank's customers, because they were all made in the ordinary course of the debtor's business. While the depositary bank had acknowledged the bank's interest in the debtor's livestock, it had not agreed to subordinate its setoff rights.

LOL Finance Co. v. Paul Johnson & Sons Cattle Co.,
[758 F. Supp. 2d 871](#) (D. Neb. 2010)

Lender with perfected security interest in cattle placed by debtor at feedlot lost priority in cash proceeds of cattle that feedlot deposited into bank that had a security interest in the deposit account to secure the feedlot's debt. However, bank might be liable for aiding and abetting feedlot's conversion of collateral.

Kentucky Highlands Investment Corp. v. Bank of Corbin, Inc.,
[217 S.W.3d 851](#) (Ky. Ct. App. 2006)

Depositary's setoff rights have priority over rights of creditor with security interest in deposit account as proceeds of receivables who lacked control, even though the debtor improperly deposited such proceeds in an apparent effort to thwart the creditor; the collusion standard of § 9-332(b) does not apply to priority in the deposit account itself.

Agricultural Products

In re Grain,
[2011 WL 2462037](#) (Bankr. E.D. Tex. 2011)

Bank with a security interest in farmer's grain deposited into a silo was entitled only to a pro rata portion of the proceeds of the grain sold after it was discovered that the silo operator had insufficient grain to cover all the claims to the grain.

Farm Credit of Northwest Florida, ACA v. Easom Peanut Co.,
[2011 WL 4057786](#) (Ga. Ct. App. 2011)

Lender's perfected security interest in debtor's peanuts and the proceeds thereof may not have priority over unperfected security interests of sellers if lender acted in bad faith in assuring the sellers of the debtor's financial stability and that they would be paid. However, lender's security interest had priority over the possessory lien of a bailee/processor that had not issued warehouse receipt because the applicable Georgia statute expressly provides that a bailee's lien is inferior to a recorded lien, which the lender's security interest was. Although the bailee/processor may have a claim in quantum meruit against the lender for processing services provided at the lender's direction, that claim is not a prior lien on the proceeds of the peanuts.

In re Meadowbrook Farms Co-op.,
[2011 WL 2293389](#) (S.D. Ill. 2011)

Livestock seller that was entitled under the Packers and Stockyard Act of 1921 to treat the buyer's livestock sale proceeds as being held in trust for the seller until paid in full was also entitled to collect from the trust attorney's fees incurred in litigating its priority because the sales agreement so provided.

OTHER

In re Wilson,
[2010 WL 5341917](#) (Bankr. D. Neb. 2010)

Creditor with a perfected security interest in debtor's action against home builder for negligent construction had priority over earlier mortgagee in the proceeds of a settlement of that claim to the extent the claim was for personal injury but mortgagee had priority to the extent that the claim was for property damage and represents a reduction in value of the mortgagee's collateral.

In re North End Timber Productions, LLC,
[2007 WL 4468706](#) (Bankr. D. Mont. 2007)

Subordination agreement extends to insurance proceeds of the collateral.