

# Second Generation Proceeds: The Conflict Between After-acquired Property and Proceeds in Bankruptcy

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## Introduction

It is generally understood and accepted, without debate, that the filing of a bankruptcy petition cuts off the operation of so-called after-acquired property security clauses. This results in the debtor or trustee having rights in assets acquired postpetition that they would not have had without the bankruptcy filing. However, in a series of decisions from outside the Sixth Circuit Court led by *In re Bumper Sales, Inc.*<sup>1</sup> courts have found that the lien of a prepetition lender can extend to property typically thought of as after-acquired collateral. This is not because of the existence of an after-acquired property clause but because the postpetition collateral is found to be proceeds of the prepetition lender's prepetition collateral. These "second generation proceeds" cases blur the line between after-acquired property and proceeds and can lead to outcomes that initially appear inconsistent with the general principles of the Bankruptcy Code. However, the cases may not be as far-reaching as they at first appear.

## After-acquired Property Clauses and Proceeds in Bankruptcy

The after-acquired collateral clause is a reality of modern commercial financing. Typical secured financing will provide the lender with a security interest not only in a borrower's current assets but also in similar assets acquired by the borrower in the future. By encumbering not only present but also future assets, after-acquired collateral clauses effectively prevent a borrower from obtaining cash or financing from any other source based on the value of these future assets without the consent of the existing lender. They would appear to leave a borrower with no financing alternative in bankruptcy.

The Bankruptcy Code, however, aims to assist the debtor's reorganization by allowing it to use property acquired after the bank-

ruptcy petition as a source of funding its ongoing operations.<sup>2</sup> 11 USC § 552(a) provides:

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.

Nevertheless, the Bankruptcy Code recognizes that prepetition lenders must be allowed some protection for their prepetition interests. See *Arkison v Frontier Asset Mgmt., LLC (In re Skagit Pac Corp.)*.<sup>3</sup> Section 552(b)(1) therefore provides an exception governing proceeds:

Except as [otherwise] provided...if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Generally speaking, the "applicable non-bankruptcy law" that determines the extent of a security interest is the Uniform Commercial Code (UCC).<sup>4</sup>

The UCC defines proceeds as:  
...(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (B) whatev-

er is collected on, or distributed on account of, collateral; (C) rights arising out of collateral; (D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or (E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

UCC § 9-102(64). Also relevant is UCC § 9-315(c), which provides that “[a] security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected.”<sup>5</sup>

Although an initial reading of the relevant UCC provisions suggests that “proceeds” is what is actually received in direct exchange for collateral, as well as rights to damages and insurance proceeds where value is lost, the concept of “proceeds” has expanded over time with each revision of the UCC.<sup>6</sup> In a bankruptcy, this expanded concept of “proceeds” may conflict with section 552(a). This conflict has led to a series of cases in which prepetition lenders advanced a “second generation” proceeds theory to argue that their liens in prepetition proceeds extend to and cover postpetition inventory, accounts, and other collateral that their after-acquired property clauses could not reach.

### **Second Generation Proceeds and Bumper Sales**

*Bumper Sales* appears to be the most widely cited case supporting the theory of second generation proceeds. *Bumper Sales* arose out of the bankruptcy of a company seeking to increase its inventory of car and truck bumpers through a lending relationship with a small asset-based lender. This prepetition lender held an uncontested, perfected security interest in substantially all of the debtor’s prepetition assets. Although no formal cash collateral order was ever entered, the debtor and the prepetition lender had an agreement pursuant to which the debtor could use cash collateral in exchange for making current loan payments and remaining in compliance with the terms of the prepetition loan documents, and the prepetition lender was intended to receive a postpetition lien.<sup>7</sup> All parties additionally stipulated that the debtor’s postpe-

tion operations, including the purchase of new inventory, were funded exclusively by the proceeds of the prepetition lender’s cash collateral.<sup>8</sup>

Eight months into the debtor’s bankruptcy proceedings, the prepetition lender filed a motion seeking to condition the use of cash collateral and seeking adequate protection for its security interest in all of the debtor’s assets.<sup>9</sup> The bankruptcy court found that the lender’s valid interest in prepetition assets and proceeds continued postpetition to the extent of the lender’s unpaid claim and granted the lender a lien on pre- and postpetition collateral. The district court affirmed, and the creditors’ committee appealed.<sup>10</sup>

On appeal, the Fourth Circuit Court believed that a four-part analysis would determine whether the debtor’s postpetition accounts receivable and inventory were after-acquired property or proceeds of prepetition collateral: (1) does a prepetition security agreement cover prepetition accounts and inventory; (2) postpetition, did the debtor receive proceeds of prepetition accounts and inventory; (3) is postpetition inventory second generation proceeds of prepetition inventory and accounts, and are postpetition accounts proceeds of postpetition inventory; and (4) did the lender’s consent to the use of proceeds end its security interest?<sup>11</sup>

In *Bumper Sales*, an affirmative answer to the first and second requirements was not disputed by the parties.<sup>12</sup> In evaluating the third requirement, the court applied the UCC’s definition and treatment of proceeds and found that the parties’ stipulation that debtor’s postpetition operations were financed exclusively by the prepetition lender’s cash proceeds meant that the proceeds remained identifiable postpetition.<sup>13</sup> The debtor then used the cash proceeds to purchase new inventory. While postpetition inventory is typically considered after-acquired property, the court concluded that treating it as after-acquired property in the *Bumper Sales* case:

...could completely deprive the secured party of his pre-petition perfected security interest. Therefore, the term “proceeds”<sup>14</sup> should be read broadly...to include after-acquired property, at least where inventory and accounts are concerned and there is no improvement in position. This is nothing more than a post-petition substitution of collateral.<sup>15</sup>

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Ultimately, the Fourth Circuit Court “agree[d] that Section 552(b) covers second generation proceeds, even if they are in the form of inventory, because such proceeds are clearly contemplated by the UCC...The only requirement is that the second generation proceeds be traceable to the original collateral...” [a fact to which, again, the court found the parties had stipulated].<sup>16</sup> The court went on to find that the lender’s consent to the use of cash collateral did not affect its security interest in the proceeds of cash collateral.<sup>17</sup> With the four-part test met, the Fourth Circuit Court upheld the lower courts’ decisions extending the prepetition lender’s liens.

### Subsequent Interpretations of Second Generation Proceeds

Rather than interpreting it as creating a broad general rule, many subsequent cases have emphasized the fact-specific nature of the *Bumper Sales* holding and applied its rule narrowly. In *In re Package Design & Supply Co, Inc.*,<sup>18</sup> the prepetition lender to debtor, a packaging supply manufacturer and distributor, permitted the use of cash collateral without court order for six months before seeking (jointly with the debtor) court approval of a cash collateral agreement. The trustee and an unsecured creditor objected, arguing that by failing to act promptly the lender had “rolled out” of its secured position due to the operation of section 552(a).<sup>19</sup>

The court found that the popular belief that prepetition creditors can roll out of a secured position postpetition “...must be reconciled with the undeniable fact that under the [UCC], second generation proceeds of lien proceeds are merely ‘proceeds of proceeds’ and are subject to the initial lien without regard to any ‘after-acquired property’ clause, where such second generation assets are identifiable as such.”<sup>20</sup> A prepetition lien may extend to assets typically considered after-acquired collateral not through operation of an after-acquired property clause but by virtue of a prepetition perfected security interest in proceeds. Similar to *Bumper Sales*, the court found that the debtor had no unencumbered assets on the petition date and that all postpetition needs had been funded through the use of cash collateral.<sup>21</sup> The court additionally found that the definition of proceeds was meant to be flexible, particularly given the equitable component of 11 U.S.C. § 552(b).<sup>22</sup>

The *Package Design* court, however, believed that such equitable considerations, as well as 11 U.S.C. § 506(c),<sup>23</sup> would prevent a prepetition secured creditor from using a proceeds claim to benefit from value added by others.<sup>24</sup> When value is added from other sources, commingling of prepetition and postpetition cash and assets is likely, particularly with the passage of time, and the secured creditor must establish a link between its prepetition proceeds and postpetition assets, making for a more demanding analysis.<sup>25</sup> Although the *Package Design* court believed its fact pattern to be similar to *Bumper Sales*, it remanded for further evidence to be certain that none of the debtor’s postpetition assets were “enhanced” by the use of unencumbered cash or equity that would otherwise have been available to unsecured creditors.<sup>26</sup>

The *Skagit* court expanded the concept of postpetition value by looking not just at new sources of funding but at the value of the debtor’s efforts in the operation of its business. In *Skagit*, the debtor was a manufacturer of modular trailers. Shortly after its bankruptcy petition, it was awarded a contract to build four trailers, leading to a postpetition account receivable paid subsequent to conversion of the bankruptcy to Chapter 7.<sup>27</sup> As in *Bumper Sales*, the use of the prepetition lender’s cash collateral proceeded postpetition without the benefit of a cash collateral order or a replacement lien, and the prepetition lender<sup>28</sup> subsequently sought to foreclose on the postpetition payment.<sup>29</sup>

The lender alleged that the payment received for the postpetition receivable was proceeds of its prepetition collateral, offering the debtor’s declaration that the collection of prepetition accounts and proceeds from the sale of prepetition inventory funded the postpetition construction of the four trailers.<sup>30</sup> The court, however, indicated its belief 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...Thus, any portion of the [postpetition 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).”<sup>31</sup> The court continued, “[c]ase law supports the proposition that where it is only postpetition acts which generate an account receiv-

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able, those post-petition receivables will not be considered proceeds because there is no interest in, or connection to, the right in the account receivable created pre-petition."<sup>32</sup> The account arising postpetition from the sale of the modular trailers could only be proceeds of the lender's prepetition collateral if evidence linked the money collected from prepetition accounts to those postpetition accounts.

The *Skagit* court's desire to ensure that the debtor benefited from its postpetition efforts differed from the *Bumper Sales* approach and led to a tracing analysis. Once cash proceeds are deposited into an account and commingled with other funds, they are no longer considered to be identifiable as proceeds unless the secured creditor establishes a link.<sup>33</sup> The burden of proof of tracing proceeds, both under *Skagit* and generally, falls on the secured party claiming the interest.<sup>34</sup>

When tracing of proceeds is required, courts look to equitable state-law tracing methods, the most widely used of which is the "lowest intermediate balance rule" (LIBR).<sup>35</sup> The LIBR is used to trace commingled proceeds and assumes that the alleged proceeds are the last amounts withdrawn from an account. Where the amount on deposit in the account falls below the amount of the alleged proceeds, the maximum amount that the secured creditor can trace is the lowest balance of the account between the time the proceeds are commingled and the time respective rights in the account are determined.<sup>36</sup> In *Skagit*, the secured creditor had used neither the LIBR nor another tracing method to identify its proceeds; the bankruptcy appellate panel therefore held that the bankruptcy court abused its discretion in finding the postpetition account arising from the sale of the modules to be proceeds of the lender's prepetition collateral.<sup>37</sup> The court emphasized that the facts were not as clear as in *Bumper Sales*, where all parties stipulated to the link between prepetition and postpetition assets.<sup>38</sup>

Another case evidencing the movement away from the broad tracing permitted in *Bumper Sales* (and relied upon by the *Skagit* court) is *In re Cafeteria Operators, LP*.<sup>39</sup> *Cafeteria Operators* relied on the equitable exception provided by 11 U.S.C. § 552(b)(1) to find that postpetition restaurant revenues are largely attributable to the efforts of the debtor and should not fully inure to the benefit of prepetition secured creditors despite the fact that

their cash collateral or proceeds may have purchased the unprepared food and beverages served by the restaurant.<sup>40</sup> Per the *Cafeteria Operators* court, the full value of the postpetition receivables could not constitute proceeds of prepetition collateral because "[f]rom a plain reading of § 552, revenues generated post-petition solely as a result of the debtor's labor are not subject to a pre-petition lender's security interest."<sup>41</sup>

*Cafeteria Operators* limited the prepetition secured creditors' proceeds claim to the value of their prepetition inventory that was used to generate postpetition revenue.<sup>42</sup> Ultimately, the court concluded that the debtor's use of cash collateral could be conditioned on the prepetition lenders receiving a replacement lien in postpetition inventory, plus, to the extent inventory levels decreased postpetition, a replacement lien of the highest possible priority in additional assets to maintain the lenders' prepetition secured position.<sup>43</sup> The recently decided appeal in *Qmect, Inc v Burlingame Capital Partners II, LP (In re Qmect, Inc)*,<sup>44</sup> however, affirmed a prior decision holding that where a prepetition proceeds lien was traced to postpetition collateral, any postpetition increase in value is also part of the proceeds of the prepetition lender's collateral. The *Qmect* court distinguished *Skagit*, stating that there the prepetition lender lacked a blanket lien.<sup>45</sup> While *Qmect* does not specifically cite *Bumper Sales*, its holding seems to be a return to *Bumper Sales*' expansive approach.

### Reconciling Second Generation Proceeds Cases with the Bankruptcy Code

It is difficult to understand how the second generation proceeds theory supported by *Bumper Sales*, *Package Design*, and, albeit to a lesser degree, *Skagit* and *Cafeteria Operators*, as well as the expansive proceeds concept endorsed by *Qmect*, can be consistent with the policy behind 11 U.S.C. § 552. Nevertheless, these cases remain good law, and *Bumper Sales* in particular is widely cited and not heavily criticized. However, a common theme between certain of these cases may explain their origins and suggest their limitations.

Each of *Bumper Sales*, *Package Design*, and *Skagit* involve Chapter 11 proceedings where the prepetition lender permitted the debtor to use cash collateral but did not require court approval of a cash collateral order ei-

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ther at all or until several months after the petition date. In *Cafeteria Operators*, while the prepetition lender and debtor agreed to an initial, limited use of cash collateral, they were never able to come to agreement on a final order; the case arose out of the debtor's motion to allow continued use of cash collateral without the consent of the lender. Cash collateral orders typically afford a number of protections to prepetition secured parties, including a replacement lien in postpetition assets and/or a lien in unencumbered prepetition and postpetition assets to protect the secured creditor for any diminution in value of its prepetition collateral during the bankruptcy proceedings. With these liens, a lender likely would not need to resort to second generation proceeds arguments to protect its interests.

In *Bumper Sales*, *Package Design*, *Skagit*, and *Cafeteria Operators*, the lenders were allowing the debtor to use cash collateral to continue its operations but failed to protect their own interests, either at all or in a timely manner. Although the holdings are not expressly limited, perhaps, ultimately, stretching the concept of second-generation proceeds is the court's way of trying to help these creditors, without whose cash collateral the debtors evidently would not have been able to operate postpetition and attempt to reorganize.<sup>46</sup> The analysis of these cases would not seem to protect a prepetition lender in bankruptcy proceedings involving a postpetition lender or other new financing or value, as it could not easily be said that postpetition assets were attributable solely or largely to prepetition proceeds or cash collateral.

Notwithstanding *Bumper Sales* and the second-generation proceeds theory, the prudent lender will still protect its interests by pursuing the protection of a cash collateral order and replacement lien at the earliest appropriate opportunity.

## NOTES

1. 907 F2d 1430 (4th Cir 1990).
2. See Collier on Bankruptcy, 15th ed. ¶ 552.01[1] (citations omitted); *In re Bumper Sales*, 907 F2d at 1436 (citation omitted).
3. 316 BR 330, 3365 n.4 (9th Cir BAP 2004) (hereafter, *Skagit*).
4. Collier, ¶ 552.02[1]. Most courts use the already expansive definition of proceeds under the UCC, although some others have found that the Bankruptcy Code did not intend the Uniform Commercial Code's definition to be an absolute limitation. See Collier ¶ 552.02[2] (citations omitted). The basis for an alterna-

tive definition of proceeds comes from a statement in the legislative history indicating that the meaning of "proceeds" is not limited to the UCC definition but also covers "property into which property subject to the security interest is converted." *In re Bumper Sales*, 907 F2d at 1437. The *Bumper Sales* court noted, however, that many courts reviewing this question have found the statutory reference to "applicable nonbankruptcy law" to be more compelling than legislative history and have applied the UCC definition. *Id.* (citations omitted).

5. The prior version of UCC Article 9, which both defined proceeds and discussed perfection in proceeds in § 9-306, included a subsection which specifically addressed proceeds in insolvency proceedings. Prior § 9-306(4) provided that in an insolvency proceeding a secured creditor with a perfected security interest in proceeds had a perfected security interest only in identifiable non-cash proceeds, separate deposit accounts containing only proceeds, identifiable cash proceeds in the form of money or checks not commingled with other money or deposited into a deposit account prior to the insolvency proceedings, and cash and deposit accounts in which proceeds have been commingled but the perfected security interest is subject to a right of setoff and limited to a calculation based on the debtor's cash receipts in the ten days prior to the insolvency proceeding. Neither old § 9-306(4) nor any provisions specifically addressing perfected security interests in proceeds in insolvency proceedings were incorporated into revised Article 9. There is no specific discussion of the rationale for its exclusion, only the indication that "[e]xcept as otherwise provided by the Bankruptcy Code, the debtor's entering into bankruptcy does not affect a secured party's right to proceeds." UCC Official Comment to § 9-315, #8.

6. White & Summers, Uniform Commercial Code, § 31-17(a) (5th ed. 2002).

7. *In re Bumper Sales*, 907 F2d at 1432, 1433.

8. *Id.* at 1433.

9. *Id.*

10. *Id.*

11. *Id.* at 1436-1437.

12. *Id.* at 1437.

13. *Id.*

14. *Bumper Sales*, as well as *Package Design* (discussed below), were decided under old Article 9, including § 9-306 (which is largely but not entirely enacted in current § 9-315).

15. *Id.* at 1439 (quoting Clark, *The Law of Secured Transactions under the Uniform Commercial Code*, ¶ 6.6[3] at 6-47 (1980)).

16. *Id.*

17. *Id.* at 1441.

18. 217 BR 422 (Bankr WDNY 1998).

19. *Id.* at 423.

20. *Id.* (citing, among other authority, *Bumper Sales*).

21. *Id.*

22. *Id.* at 424.

23. 11 U.S.C. § 506(c) provides in part "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim..."

24. *Id.* at 425.

25. *Id.* at 427.

26. *Id.*

27. 316 B.R. 333-334.

28. At this point in the case the lender was no longer the third-party prepetition lender but rather an LLC formed by the debtors' principals to manage the interests of the prepetition lender, which they had acquired by assignment in connection with the settlement of litiga-

tion instituted against them by the prepetition lender based on their guarantee of the underlying debt.

29. *Id.* at 333, 334.

30. *Id.* at 334.

31. *Id.* at 336 (citations omitted).

32. *Id.*

33. *Id.* at 338.

34. *Id.* (citations omitted). *See also First Bank v. North Country Bank & Trust (In re Superior Used Cars, Inc)*, 258 BR 680, 686 (Bankr WD Mich. 2001) (finding that, under Michigan law, the secured creditor bears the burden of tracing and identifying proceeds). At least one court has suggested that the burden of proof can be shifted from the secured creditor to the debtor where the debtor wrongfully commingles funds. That court, however, didn't need to fully address the issue as it found that the debtor had not in fact acted wrongfully. *See In re Qmect, Inc*, No. 04-41044T, 2006 Bankr LEXIS 1489, at \*13-14 (Bankr ND Cal. June 26, 2006).

35. *See In re Skagit*, 316 BR at 338 (citations omitted); UCC, Official Comment to § 9-315 No. 3.

36. *In re Skagit*, 316 B.R. at 338.

37. *Id.* at 340.

38. *Id.* at 339-340.

39. 299 B.R. 400 (Bankr. N.D. Tex. 2003).

40. *Id.* at 408-409.

41. *Id.* at 405.

42. *Id.* at 409.

43. *Id.* at 410.

44. 373 BR 100 (Bankr ND Cal 2007).

45. In fact the prepetition lender in *Skagit* had a very comprehensive lien, covering equipment, inventory, accounts receivable, chattel paper, general intangibles and all proceeds.

46. The *Package Design* court believed that its fact pattern, where all postpetition needs are funded exclusively through the use of cash collateral, is quite common in smaller bankruptcies.



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