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SECURITY INTERESTS IN PROCEEDS OF COLLATERAL: IMPACT OF BANKRUPTCY

The post-bankruptcy effect of pre-bankruptcy liens in some cases raises complex issues for bankruptcy courts. In exploring these issues, the authors discuss the general effect of bankruptcy on security interests, the protection of “cash collateral,” and the characterization of assets as either “proceeds” of collateral or “Post-Bankruptcy Property.” They close discussing the importance of settlement and some “outlier” cases.

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In order to obtain a traditional secured loan, a borrower is typically required to grant to the lender a “blanket lien” in “all assets,” including assets that are acquired during the life of the loan.¹ This is typical because it reflects the reality of most businesses; inventory is sold, converted to accounts receivable and ultimately cash, and that cash is reinvested in the business through the purchase of new inventory or other assets valuable to the business. It would not be practical to expect lenders to constantly revise and amend some finite, specific description of the assets that are subject to their liens. The Uniform Commercial Code recognizes this practical reality and provides for the granting and perfection of a lien that automatically attaches to this “value” as the precise nature of the assets change over time.² However, if a borrower subsequently files for bankruptcy, the desire to provide a lender with certainty is complicated and balanced with contrary public policies, such as the importance of providing a debtor with a “fresh start.”

Accordingly, the effect of bankruptcy on after-acquired assets often raises complex issues that must be understood by lenders.

I. BANKRUPTCY NUTS AND BOLTS

a. Effect of Bankruptcy on Security Interests

Section 552 of the Bankruptcy Code governs the post-bankruptcy effect of pre-bankruptcy liens and is the starting point in determining whether a lender has rights to assets acquired post-bankruptcy.³ Somewhat surprisingly, section 552(a) provides that pre-bankruptcy liens do not attach to certain assets acquired post-bankruptcy (“Post-Bankruptcy Property”). In other words, section 552(a) is an exception to the well-settled rule that liens survive a borrower’s bankruptcy. Section 552(a) recognizes the need to provide a borrower with a reasonable chance of rehabilitating its business and emerging from bankruptcy with a manageable capital structure. Accordingly, courts construe section 552(a) to

¹ In some foreign jurisdictions, this is referred to as a “floating lien.”

² U.C.C. § 9-204(a).

³ Section 552 applies only to consensual liens, not tax liens and other nonconsensual liens.

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