Article 9's Bankrupt Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC "Proceeds" Definition

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Ten years ago, just as revised Article 9 was becoming effective, I documented how several of the Article 9 revisions[1] had little or no nonbankruptcy function, but were designed primarily to alter bankruptcy law outcomes in favor of secured creditors.[2] I argued that such attempts to amend federal bankruptcy law through the state uniform laws revision process were improper[3] and suggested theories that would limit or avoid the intended bankruptcy law changes.[4] This anniversary symposium provides an excellent opportunity to revisit one of those Article 9 revisions in greater detail and see how successful the drafters' anti-bankruptcy agenda has been.

I. PROCEEDS AND BANKRUPTCY

One of the least justifiable revisions was the expansion of the Article 9 definition of "proceeds."[5] The prior version of Article 9 had a fairly conservative definition of

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1. As used in the article, "revised Article 9" or the "Article 9 revision" refer to the 1999 revision of Article 9. References to "UCC 9-XXX" or "section 9-XXX" are to sections of revised Article 9. "Former Article 9" and "prior version of Article 9" refer to the 1972 version of Article 9. References to "former UCC 9-XXX" or "former section 9-XXX" refer to sections of former Article 9.

2. *See* G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 5-6 (2001).

3. *See id.* at 19-24. The response given to those points by the revision's Reporters appears in Steven L. Harris & Charles W. Mooney, Jr., *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 AM. BANKR. INST. L. REV. 85, 86-104 (2001).

4. *See generally* Warner, *supra* note 2.

5. *Id.* at 54-61.

proceeds that was based largely on a replacement model. Under the former law, proceeds were limited to what the debtor received in exchange for the disposition of the collateral.[6] The revision greatly expanded the proceeds definition. While retaining the replacement concept, it added to the proceeds definition future assets that were generated by or related to the secured creditor's collateral.[7] Examples of these new classes of proceeds include income received by the debtor for leasing or licensing the collateral.[8] In addition, the revision added a new, but undefined, category of "rights arising out of collateral."[9] This category reflects the shift to a "generation" model and represents a radical expansion of the proceeds concept.

6. *See* U.C.C. § 9-306(1) (1972). At the time the Bankruptcy Code was adopted in 1978, the section 9-306(1) definition of proceeds stated, in relevant part:

> "Proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are "cash proceeds". All other proceeds are "non-cash proceeds".

A 1994 amendment added to the proceeds definition the language: "Any payments or distributions made with respect to investment property collateral are proceeds." U.C.C. app. XII § 9-306(1) (1994). This was the first introduction of a non-replacement model for proceeds and was designed to overrule the decision in *FDIC v. Hastie (In re Hastie)*, 2 F.3d 1042, 1045-46 (10th Cir. 1993), holding that cash dividends on stock were not proceeds because they failed to meet the "disposition" requirement.

7. *See* U.C.C. § 9-102(a)(64) (2008). The proceeds definition of revised Article 9 reads:

> "Proceeds", except as used in Section 9-609(b), means the following property:
>
> (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;
>
> (D) to the extent of the value of the 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.

Id.

8. *See* U.C.C. § 9-102(a)(64)(A) (2008).

9. U.C.C. § 9-102(a)(64)(C) (2008). Although that language was new, the drafters chose not to explain it in the Official Comments. *See id.* § 9-102 cmt. 13 (explaining "Proceeds-Related Definitions"). Further, the UCC definition of "right" is not helpful because it is nothing more than a circular reference to "remedy", the definition of which simply refers back to rights. *Compare id.* § 1-201(b)(34) ("'Right' includes remedy."), *with id.* § 1-201(b)(32) ("'Remedy' means any remedial right . . . ."). Thus, since 'right' is a very broad concept, this language potentially pulls into the proceeds definition all future assets the debtor's receipt of which in some way traces to the secured creditor's collateral.

Apart from bankruptcy considerations, there was little reason to tinker with the proceeds definition. Professors Steven L. Harris and Charles W. Mooney, Jr., the Reporters for the Article 9 revision, argued that the changes were needed to expand the lending base available to secured creditors and thereby increase the debtor's ability to obtain financing.[10] This point is easily refuted in the proceeds context by considering that Article 9 broadly validates contractual after-acquired property clauses[11] and allows almost all such future assets easily to be described in the security agreement using very generic category or UCC defined type descriptions.[12] Thus, the main nonbankruptcy difference between future assets that qualify as proceeds and those that do not is that the secured party must contract for a security interest in future non-proceeds, but acquires a security interest in proceeds without the need for a term in the security agreement.[13] If the parties expected that the debtor's acquisition of a future asset was sufficiently certain to justify an increase in the amount of credit advanced, they easily could obtain a security interest in the future asset without use of the expanded proceeds definition. In fact, the expanded proceeds rule will not increase the amount of credit extended, because it captures extra collateral only in those cases where the parties did not care enough about the item to describe it in the security agreement.[14]

Other significant nonbankruptcy consequences of labeling collateral as proceeds are the automatic perfection and related priority rules.[15] These rules generally

10. *See* Harris & Mooney, *supra* note 3, at 96. This argument was raised in rebuttal to the entire set of revisions my article had challenged and was not asserted as a specific response to the proceeds issue.

11. *See* U.C.C. § 9-204(a) (2008) (providing "a security agreement may create or provide for a security interest in after-acquired collateral"). The only exceptions are commercial tort claims and certain consumer goods. *See id.* § 9-204(b).

12. Use of a category or UCC type is *per se* sufficient as a description of collateral. *See* U.C.C. § 9-108(b)(2)(3) (2008). Again, commercial tort claims and consumer goods are excluded from the description by UCC type rule, as are securities entitlements, securities accounts, and commodities accounts. *See id.* § 9-108(e).

13. *Compare* U.C.C. § 9-203(f) (2008) (stating "attachment of a security interest in collateral gives the secured party the right to proceeds"), *with id.* § 9-204(a) (stating "a security agreement may create or provide for a security interest in after-acquired collateral").

14. The two cases in which the *expanded* proceeds definition may reach future assets that could not be reached by a properly drafted after-acquired property clause are consumer goods and commercial tort claims. *See supra*, note 12. Note that the effect of the change in these areas will be small because the former Article 9 version of the proceeds definition captured any items received by the debtor in exchange for the original collateral. The consumer realm is beyond the scope of this paper, but in any event strong policy reasons support that exclusion. That leaves those commercial tort claims that do not qualify as something received by the debtor upon disposition of the collateral. It seems unlikely that the possibility that a solvent third party will commit a future tort would be sufficient to cause lenders to increase the lending base in enough cases to justify a change in the proceeds definition.

15. *See* U.C.C. § 9-315(c), (d) (2008); *id.* § 9-322.

provide that, if the original collateral was perfected, its proceeds are perfected automatically and enjoy the same priority date as the original collateral.[16] However, the expanded proceeds definition does nothing to expand the lending base beyond what easily could be achieved using a contractual after-acquired property clause. Any future asset that would be significant enough to justify increased financing could become perfected as soon as the debtor acquired rights in it and could enjoy the same priority date as other collateral simply by listing its UCC type in the financing statement or by using an "all assets" designation of collateral.[17] Indeed, because of the automatic relation-back perfection feature of proceeds, the expansion of the definition is likely to generate significant new problems, because it creates priority conflicts where none previously would have existed.[18]

With no significant nonbankruptcy justification for the revision's radical expansion of the proceeds definition,[19] we turn to the bankruptcy implications of the

16. *See* U.C.C. § 9-315(c) (2008); *id.* § 9-322(b)(1). Section 9-322(b)(1) provides that "the time of filing or perfection as to a security interest in collateral is also the time of filing or perfection as to a security interest in proceeds."

17. U.C.C. § 9-504(2) (2008). The "all assets" designation would cover any type of collateral that could be perfected by filing.

18. Under a disposition or replacement model, the proceeds of one creditor's collateral will rarely also be proceeds of another creditor's collateral. However, under a value generation model, two different items of collateral might well both contribute to the creation of the generated asset. Unlike the case of commingled goods, where a pro-ration rule is used, see U.C.C. § 9-336(f) (2008), the proceeds rule is a first in time rule that will give one of the contributing creditors priority over the other. In addition, if the "rights arising out of collateral" prong of the new proceeds definition has any significant scope, it will give secured creditors proceeds claims in cases where it may not be obvious to outside observers that there is a relationship between the original collateral and the claimed proceeds. *Id.* § 9-102(a)(64)(c). For example, if the addition of a luxury retailer's brand name to jeans greatly increases the price that can be received by the retailer when it sells the jeans, the holder of a security interest in the retailer's trademark might be able to argue the accounts created by selling the jeans were proceeds of its trademark. This would create a priority dispute with the holder of a security interest in the retailer's inventory. The inventory lender's UCC search that produced a financing statement listing the trademark collateral may not put it on notice that the accounts would be encumbered. *See id.* § 9-315(d)(1) (stating the "same office rule" for continued perfection in proceeds).

19. The expansion of the proceeds definition also fails to further the default contract rationale for the automatic lien on proceeds. *See* R. Wilson Freyermuth, *Rethinking Proceeds: The History, Misinterpretation and Revision of U.C.C. Section 9-306*, 69 TUL. L. REV. 645, 647 (1994) (stating that the rationale for the proceeds rule is that it "codif[ies] the *ex ante* bargain of the hypothetical reasonable debtor and secured party"). It is reasonable to assume that the great majority of rational debtors and creditors probably would have agreed, had they considered the question, that the security interest would extend to whatever the debtor received if it disposed of the creditor's original collateral. This justifies the section 9-203(f) contractual gap filler that grants an automatic lien on proceeds of the replacement variety. (This rationale might even apply to the anti-*Hastie* amendment in 1994 because a debtor pledging stock might naturally expect the pledge to include the dividends received during the period of the pledge.) On the other hand, it seems very unlikely that

change. Here the anti-bankruptcy agenda becomes clear.[20] While it makes little difference outside of bankruptcy whether a secured party acquires future collateral through a contractual after-acquired property clause or by virtue of the proceeds rule, that distinction is of critical importance in bankruptcy. As a general rule, contractual after-acquired property provisions are not effective to create a security interest in property that the bankruptcy estate acquires after the filing of a petition in bankruptcy.[21] The exception to this rule is that the security interest will attach to property acquired by the bankruptcy estate after filing if that property constitutes "proceeds" of the secured creditor's prepetition collateral and certain other conditions are satisfied.[22]

Thus, the expanded proceeds definition, if carried forward into the Bankruptcy Code, might greatly enhance the rights of secured creditors against assets created during the bankruptcy process.[23] For example, assume that an automobile rental company filed Chapter 11 and continued to operate its car rental business. Under the old proceeds definition, a creditor with a security interest in the fleet of rental cars would have no claim to the rental income generated by rental of those cars postpetition.[24] The new definition would, however, consider such rental income to be proceeds of the cars[25] and extend the secured creditor's lien to all postpetition rental

most rational debtors would have agreed to grant a lien on all assets they could generate through the use of a secured creditor's collateral. Granting a security interest in equipment to an equipment lender in no way suggests that the debtor intended to encumber the revenue it could generate by using or even leasing the equipment. When rental car company buy new cars on credit from an automobile wholesaler and grants the wholesaler a security interest in the cars to secure their purchase price, does that action in any way suggest or imply that the rental car company also intended to grant the manufacturer a security interest in its accounts? Just stating the question demonstrates the absurdity and shows how the revision undermines one of the justifications for the proceeds rule. *Contra id.* (asserting, without empirical support, that reasonable debtors and secured parties would expect the security interest to extend to rental income).

20. *See* C. Scott Pryor, *Revised Uniform Commercial Code Article 9: Impact in Bankruptcy*, 7 AM. BANKR. INST. L. REV. 465, 500 (1999) (stating that drafters chose to achieve their goal by amending the proceeds provision rather than asking Congress to amend Bankruptcy Code section 552(b)).

21. *See* 11 U.S.C. § 552(a) (2006). Section 552(a) states: "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."

22. *See* 11 U.S.C. § 552(b)(1). The exception also covers "products, offspring, [and] profits." Another exception applies to rents and certain hotel revenues. *Id.* § 552(b)(2).

23. Pryor, *supra* note 20, at 503.

24. *See* Gen. Elec. Credit Corp. v. Cleary Bros. Constr. Co. (*In Re* Cleary Bros. Const. Co.), 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980) (holding that rental of equipment does not produce proceeds).

25. The U.C.C. § 9-102(a)(64)(A) (2008) "lease" provision presumably would capture this revenue stream. Alternatively, the debtors' right to rental payment could be viewed as a right arising out of the leased equipment collateral. *See id.* § 9-102(a)(64)(C).

income, thereby diverting the reorganization value of the enterprise from the general unsecured creditors to the secured creditor.

Of course, the Article 9 revision only amended state law. How does that translate into a change in the bankruptcy law rules?

While the Reporters' broad reading of *Butner v. United States* relies on deference to state law property rights in bankruptcy to support many of the anti-bankruptcy revisions, the revised proceeds definition does not rely on deference to state law for its bankruptcy impact.[26]

Instead, the incorporation of Article 9's definition of proceeds into section 552 is based on the absence of a definition of that term in the Bankruptcy Code. This led the Fourth Circuit Court of Appeals to conclude in the seminal case of *In re Bumper Sales, Inc*. that section 552(b) incorporates the UCC's definition of proceeds.[27] The majority view follows the *Bumper Sales* approach of looking to Article 9 for the meaning of proceeds in section 552 of the Bankruptcy Code.

That approach provides a possible vector for amending section 552 through a change in the state law proceeds definition.[28] The success of the exercise depends on courts either not noticing that the definition has changed or interpreting *Bumper Sales* to require incorporation of a variable state law definition, rather than one fixed to the state law definition as of the time the Bankruptcy Code was adopted in 1978.

How successful has this *sub silentio* amendment to the Bankruptcy Code been? The early indications are that the strategy is working. Only two reported decisions have discussed the Bankruptcy Code section 552 proceeds definition since revised Article 9 became effective. Both followed the *Bumper Sales* approach of looking to state law for the definition of proceeds and both quoted the new definition of

26. 440 U.S. 48, 55 (1979), *superseded in part by statute*, Act. of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549; *see* Harris & Mooney, *supra* note 3, at 88 ("Subject to extremely limited exceptions, the Bankruptcy Code offers a blank check to the makers of nonbankruptcy law to define and delineate property law principles that will prevail in bankruptcy.").

27. *See* 907 F.2d 1430, 1437 (4th Cir. 1990).

28. This is not the first instance of a change in the Article 9 proceeds definition designed to exploit this approach. The *Hastie* case that blocked the secured creditor's proceeds claim to cash dividends of stock was decided under section 552(b) of the Bankruptcy Code. The 1994 amendment to former Article 9's proceeds definition was designed to change that outcome. Revised Article 9 carried that change forward and extended its asset generation model to additional classes of collateral. The Official Comment to U.C.C. § 9-102(a)(64) expressly refers to Bankruptcy Code section 552(b). The comment states: "This section rejects the holding of *FDIC v. Hastie*, 2 F.3d 1042 (10th Cir. 1993) (postpetition cash dividends on stock subject to a prepetition pledge are not 'proceeds' under Bankruptcy Code Section 552(b)), to the extent the holding relies on the Article 9 definition of 'proceeds.'" U.C.C. § 9-102 cmt. 13(a) (2008). Although the Official Comments do not even suggest a section 552(b) motivation for the other expansive additions to the proceeds definition, the drafters of revised Article 9 were well aware of the possible opportunity to amend bankruptcy law through the proceeds definition.

proceeds from revised Article 9.[29] Neither opinion turned on the difference between the former and revised definitions. But more important for present purposes, neither court recognized that the definition had changed or that it was applying a very different version of the section 552(b)(1) proceeds rule than the *Bumper Sales* court, or any pre-revision court, had applied.

Thus, without anyone noticing, the revised definition of proceeds has established a beachhead in bankruptcy jurisprudence. With two reported decisions as authority for use of the revised definition, and with the revised definition being the only definition future researchers will likely see when they turn to the UCC as *Bumper Sales* instructs, it is likely only a matter of time before it becomes well-established that the revised Article 9 definition of "proceeds" applies in section 552 of the Bankruptcy Code.

While such a change will enhance the secured creditor's position in a bankruptcy case, it may not change the ultimate outcome very much. This is because there is an exception to the proceeds exception that provides the bankruptcy court with the discretion to limit the secured creditor's lien on postpetition proceeds "based on the equities of the case."[30] The better reasoned decisions interpreting this provision indicate that the equities language is designed to prevent secured creditors from receiving windfalls by taking assets that would otherwise go to rehabilitating the debtor.[31] Thus, although more secured creditors will win the battle over whether their claimed lien is on proceeds, the focus of the fight over distribution of a firm's reorganization value will simply shift to the equities exception. The Article 9 revision puts new pressure on the equities exception and may cause courts to apply it more aggressively. While courts may have been hesitant to apply the equities exception to proceeds of the *replacement* variety, the expansion of the proceeds definition to include assets *generated by* or *arising from* the collateral may have weakened the equities favoring the secured creditor.[32]

29. *See* Arkison v. Frontier Asset Mgmt. (*In re* Skagit Pacific Corp.), 316 B.R. 330, 337 (B.A.P. 9th Cir. 2004); Qmect, Inc. v. Burlingame Capital Partners II, 373 B.R. 682, 686-87 (N.D. Cal. 2007).

30. 11 U.S.C. § 552(b)(1) (2006).

31. *See, e.g.*, Stanziale v. Finova Capital Corp. (*In re* Tower Air, Inc.), 397 F.3d 191, 205 (3d Cir. 2005); *see also In re* Patio & Porch Systems, Inc., 194 B.R. 569, 575 (Bankr. D. Md. 1996).

32. Just as "generation" provides a much weaker nexus between the original collateral and the claimed proceeds than "disposition," the equities favoring a secured creditor whose collateral is merely used are weaker than those favoring a secured creditor whose collateral is used up. Thus, while a secured creditor with a security interest in slot machines, video games, or pay telephones may now be able to assert successfully that its prepetition lien on the machine gives it a lien on all coins that pass through the machine postpetition, what equities favor giving it the actual coins? (Note that the creditor is compensated for any depreciation of the machines under the adequate protection requirement of Bankruptcy Code section 363(e)).

Under prior law, the secured creditor's claim would be cut off completely at the proceeds

Thus, while the revision of Article 9's proceeds definition may succeed in altering the proceeds definition of section 552 of the Bankruptcy Code, that victory may prove to be a pyrrhic one. However, even if the revised definition captures more of the reorganization value for secured creditors in bankruptcy cases, that benefit comes at the cost of imposing a greatly expanded proceeds definition on nonbankruptcy transactions. As noted earlier, the generation model is contrary to the contractual gap filler rationale behind the nonbankruptcy lien-extension feature of the proceeds rule.[33] The expanded proceeds rule harms debtors who are surprised to discover that the proceeds definition granted to the secured creditor additional collateral that the debtor would not have agreed to pledge. The nonbankruptcy lien-extension and priority features of the proceeds rule cause the expanded proceeds definition to harm secured creditors who are surprised to discover, or even lose to, a creditor who can assert a competing "rights arising out of the collateral" proceeds claim against their collateral. These harms in nonbankruptcy transactions may far outweigh any benefit secured creditors obtain in bankruptcy cases from the change.

II. SNEAKING IN THROUGH THE BACK DOOR

In the ten years since revised Article 9 became effective, only two reported decisions have mentioned Article 9's revised definition of proceeds in the context of Bankruptcy Code section 552(b)(1). Both cited to Article 9 and quoted the revised definition as the proper definition for proceeds under Bankruptcy Code section 552(b)(1). However, neither court seemed to be aware that the definition had changed and neither analyzed the new definition or relied upon its changed language to reach a result. Nonetheless, the revised proceeds definition has begun the process of becoming engrafted into bankruptcy law, and it has done so without any careful analysis of whether it should become part of the bankruptcy law.

The first court to consider the revised proceeds definition was the Ninth Circuit Bankruptcy Appellate Panel in *In re Skagit Pacific Corp.*[34] Clearly, the court was not aware that it was creating new law on this point. Indeed, its discussion of the meaning of proceeds mixes the revised definition with the prior one. The court begins its analysis in classic *Bumper Sales* fashion by stating, "Whether particular

argument. *See* CLC Equip. Co. v. Brewer (*In re* Value-Added Communications, Inc.), 139 F.3d 543, 546 (5th Cir. 1998) (holding that coins are not proceeds of pay telephones); *In re* S&J Holding Corp., 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984) (holding that coins are not proceeds of video game machines). While the equities of the case likely will limit the reach of the creditor's postpetition lien on the coins, it may now at least capture a portion of the coin revenue. *Cf. In re* Delbridge, 61 B.R. 484, 490-91 (Bankr. E.D. Mich. 1986) (adopting a formula for apportioning postpetition milk between the farmer and the secured creditor with a lien on the cow that produced the milk).

33. *See* 11 U.S.C. § 552(a).

34. 316 B.R. at 330.

property constitutes proceeds is determined by state law."[35] The court then quotes the expansive revised Article 9 definition of proceeds.[36] However, clearly the court was not aware of the revision because, in the very next sentence, it cites a pre-revision case and paraphrases the *former* definition. The court states, "Washington courts have held that 'proceeds' should be given a flexible and broad content which includes *whatever is received for the sale or other disposition of collateral*."[37]

In *Skagit Pacific*, the debtor was in the business of manufacturing and selling "modular offices and trailers."[38] At issue was money the debtor received postpetition in payment of a particular contract to build and deliver four modular trailers.[39] The contract was entered into postpetition and all performance occurred postpetition.[40] The secured creditor argued that the funds received in payment of that contract were proceeds of its prepetition security interest in the debtor's inventory, equipment, and accounts receivable.[41] However, rather than trace funds received from the sale of prepetition inventory or from the collection of prepetition receivables, the secured creditor argued that the contract payment was proceeds of its collateral merely by virtue of the fact that it had permitted its cash collateral to be used in the debtor's on-going postpetition business operations.[42] Essentially, the argument was that the funds generated by the creditor's prepetition collateral were used to pay expenses such as utilities, supplies, wages, and operations and, in that process, new accounts receivable were created, including the one in dispute.[43]

35. *Id.* at 337. The court cites the Ninth Circuit case of *In re Days Cal. Riverside Ltd. P'ship*, 27 F.3d 374, 376 (9th Cir. 1994), for that proposition, even though that decision involved the "rents" provision of section 552(b), rather than the proceeds provision.

36. *Skagit Pacific*, 316 B.R. at 337.

37. *Id.* (emphasis added).

38. *Id.* at 333.

39. *Id.*

40. *Id.*

41. *Id.* at 334. The parties agreed that, prepetition, the secured party "held a valid and perfected security interest in Skagit's inventory, equipment, accounts receivable, chattel paper and general intangibles, including those after-acquired, and the proceeds of such collateral." *Id.* at 335.

42. While the secured creditor's precise tracing methodology was unclear to the court, *id.* at 338-39, the creditor's argument was that it was entitled to a pro rata share of the contract payment. *Id.* at 334. The creditor argued:

> In a manufacturing setting such as Skagit Pacific's, all overhead is directly and indirectly related to the production of new work. . . . These funds do not have to be traced directly to the production of any particular receivable – [the secured creditor's] cash collateral was used to produce *all* the receivables, and in a manufacturing setting, all of the overhead is directly or indirectly used for the benefit of producing the work, which generates the receivable.

Id. at 339 n.8.

43. *Id.* at 336. The secured creditor was forced to rely on a proceeds argument because it allowed the debtor to use its cash collateral without obtaining a replacement lien on the postpetition receivables as adequate protection of its interest in the cash collateral. *Id.* at 333.

The court rejected that argument for two reasons. Although the court quoted the expansive revised Article 9 proceeds definition, it used a disposition-based proceeds analysis rather than an asset generation analysis. While the court acknowledged that the creditor's cash collateral was used to fund on-going business operations, it adopted the view that "revenue generated by the operation of a debtor's business, postpetition, is not considered proceeds if such revenue represents compensation for goods and services rendered by the debtor in its everyday business performance."[44] The court also appeared to adopt the view that a newly-created asset must be divided into its proceeds and non-proceeds parts.[45] The court states:

> [A]ny portion of the [disputed] 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 other's labor) throughout the process of the reorganization effort will likewise not be subject to a creditor's prepetition interest.[46]

Ultimately, the *Skagit Pacific* decision did not turn on the proceeds definition, but rather on UCC section 9-315(a)(2), which limits the security interest to those proceeds that are "identifiable."[47] Since the secured party failed adequately to show a

44. *Id.* at 336 (citing *In re* Cafeteria Operators, 299 B.R. 400, 405 (Bankr. N.D. Tex. 2003)). This is not necessarily inconsistent with use of the revised Article 9 definition of proceeds. While the need to establish "indentifiab[ility]" of the claimed proceeds, as required by UCC section 9-315(a)(2), presents a serious problem for the secured creditor under either definition (see discussion following). Neither the new nor former proceeds definition requires that a business' income be treated as proceeds of funds provided as general financing. Note that the creditor's situation is not the common and fairly easy to analyze case where an item of the creditor's inventory collateral is sold to generate a receivable, or even where the inventory item is enhanced through labor and then sold. Under either definition, it would require a very liberal interpretation of what is "acquired" or "received" by the debtor upon disposition of the funds to conclude that general business revenues are proceeds of financing. The "rights arising out of collateral" prong of the revised Article 9 definition might provide an easier path to such a result, but even that would require a liberal interpretation of what is meant by "arising." *See* U.C.C. § 9-102(a)(64)(C) (2008). Nonetheless, if one reads the revised definition to adopt a "generation by" approach, the secured creditor's argument has some appeal.

45. This approach seems to merge improperly the "equities of case" analysis of Bankruptcy Code section 552(b)(1) into the initial proceeds determination. Where both the estate and the creditor's collateral combine to produce a new valuable asset, the "equities of the case" exception to the proceeds rule gives the bankruptcy court the discretion to apportion the value between the estate and the secured creditor. *See* 11 U.S.C. § 552(b)(1) (2006); *see generally In re* Delbridge, 61 B.R. 484 (Bankr. E.D. Mich. 1986) (apportioning proceeds).

46. *Skagit Pacific*, 316 B.R. at 336.

47. U.C.C. § 9-315(a)(2) (2008) ("[A] security interest attaches to any *identifiable* proceeds of collateral.") (emphasis added).

transactional link between the purported proceeds and its prepetition collateral, it was not entitled to assert a security interest in the postpetition assets.[48] Thus, although the court's use of the revised Article 9 proceeds definition can be dismissed as *dicta*, the decision shows how easily the revised definition can infiltrate bankruptcy law.

The second case to deal with the new definition in the context of Bankruptcy Code section 552(b)(1) is *Qmect, Inc. v. Burlingame Capital Partners II*.[49] Like the *Skagit Pacific* court, the *Qmect* court began with the proposition that "[s]tate law governs whether or not a particular item of collateral constitutes proceeds of the lien" under Bankruptcy Code 552(b)(1).[50] *Qmect* did not rely on the *Bumper Sales* line of cases for this proposition, but instead cites *Butner v. United States*[51] as authority for its view that section 552(b)(1) incorporates the state law definition of proceeds.[52]

This is an incorrect reading of *Butner*.[53] *Qmect* cites to page fifty-seven of the *Butner* decision, but that page contains no such general rule.[54] While *Butner* did involve the question of a mortgagee's right to postpetition rents, the court decided it under the prior Bankruptcy Act,[55] which had no analog to section 552 of the Bankruptcy Code.[56]

Butner does not stand for a general proposition that state law always must control the rights of secured creditors in bankruptcy cases. It stands for the much more limited proposition that, in the absence of a statutory provision or some federal interest requiring a different result, property interests in bankruptcy are created and defined by state law.[57] Since there was no statute or federal interest identified in *Butner*, the Court held that state law determined the mortgagee's right to postpetition rents.[58] It is in this context that the Court makes the statement that *Qmect* misconstrues. The language relied upon by *Qmect* was merely a restatement of the *Butner* Court's interpretation that the Bankruptcy Act looked to state law for the decisional rule regarding the right to postpetition rents. This is clear from the phrasing used by the *Butner* Court, "The essential point is that in a properly

48. *Skagit Pacific*, 316 B.R. at 338-40.

49. 373 B.R. 682 (N.D. Cal. 2007).

50. *Id.* at 686-87.

51. 440 U.S. 48, 55 (1979), *superseded in part by statute*, Act. of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549.

52. *Id.* at 54-55.

53. If *Butner* did require that section 552(b)(1) replicate the state law rights of secured creditors, then the scope of section 552(b)(1) would expand or contract as state law changed and use of the revised Article 9 definition of proceeds would be correct.

54. 373 B.R. at 686-87 (citing *Butner*, 440 U.S. at 57).

55. *See* National Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.

56. *See Butner*, 440 U.S. at 54 ("Congress has not chosen to exercise its power to fashion [a federal rule governing the right to postpetition rents].").

57. *Id.* at 55.

58 *Id.* at 56.

administered scheme *in which the basic federal rule is that state law governs . . . .*"[59] Further, since *Butner* was not interpreting the definition of proceeds or a predecessor statute to section 552, it provides no authority for what that term might mean in the Bankruptcy Code.

Even though its reason for looking to state law for a proceeds definition was incorrect, the *Qmect* court followed its statement of that proposition with a quotation of the revised Article 9 definition of proceeds.[60] The court did not, however, analyze the new definition or apply its terms to the issue before it.[61]

Instead, like *Skagit Pacific*, the focus of the *Qmect* decision was on the UCC section 9-315(a)(2) requirement that the proceeds be identifiable. Thus, *Qmect's* adoption of the revised Article 9 proceeds definition might be dismissed as *dicta*. However, although the opinion is framed in terms of a tracing analysis, the court's language resonates with the new definition's "generation" approach to proceeds. For example, the court speaks in terms of whether the "postpetition assets were *generated from* secured lenders' collateral"[62] and concludes that, "[n]othing other than secured lenders' collateral could have generated revenue, so all proceeds, even the increase in value, were proceeds of secured lenders' collateral."[63]

Unlike *Skagit Pacific*, the *Qmect* court took a very broad view of the reach of the secured creditors' proceeds lien. The argument was essentially the same as that rejected by the *Skagit Pacific* court. The *Qmect* secured creditors argued that since they held blanket liens on virtually all of the debtor's assets and since their cash collateral was used to finance the debtor's on-going operations, all revenues generated by continued business operations constituted proceeds of their cash collateral.[64]

Rather than analyze the "proceeds" definition or require the secured creditors to present detailed tracing evidence, the court reached its result by working from the opposite direction. Since the only other postpetition financing that the debtor received had been used to satisfy prepetition obligations, the court reasoned that all postpetition receivables therefore had to be proceeds of the secured creditors' collateral.[65] As the court stated, "[T]here were, in effect, no sources to which the

59. *Id.* at 57 (emphasis added).

60. Qmect, Inc. v. Burlingame Capital Partners II, 373 B.R. 682, 687 (N.D. Cal. 2007).

61. The secured creditor did not base its argument on the expansive nature of the revised definition, but instead asserted a more traditional replacement theory of proceeds. *See* Brief of Appellees, *Qmect*, 373 B.R. 682 (No. C-06-05401), 2007 WL 1510105.

62. *Qmect*, 373 B.R. at 687 (emphasis added). In addition, the court paraphrases the bankruptcy trustee's argument as an assertion that "the proceeds from the continued postpetition operation of Qmect were *not derived from* those assets." *Id*. (emphasis added).

63. *Id.* at 688.

64. *See* Brief of Appellees, *supra* note 61.

65. *Qmect*, 373 B.R. at 687.

postpetition accounts receivable could be traced *other than* the secured lenders' collateral. Nothing other than secured lenders' collateral could have generated revenue, so all proceeds, even the increase in value, were proceeds of secured lenders' collateral."[66]

The only significant factual distinction between *Skagit Pacific* and *Qmect* was that the purported proceeds in *Skagit Pacific* were comingled with non-proceeds, whereas in *Qmect* they were not. The *Qmect* court failed to realize that this was the only difference in the cases. Instead *Qmect* distinguished *Skagit Pacific* on two grounds. First, based on the comingling distinction, it read *Skagit Pacific* to be limited to the issue of tracing comingled assets, and then used its "no other possible source" analysis to distinguish the outcomes.[67] Second, it distinguished *Skagit Pacific* on the grounds that, unlike the blanket lien that the *Qmect* lenders had, "the lender in *Skagit Pacific* only had a security interest in certain trucks and inventory of the debtor."[68] This assertion is pulled from the secured creditors' brief,[69] but it is simply not true. Although a second issue raised on appeal in *Skagit Pacific* involved the secured creditor's purported security interest in certain titled vehicles, its lien was not limited to those vehicles, or to those vehicles and inventory. Like the *Qmect* lenders, the *Skagit Pacific* lender clearly held a blanket security interest on virtually all of the debtor's assets. As the *Skagit Pacific* court stated in the facts section of the opinion, "The parties agree that [the secured party] held a valid and enforceable prepetition security interest in owned or after-acquired equipment, inventory, accounts receivable, chattel paper, general intangibles, and all proceeds of such collateral."[70]

The *Qmect* court ignored the trustee's argument that the lenders' cash collateral was not the only source of financing for postpetition operations because, for example, the debtor's employees provided labor in advance of salary payments and suppliers provided materials on credit.[71] Those advances of trade credit were repaid from the proceeds of the postpetition receivables and not from the lenders' prepetition cash collateral.[72] Although the *Qmect* court did not discuss the argument that the expansion of the Article 9 proceeds definition might have the anti-bankruptcy effect of diverting the reorganization value from the estate to the secured creditor, its decision had precisely that effect.[73]

66. *Id.* at 688. As a result of the postpetition operations, the lenders' cash collateral appreciated from $742,837 to $1,570,000. *Id*. at 687.

67. *Id.* at 687-88.

68. *Id.* at 688.

69. *See* Brief of Appellees, *supra* note 61.

70. 316 B.R. 330, 333 (B.A.P. 9th Cir. 2004).

71. *See* Brief of Appellant, *Qmect*, 373 B.R. 682 (No. 06-5401), 2007 WL 1510106.

72. *Id.*

73. The trustee made the argument that the lenders' were trying to capture the reorganization

III. INCORPORATION OF STATE LAW INTO SECTION 552(b)(1)

The early post-revision cases suggest that the change in the Article 9 definition of proceeds will filter into the interpretation of the proceeds provision of Bankruptcy Code section 552(b)(1) and dramatically alter the balance between secured and unsecured creditors in terms of how much of the reorganization value of the enterprise the secured creditor's prepetition lien can reach. The effect will be to change the outcomes in cases where postpetition proceeds are in dispute. But, does a proper reading of section 552(b)(1) mandate that result?

Section 552(b)(1) provides, in relevant part:

> [I]f 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.[74]

Although many terms are defined in the Bankruptcy Code, Congress failed to include in the statute a definition of proceeds.[75] This raises the question whether revised Article 9 supplies the definition for the term proceeds as used in that section. Unfortunately the tools of statutory construction are not precise and rarely yield a single clear answer. The interpretation of proceeds in section 552(b)(1) presents a few obvious possibilities.

The first option is that Article 9 does not control the meaning of the term proceeds as used in section 552(b)(1) of the Bankruptcy Code. Instead, the interpretation of the term proceeds is a matter of federal law and it should be interpreted in light of the purposes of section 552 – the "federal law" interpretation. Under this view, the meaning of the term might be broader or narrower than the Article 9 definition, but proceeds would have a stable meaning that would not vary over time as Article 9 was amended or vary geographically depending on a particular state's adoption of a nonuniform provision or unique interpretations of Article 9 given by that state's courts.

This approach is supported by the legislative history and was reflected in an early edition of the *Norton Bankruptcy Law & Practice* treatise law that was cited and

value that was created by the Chapter 11 process and that the reorganization value was not part of the lenders' prepetition collateral. *See id.*

74. 11 U.S.C. § 552(b)(1) (2006).

75. 11 U.S.C. § 101 (defining terms).

rejected in the *Bumper Sales* opinion.[76] Several cases also adopt the federal law interpretation of proceeds in section 552(b)(1).[77] While most of these cases also adopt *Norton's* view that the federal meaning of proceeds is broader than the Article 9 definition of proceeds was in 1978,[78] the rehabilitative purpose of bankruptcy law could support a more restrictive federal law meaning.[79]

A variation on the federal law interpretation is that federal law determines the meaning of the term proceeds as used in Bankruptcy Code section 552(b)(1), but that Congress intended to adopt the state law meaning of that term as it was understood in 1978 when the Bankruptcy Code was enacted. This view is based on the idea that the term "proceeds" as defined in the 1972 version of Article 9 had a well-understood and virtually uniform meaning in all states.[80] Thus, when Congress used that term in the personal property security interest context in section 552(b)(1), it was referring to the term of art used in the uniform law that governed the great majority of security interests in personal property[81]—the "adoption" interpretation. Under this view, state law would be the reference source for the meaning of proceeds, but the definition would be a static one, frozen in time as of 1978. It is not clear how many cases adopt this view because many of the opinions simply cite to Article 9 for the proceeds definition without discussion or they state that the proceeds definition is supplied by the UCC without discussing the distinction between using the UCC as the initial reference source for that term and incorporating the UCC provision as the operative legal rule.[82] Under the adoption interpretation, the revision of Article 9 and its expansion of the proceeds concept would not affect the meaning of proceeds in section 552(b)(1).

At the other end of the spectrum, section 552(b)(1) could be interpreted to defer to state law completely. In other words, section 552(b)(1) incorporates the state law of proceeds and the term "proceeds" means whatever the law of the relevant state

76. *See infra* note 113 and accompanying text. The current edition of the *Norton* treatise continues to take this view. 4 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 72:3 (3d ed. 2010).

77. *See* 1 COLLIER ON BANKRUPTCY ¶ 552.02[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); *see e.g.*, Great-West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843, 851 (N.D. Ohio 1994).

78. *See, e.g.*, James Cable Partners v. Citibank (*In re* James Cable Partners), 141 B.R. 772, 776 (Bankr. M.D. Ga. 1992).

79. *See* United Va. Bank v. Slab Fork Coal Co. (*In re* Slab Fork Coal Co.), 784 F.2d 1188, 1191 (4th Cir. 1986) (emphasizing the balance section 552 strikes "between the rights of secured creditors and the rehabilitative purposes of [bankruptcy law]").

80. *See In re* Ledis, 259 B.R. 472, 478 (Bankr. D. Mass. 2001) (using the UCC definition because of its nearly universal adoption).

81. *Id.*

82. *See, e.g.*, *In re* Megamarket of Lexington, Inc., 207 B.R. 527, 532 (Bankr. E.D. Ky. 1997).

says "proceeds" means at the relevant point in time[83]—the "nonbankruptcy law incorporation" interpretation. Presumably, the meaning of the term would also vary depending upon the context. For example, where the collateral includes both collateral governed by Article 9 and collateral such as an insurance policy that is excluded from Article 9,[84] the Article 9 definition of proceeds would determine what constitutes proceeds of the Article 9 collateral, while the relevant non-Article 9 law would determine what constitutes proceeds of the non-Article 9 collateral.[85]

A. *Is There Any Federal Law in Section 552(b)(1)?*

Section 552 clearly does incorporate some nonbankruptcy law. Indeed, section 552(b)(1) expressly refers to "applicable nonbankruptcy law" in one instance.[86] The question is the extent of that incorporation.

Section 552 begins with subsection (a), a broad general rule that protects postpetition property from the reach[87] of prepetition security agreements.[88] This rule

83. This is different from the pure *Butner* analysis incorrectly relied upon by the *Qmect* court, and mentioned in various other cases. *See, e.g.*, *In re* Rumker, 184 B.R. 621, 624 (Bankr. S.D. Ga. 1995). The pure *Butner* analysis does not purport to interpret the language of section 552(b)(1), but rather reads *Butner* to require deference to nonbankruptcy law. As discussed above, this is a misreading of *Butner*. *Butner* was decided when there was no statutory provision to interpret and held that in the absence of a statute or bankruptcy policy requiring a different result, "the basic federal rule is that state law governs." 440 U.S. 48, 57 (1979), *superseded in part by statute*, Act. of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. The question posed by the revision of the Article 9 proceeds definition is *whether* section 552(b)(1) is a statute requiring a different result. *See* Great-West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843, 849 (N.D. Ohio 1994) (noting that section 552 is such a statute). The answer turns on the meaning of the term proceeds, and for that *Butner* provides no guidance.

84. *See* U.C.C. § 9-109(d)(8) (2008) (excluding insurance policies from Article 9 coverage).

85. Federal nonbankruptcy law or foreign law might even supply the proceeds definition if the transaction was one where state law was preempted under the Supremacy Clause of the Constitution. U.S. CONST. art. VI, § 1, cl. 2; U.C.C. § 9-311(a)(1) (2008) (deferring for perfection rules to federal statutes, regulation and treaties that preempt the UCC); U.C.C. § 9-104(a) (1972) (deferring to federal law). It is unclear how the nonbankruptcy law incorporation interpretation of section 552(b)(1) would apply if the incorporated law has a proceeds-like principle, but does not use the label "proceeds" to describe that construct. Presumably the secured creditor would have no rights to postpetition collateral since there would be no federal meaning of "proceeds" that could be used to determine whether the particular asset grabbing principle was a "proceeds" type of rule.

86. 11 U.S.C. § 552(b)(1) (2006).

87. The drafting process did not take place in a void. Congress was well aware of Article 9 of the UCC and discussed it a length in the committee reports. Both the House and Senate reports begin their discussions of section 552 with the statement, "Under the Uniform Commercial Code, Article 9, creditors may take security interests in after-acquired property. This section governs the effect of such a prepetition security interest in postpetition property." H.R. Rep. NO. 95-595, at 376 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332; *see* S. REP. NO. 95-989, at 91 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877 (replacing "This section" with "Section 552").

is subject to an exception for proceeds (and certain other categories of postpetition property) in subsection (b)(1).[89] Subsection (b)(2) was added in 1994.[90] That amendment pulled "rents" out of the list of postpetition assets subject to the section 552(b)(1) exception and placed it in a new, similarly worded, exception designated as subsection (b)(2).[91] In addition, it added hotel use and occupancy fees to the types of

88. Section 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."

89. *See* 11 U.S.C. § 552(b)(1).

90. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, 4126.

91. *Id.*; *see* 11 U.S.C. § 552(b)(2). It is not clear whether the amendment failed to recognize that the term "profits" was also a real estate term that should have been moved into subsection (b)(2), or whether that term was left in subsection (b)(1) because only "rents" had generated controversy. Profits is a term of art that refers to property generated by real estate. BLACK'S LAW DICTIONARY 1330 (9th ed. 2009). Thus, this naturally would have been included in the newly created real estate and hotel provisions of subsection (b)(2). Interestingly, a broad reading of the term rents could capture at least some of the personal property collateral that the revised Article 9 definition of proceeds now extends to. *See* U.C.C. § 9-102(a)(64) (2008) (including "whatever is acquired upon . . . lease . . . of collateral"). Although no language in section 552 expressly limits the terms rents or profits to real estate, both are used to refer to postpetition property generated by real estate. The legislative history supports this limitation. The terms "rents and profits" first appeared in section 4-715 of the bill proposed by the National Conference of Bankruptcy Judges [hereinafter "Judges' Bill"] that was introduced as H.R. 32, 94th Cong. (1975). The bill proposed by the Commission on the Bankruptcy Law of the United States [hereinafter "Commission Bill"], to which the Judges' Bill was a response, was introduced as H.R. 31, 94th Cong. (1975). Section 7-202 of the Commission Bill simply permitted the estate to "use property of the estate subject to a lien, and the proceeds thereof" without distinguishing between real and personal property. The Judges' Bill differentiated between "rents and profits" and "proceeds," and treated each in different subsections. One subsection permitted the estate to use "rents and profits *of real estate*." *See* H.R. 32, § 4-715(a)(1) (emphasis added). The other, a precursor to the special "cash collateral" rules of Bankruptcy Code section 363(c)(2), allowed the estate to use "the proceeds of collateral" but only if notice was given to the secured party. *Id.* § 4-715(a)(3). The words "product, and offspring" are added to the word "proceeds" in a revision of the Commission Bill that was proposed by the National Bankruptcy Conference. *Bankruptcy Act Revision: Hearing on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. app. ser. no. 27 (1975-77), *reprinted in* 7 BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY 376 (Alan N. Resnick & Eugene N. Wypyski, eds., 1979) [hereinafter "NBC Proposed Bill"]. The NBC Proposed Bill did not mention rents or profits. Although that NBC Proposed Bill was not adopted, it's addition of the product and offspring terms do appear in the bill that reflected the compromise between the Commission Bill and the Judges' Bill. Thus, the phrase "proceeds, product, or offspring of property" appears in H.R. 6, which has the Bankruptcy Code's numbering of section 552 and much of its language. H.R. 6, 95th Cong., § 552(b) (1977), *reprinted in* 11 BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY 101-02 (Alan N. Resnick & Eugene N. Wypyski, eds., 1979). This early version of section 552 does refer to rents or profits, but in an exclusionary rather than inclusive way. In contrast to the enacted version of section 552(b), H.R. 6 states that "any such proceeds, product, or offspring, *not including rents or profits*, acquired by the estate after the commencement of the case

postpetition property that might be subject to the lien created by a prepetition security agreement.[92]

Focusing on the language of section 552(b)(1), the first clause of the above-quoted excerpt states the conditions that must be satisfied in order for the proceeds exception rule to apply. Although this clause does not contain an express reference to "applicable nonbankruptcy law," it presumably looks to nonbankruptcy law to determine whether "the debtor and an entity entered into a security agreement before the commencement of the case."[93]

The next part of the provision requires a determination that "the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case" and whether it also "extends" to property that constitutes "proceeds . . . of such property."[94] The "extends" analysis again looks to nonbankruptcy law to determine the reach of the prepetition security interest. This is clear from the legislative history. As House Report 595 states:

> "Extends to" as used here would include an automatically arising security interest in proceeds, as permitted under the 1972 version of the Uniform Commercial Code, as well as an interest in proceeds specifically designated, as required under the 1962 Code or similar statutes covering property not covered by the Code.[95]

The critical question is whether the reference to proceeds also incorporates nonbankruptcy law. Here House Report 595 could hardly be clearer. Its answer is a resounding "no." House Report 595 states, "The term 'proceeds' is not limited to the technical definition of that term in the U.C.C., but covers any property into which

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are subject to the security interest." *Id.* (emphasis added). The exclusionary language is converted to inclusionary language and the phrase "proceeds, product, offspring, rents, or profits" appears in H.R. 8200 and the competing Senate Bill, S. 2266, which are the bills ultimately passed by the House and Senate. H.R. 8200, 95th Cong., § 552(b) (1977), *reprinted in* B COLLIER ON BANKRUPTCY app. pt. 4(d) at app. pt. 4-941 (Alan N. Resnick & Harry J. Sommer, eds., 15th ed. 2009); S. 2266, 95th Cong. § 552(b) (1978), *reprinted in* C COLLIER ON BANKRUPTCY, *supra*, at app. pt. 4-1810. Thus, Congress simply deleted the words "not including" from H.R. 6 and stuck the real estate constructs of rents and profits onto the end of the list of the personal property ones to create a single string of words "proceeds, product, offspring, rents, and profits," presumably assuming that their real estate character was obvious and that a more awkward phrasing like "proceeds, product, and offspring of personal property and rents and profits of real estate" was not necessary.

92. *See* 11 U.S.C. § 552(b)(2).

93. *See* 11 U.S.C. § 552(b)(1)-(2). While this is mostly a factual inquiry, the "entered into" language might trigger a legal inquiry for which nonbankruptcy law would supply the decisional rule.

94. *Id.*

95. H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333.

property subject to the security interest is converted."[96] Two points are very clear from this statement. First, the drafters of section 552(b)(1) did not intend to adopt the UCC definition of proceeds. Second, they certainly did not intend to incorporate the state law of proceeds with all of its particulars.[97] Thus, proceeds is used in section 552(b)(1) as a federal bankruptcy law term of art and it operates as an independent federal limitation on the extent to which state law may validate security interests in postpetition assets under a proceeds rubric. Second, House Report 595 makes clear that the federal concept of proceeds is based on a conversion model.[98] Thus, section 552(b) permits the secured creditor's prepetition lien to extend only to postpetition "property into which [collateral] is converted," and not to postpetition property that is generated by or arises from the collateral.[99] The relevant nexus between the prepetition collateral and the postpetition asset is that the postpetition asset in some way replaces the prepetition collateral. While this is virtually identical to the proceeds definition in former Article 9, the asset generation concept added to revised Article 9's proceeds definition is much broader than the section 552(b)(1) proceeds concept.

Section 552(b)(1), if properly construed, creates a dual filter to limit the postpetition effect of prepetition security agreements.[100] First, the lien on postpetition assets cannot extend further than it would in the absence of a bankruptcy. Here is

96. *Id.*

97. The Senate Report does not contain a similar statement about proceeds. It does, however, contain a two-sentence comment that may support the nonbankruptcy law incorporation approach, but which appears to have gone unnoticed by courts and commentators. The Senate Report states:

> Subsection (b) provides an important exception consistent with the Uniform Commercial Code. If the security agreement extends to proceeds, product, offspring, rents, or profits of the property in question, then the proceeds would continue to be subject to the security interest pursuant to the terms of the security agreement and provisions of applicable law. . . .

S. REP. NO. 95-989, at 91 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877.

Senate Report 989 came later than House Report 595. In contrast to House Report 595 that had to explain newly added statutory, there was no change in the relevant proceeds statutory language that needed to be explained. *Compare* S. 2266, 95th Cong., § 552(b) (1978), *reprinted in* C COLLIER ON BANKRUPTCY, *supra* note 93, at app. pt. 4-1810, *with* H.R. 8200, 95th Cong., § 552(b) (1977), *reprinted in* B COLLIER ON BANKRUPTCY, *supra* note 93, at app. pt. 4-941. The focus of the Senate Report was on the difference between its version and the House's version of the provision that became the equities of the case exception. Thus, little thought may have been given to the paraphrasing of the basic proceeds rule that served as the background for the discussion of Senate's proposed improvement in position exception to the proceeds rule.

98. *See* H.R. REP. NO. 95-595, at 377.

99. *See id.* at 376-77.

100. *See* Great-West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843, 846 (N.D. Ohio 1994) (discussing this approach).

where applicable nonbankruptcy law and the expanded definition of proceeds in revised Article 9 operate. Section 552(b)(1) does not distinguish between contractual and automatic lien grants.[101] Thus, regardless of whether the security interest arises from language in the security agreement, from a case or statute that automatically extends the lien to proceeds and uses that particular term, or from a case or statute that automatically extends to lien to future assets without using the term proceeds, the lien will pass through the applicable nonbankruptcy law filter.[102] Second, regardless of the breadth of applicable nonbankruptcy law, the lien is limited to those postpetition assets that are sufficiently connected to the prepetition collateral to constitute proceeds under federal bankruptcy law.

Thus, because of the nonbankruptcy law filter, the postpetition lien will never be more extensive than it would be outside of bankruptcy. Even if the federal bankruptcy law meaning of proceeds was broader than the applicable nonbankruptcy law proceeds concept or there was no proceeds concept at all in the nonbankruptcy law, the federal definition would not operate to extend the lien. Conversely, the postpetition lien will never reach assets that are not proceeds of the prepetition collateral under bankruptcy law, regardless of how broad the proceeds concept may be under applicable nonbankruptcy law.[103]

101. *See supra* note 85 and accompanying text. If it did draw such a distinction, then it might not protect proceeds claims in states where the 1972 version of Article 9 still applied because that version arguably did not grant automatic proceeds liens. House Report 595 assumes that proceeds liens were not automatic under the 1962 version of Article 9. That view is based on an inconsistency between section 9-203(1)(b) and section 9-306(2) of the 1962 version of the UCC. Language in section 9-203(1)(b) suggested that a claim to proceeds required an express term in the security agreement. *See* RAY D. HENSON, HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE app. at 432-33 (2d ed. 1979) (explaining reasons for the 1972 changes to sections 9-203 and 9-306). This may explain why Congress's statement of the nonbankruptcy law filter refers both to the security agreement and to applicable nonbankruptcy law.

102. *See* 1 COLLIER ON BANKRUPTCY, *supra* note 77, ¶ 552.02[3], at 552-11. If foreign law applied to the security agreement, the applicable legal regime might have no proceeds concept or might not use the term proceeds (e.g., the law of a non-English speaking nation), but might enforce contractual after-acquired property provisions in security agreements. This would present no problem under the two filter approach because foreign law could easily be applied to see how extensive the lien would be under nonbankruptcy law. The bankruptcy law proceeds definition could then be applied to determine the extent to which that lien would be cut off in the bankruptcy case. An approach that uses only the single filter of applicable nonbankruptcy law would yield an all or nothing result. Alternatively, one could try to determine whether the foreign law concept was in the nature of a proceeds rule, but that would involve interpreting the section 552(b)(1) term proceeds without using the applicable nonbankruptcy law–in other words, that would be the federal law approach. *See* 11 U.S.C. § 552(b)(1) (2006).

103. For example, although contrary to the ordinary meaning of proceeds, a state could adopt a nonuniform amendment to UCC 9-102(a)(64) that defines proceeds to include all future property of the same UCC type of collateral as that described in the security agreement. *See* U.C.C. § 9-102(a)(64) (2008). This hypothetical is essentially what UCC section 9-204(a) permits parties to

Thus far, we have reviewed only the language of section 552(b)(1) that sets forth the predicate to the section's operative rule. That language, under the dual filter approach, could be paraphrased as follows: "if the prepetition security agreement creates a lien that under applicable nonbankruptcy law would extend to postpetition property, then that property constitutes proceeds of prepetition collateral under bankruptcy law." The predicate "if" clause is followed by the "then" clause that states the proceeds exception to section 552(a)'s prohibition of security interests in after-acquired postpetition property. The "then" clause sets forth both filters as operative rules.

First, the statute provides that "then such security interest extends to such proceeds . . . acquired by the estate after the commencement of the case."[104] This is the federal bankruptcy law filter. It is stated as a grant rather than as a limitation because section 552(a) prevents applicable nonbankruptcy law from creating a security interest in any postpetition asset. However, it is a limited grant that applies only to postpetition proceeds. Clearly 552(b)(1), and not state law, is the source of the rule that "extends" the security interest to postpetition proceeds. Further, as discussed above, the question of how far that lien extends—i.e., what constitutes proceeds—is also determined by federal bankruptcy law.

The applicable nonbankruptcy law filter follows that grant. It is stated as a limitation. The language limits the secured party's postpetition proceeds lien "to the extent provided by such security agreement and by applicable nonbankruptcy law."[105] Nonbankruptcy law governs this part of the analysis. This clause includes the only express reference to "applicable nonbankruptcy law" anywhere in section 552. Does the use of that language in this clause necessarily indicate either that applicable nonbankruptcy law is the reference source for the meaning of the term proceeds (the adoption approach) or that the nonbankruptcy proceeds rule *controls* the first filter (the incorporation approach)? Clearly not. That language is not part of the statement of the lien grant. Rather, it comes after the granting clause and even after the statement of the security agreement limitation on that grant.[106] Thus, applicable nonbankruptcy law is used to define the scope of the limitation, but not of the grant.

do by contract through after-acquired property clauses, but merely uses a different term "proceeds" as the label for the concept. *See id.* § 9-204(a). Under the nonbankruptcy law incorporation interpretation of section 552(b)(1), such a lien would be effective in bankruptcy even though there was no nexus between the prepetition collateral and the postpetition property, thus rendering section 552(a)'s prohibition completely ineffective. *Compare* 11 U.S.C. § 552(b)(1), *with id.* § 552(a). The dual filter approach would permit the lien to reach postpetition property, but only to the extent those assets were proceeds of the prepetition collateral in the bankruptcy law sense.

104. 11 U.S.C. § 552(b)(1).

105. 11 U.S.C. § 552(b)(1).This limitation is followed by a further limitation that permits the court to limit the lien on postpetition proceeds "based on the equities of the case." *Id.*

106. It is not clear why the statutory language lists both the "security agreement" and "applicable nonbankruptcy law" as limitations on the lien grant. Simply referring to applicable

While it is also possible to read the grant and the limitation language together as a single granting clause, such a read is not only contrary to House Report 595 but also refuted by the structure of the statutory language. The structure of the sentence shows that the phrase "to the extent provided . . . by applicable nonbankruptcy law" modifies the "such security interest extends" phrase and not the "to such proceeds" phrase.[107] Were it designed to define proceeds, then it likely would have been worded something like "such proceeds as defined by applicable nonbankruptcy law." The idea that the "applicable nonbankruptcy law" language was added to section 552(b)(1) to provide a source for the proceeds definition rather than to provide a limitation on the postpetition security interest is further refuted by the inclusion of the "to the extent provided by such security agreement" language.[108] The security agreement phrase parallels the applicable nonbankruptcy law language.[109] Thus, if the incorporation view is adopted, then the security agreement is equally a source of the proceeds definition and the scope of section 552(b)(1) can be expanded by either a revision of Article 9's proceeds definition or simply by providing a broad proceeds

nonbankruptcy law would seem sufficient because the determination of whether nonbankruptcy law provides for a broad enough lien to reach the property constituting postpetition proceeds would necessarily include consideration of the *legal effect* of the security agreement. The phrasing suggests that the proceeds lien must *both* be "provided by" applicable nonbankruptcy law *and* be "provided by" the security agreement. *See* U.C.C. § 9-203(f) (2008). Of course in the case of Article 9's automatic proceeds lien, there need not be any language in the security agreement *providing* for proceeds. *See id.* §§ 9-203(f), 9-315(a)(2) (providing an automatic security interest in proceeds without regard to the phrasing of the security agreement). *Compare id.* § 9-203(b)(3)(A), *and id.* § 9-102(a)(73) (requiring the security agreement contain language that "creates or provides a security interest" in order for a non-proceeds security interest to attach). *See also* 11 U.S.C. § 101(50) (using "creates or provides for" language in the Bankruptcy Code's definition of security agreement). The reference to the security agreement is not needed in order to limit section 552(b)(1)'s reach to liens created by agreement, as opposed to judicial liens or involuntary statutory liens. That limitation on section 552(b)'s scope is inherent in its use of the defined terms "security agreement" and "security interest." *Id.* § 552(b)(1); *see id.* § 101(50)-(51) (defining those terms). The requirement that there be a prepetition security agreement is adequately assured by the predicate "if" clause that imposes that requirement. *Id.* § 552(b)(1). If the "provided by such security agreement" language is read to add any requirement beyond the "provided . . . by applicable nonbankruptcy law" requirement then it would have the effect of eliminating the very non-contractual proceeds lien that the legislative history indicates section 552(b)(1) clearly was designed to protect. *Id.; see* H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333. The reference to the security agreement most likely was added to insure that courts did not limit the section 552(b)(1) exception to proceeds liens that arose automatically, but also extended its protection to liens on proceeds that depended on language in the security agreement, such as proceeds under the 1962 version of Article 9. U.C.C. § 9-203 (1962).

107. *See* 11 U.S.C. § 552(b)(1).

108. *See* 11 U.S.C. § 552(b)(1).

109. *See* 11 U.S.C. § 552(b)(1).

definition in the security agreement. That reading puts section 552(b)(1) in direct conflict with section 552(a).

Further, if section 552(b)(1) were designed to erect only a single filter—that already imposed by the applicable nonbankruptcy proceeds law—on the reach of a prepetition security agreement to postpetition property, then it would likely be written in a far simpler fashion. For example, the proceeds exception could have been set forth simply as an exception to subsection 552(a) by adding to the end of that subsection the phrase "except to the extent that under applicable nonbankruptcy law the lien resulting from such security agreement extends to proceeds [products, etc.] of property the debtor acquired before the commencement of the case that is subject to such lien."[110] The rather convoluted structure of subsection 552(b)(1) suggests that section 552(b)(1) was not intended merely to replicate whatever state law rule existed for proceeds, but that it was intended to impose a federal law limitation on a secured creditor's ability to reach postpetition property based on a bankruptcy-specific balancing of the rights of secured creditors against the reorganization policy and the interests of the unsecured creditor body.[111]

The secured creditor is not entitled to use its prepetition security agreement to divert the reorganization value of the estate away from the estate and the unsecured creditors. Section 552(b)(1) used the term proceeds to reflect this balance.

B. Bumper Sales *Deconstructed*

Faced with the possible alternative readings of section 552(b)(1),[112] why did the *Bumper Sales* court adopt the view that the UCC definition of proceeds is incorporated into that section?[113]

110. This approach is also simpler than subsection 522(b)(1) because it does not require the lead-in language of the current provision that carves out Bankruptcy Code "sections 363, 506(c), 522, 544, 545, 547, and 548." 11 U.S.C. § 552(b)(1).. The carve out language is not necessary because this construction does not contain a grant. This example also does not include the "equities of the case" exception, but it could be added as an additional clause or as a separate sentence or subsection.

111. *See* United Va. Bank v. Slab Fork Coal Co. (*In re* Slab Fork Coal Co.), 784 F.2d 1188, 1191 (4th Cir. 1986).

112. *See* Unsecured Creditors Comm. v. Marepcon Fin. Corp. (*In re* Bumper Sales, Inc.), 907 F.2d 1430, 1437 (4th Cir. 1990). While the court addressed language located in section 55(b), this language is currently found in section 552(b)(1). *Compare* 11 U.S.C. § 552(b) (1988), *with id.* § 552(b)(1). Consequently, section 552(b) as addressed by the *Bumper Sales* court shall hereinafter be identified as section 552(b)(1).

113. *Bumper Sales*, 907 F.2d at 1437. While the *Bumper Sales* opinion does not discuss the distinction between the UCC adoption approach and the UCC incorporation approach, it appears that the court interpreted section 552(b)(1) to incorporate the UCC proceeds definition, rather than merely to have adopted the UCC definition as it existed in 1978. The court's statement of the interpretation as one where "Congress intended to defer to state law" and its emphasis on the need for identical proceeds outcomes both prepetition and postpetition support the incorporation approach. *See id.*

The most likely explanation is that the *Bumper Sales* court was well aware of the careful balance embodied in section 552(b)(1) and that it adopted the UCC definition of proceeds because it was a *narrower* definition that more accurately reflected the conversion or replacement view of proceeds. After quoting House Report 595's statement "that 'the term 'proceeds' [was] not limited to the technical definition of that term in the UCC,'"[114] the *Bumper Sales* court then cited the *Norton* treatise on bankruptcy law for the proposition that the federal law approach "encourages a broader coverage of proceeds than in the UCC."[115] The section of the *Norton* treatise cited by the court stated that proceeds includes "property into which the prepetition property is converted, property derived from the prepetition property, and income from the prepetition property that is acquired by the estate after the commencement of the case."[116] Although the *Norton* language sounds much like the revised Article 9 definition of proceeds with its asset generation approach, there is nothing in the language of section 552(b)(1) or in its legislative history to support such a broad statement. Indeed, the legislative history supports the conversion approach to the proceeds definition.[117] House Report 595's rejection of the "technical definition" in the UCC does not necessarily lead to a broader meaning of proceeds in bankruptcy. It might also yield a narrower one if the UCC definition of proceeds extended beyond the conversion principle.[118]

Nonetheless, the possibility that the federal law approach might give secured creditors a lien on a wider range of postpetition assets clearly troubled the court. After dismissing House Report 595 by calling it "a vague and isolated piece of

114. *Id.* (quoting H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333).

115. *Id.* (citing 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 38.03 (1981)).

116. NORTON, *supra* note 115. This language still appears in the current edition. *See* NORTON, *supra* note 76. As support for this statement, *Norton's* cites to page 377 of House Report 595 and states that "[t]he legislative history states that the statutory examples of after-acquired property which are subject to the exception are illustrative rather than exclusive." *Id.* However, House Report 595 contains neither examples of after-acquired property nor does it say anything about the list being illustrative. *See* H.R. REP. NO. 95-595, at 377.

117. *See* H.R. REP. NO. 95-595, at 377.

118. The use of the phrasing "is not limited to" in the statement in House Report 595 presumably is the justification for reading that statement to support the view that the section 552(b)(1) definition of proceeds is broader than the UCC definition. However, the "is not limited to" language is used to modify the word "definition" rather than a word like "property." *Id.* Thus, the statement merely indicates that the section 552(b)(1) definition of proceeds is not limited to the UCC definition of proceeds. It does not indicate whether a broader or narrow class of assets is included in the section 552(b)(1) definition. A broader meaning would have been clear if the legislative statement had included the additional words that are italicized in the following modification of the legislative statement, "The term 'proceeds' is not limited to *the property covered by* the technical definition of that term in the UCC, but covers any property."

legislative history,"[119] the court stated, "[w]e also note that the judicial creation of a definition for 'proceeds,' broader postpetition than prepetition, would produce arbitrary and potentially inequitable results. As a result, we hold that the UCC's definition and treatment of proceeds applies to Section 552 of the Bankruptcy Code."[120]

Thus, the court's rejection of the federal law approach appears to be based on its concern that the federal definition would be broader than the UCC definition. As a result, secured creditors would enjoy a broader proceeds claim in bankruptcy under section 552(b)(1) than they would have had in the absence of bankruptcy. The court was wrong on both counts, and thus its rejection of the federal law approach is suspect. As noted above, the federal law definition of proceeds would not necessarily be broader than the state law definition. It could, however, be *different from* the state law definition.[121] Nonetheless, even if the federal definition were *broader* than the UCC definition, that would not give secured creditors a broader lien in bankruptcy than they would have outside of bankruptcy.[122] The *Bumper Sales* court failed to understand that the federal law approach to section 552(b)(1) erects a dual filter for postpetition lien claims. The secured creditor must establish *both* that the postpetition property is proceeds under federal law *and* that its security interest extends to that property under applicable nonbankruptcy law. Since applicable nonbankruptcy law provides an independent limitation on the reach of the secured creditor's postpetition

119. *Bumper Sales*, 907 F.2d at 1437.

120. *Id.* As final support for its nonbankruptcy law incorporation view, the court noted that its holding "is consistent with the unstated rule of the many courts that have looked to the UCC in applying Section 552 of the Code." *Id.*

121. A judicially created definition built on the conversion principle would likely be very similar to the UCC Article 9 definition as it existed in 1978, which was based on a virtually identical "disposition" or replacement model. U.C.C. § 9-306(1) (1978). The 1994 expansion of former Article 9's proceeds definition to include "[a]ny payments or distributions made with respect to investment property" caused the bankruptcy and nonbankruptcy proceeds definitions to diverge. U.C.C. § 9-306(1) (1994). However, this is an instance where the bankruptcy definition would be *narrower* than the nonbankruptcy definition, at least with respect to non-liquidating stock dividends. *See* FDIC v. Hastie (*In re* Hastie), 2 F.3d 1042, 1045-46 (10th Cir. 1993) (holding that cash dividends on stock do not satisfy the "disposition" requirement).

122. This difference distinguishes the *Bumper Sales* situation from *Butner v. United States*. 440 U.S. 48, 55-56 (1979) 440 U.S. 48, 55 (1979), *superseded in part by statute*, Act. of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. The inequity of granting creditors a *broader* lien in bankruptcy than out of bankruptcy was one of the reasons the *Butner* Court adopted the general rule that state law governs property rights in bankruptcy. *Id.* at 56. The *Butner* Court noted that the federal law approach in that case "affords the mortgagee rights that are not his as a matter of state law." *Id.* The Court continued, "[t]he rule we adopt avoids this inequity because it looks to state law to define the security interest of the mortgagee." *Id.*

lien, the secured creditor's lien could never be broader postpetition than prepetition.[123]

The *Bumper Sales* court's only other rationale for its holding is an interpretation of the language of section 552(b)(1). Unfortunately, the court's opinion on this point consists of little more than a short conclusory statement.[124] The court does not explain its reasoning or provide any analysis to support its conclusion.[125] At the beginning of its section 552(b)(1) analysis, the court states the competing positions on the meaning of the section.[126] It states the nonbankruptcy law incorporation position as follows: "One [interpretation] infers from the absence of a Code definition and from Section 552(b)'s language limiting any security interest 'to the extent provided by . . . applicable nonbankruptcy law' that Congress intended to defer to state law, *i.e.*, to the UCC."[127] The court then stated and discussed the argument that federal law supplied the proceeds definition.[128] After discussing the legislative statement upon which that argument is based, the court stated, "However, we believe that Section 552(b)'s express reference to 'nonbankruptcy law' should take priority over a vague and isolated piece of legislative history."[129] Although there is no further discussion of the statutory construction argument, the court adopts the view that the term "applicable nonbankruptcy law" does not merely impose a limitation on the postpetition reach of a security interest, but that it also modifies the term proceeds, as used in section 552(b)(1).[130]

As discussed in greater detail above, the "applicable nonbankruptcy law" language does not modify the term proceeds, but instead provides a limitation on the

123. Under the federal law approach it does not matter whether the secured creditor's nonbankruptcy law lien arises automatically under a nonbankruptcy law proceeds rule or because of a contractual provision. This is consistent with the legislative history. *See supra* note 101 and accompanying text. Outside of bankruptcy, both after acquired property clauses and proceeds rules could add new assets to the collateral pool. Under the federal law approach, property acquired by the estate postpetition also could be added to the secured creditor's collateral pool by *either* an after acquired property clause or a nonbankruptcy proceeds rule. The only limitation would be that the postpetition property must qualify as proceeds under federal law. Thus, while the *Bumper Sales* court was wrong in assuming that a broader federal definition of proceeds would produce a broader lien postpetition than prepetition, the federal law approach could yield a broader lien postpetition than a secured creditor might receive *automatically* under the nonbankruptcy proceeds rule prepetition. If the technicality of the source of the lien was the *Bumper Sales* court's concern, rather than the possibility of a broader lien, then it is not clear why that would be either arbitrary or inequitable.

124. *See Bumper Sales*, 907 F.2d at 1437.

125. *Id.*

126. *Id.*

127. *Id.* (citing 4 COLLIER ON BANKRUPTCY ¶ 552.02 (8th ed. 1989)).

128. *See Bumper Sales*, 907 F.2d at 1437.

129. *Id.*

130. *Id.*

reach of postpetition liens.[131] However, whether the nonbankruptcy law incorporation approach or the federal law approach is the better interpretation of the section 552(b)(1) language, both interpretations are possible readings of the statute. A clearly worded statute would trigger a plain language analysis that might obviate the need to consider legislative history. However, the nonbankruptcy law incorporation interpretation of section 522(b)(1) is not such a clearly correct interpretation that it qualifies for the plain language rule of statutory construction. Faced with two plausible alternative readings of the statutory language, the court should have looked to the legislative history for guidance as to which reading was intended. Thus, when the question is whether one of two possible interpretations of the statute is correct, it is not sufficient for the *Bumper Sales* court simply to state that one of those alternative interpretations "should take priority over" the legislative history.[132]

To be fair to the court, it also supported the nonbankruptcy law interpretation with what it thought were strong policy reasons. Thus, its reasoning was that vague, but suggestive, statutory language plus strong public policy trumped contrary language in a legislative report.[133] This would be an appropriate approach but for the fact that its policy arguments were based on false assumptions.

The court may have realized that its statutory language argument was weak because it bolstered that argument by denigrating the contrary legislative history.[134] The court did not assert that the statutory language was clear, but rather dismissed the legislative statement as "a vague and isolated piece of legislative history."[135] Neither of those assertions is correct.

The statement in House Report 595 is anything but vague on the question whether the UCC supplies the section 552(b)(1) definition of proceeds. House Report 595 specifically refers to the UCC definition and it expressly rejects it.[136] Further, it follows with its own definition of proceeds as "any property into which property subject to the security interest is converted."[137] On these points House Report 595 could hardly be clearer.

If there is any vagueness in the committee report statement, it arises from the use of the terms "limited" and "technical."[138] However, whatever vagueness is created by those terms goes to the *scope* of the federal proceeds definition and not to its *source*.

131. *See supra* note 106 and accompanying text.
132. *See* 907 F.2d at 1437.
133. *See id.*
134. *See id.*
135. *Id.*
136. H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333.
137. *Id.*
138. *Id.*

What is meant by the statement that the term proceeds "is not *limited* to the *technical* definition of that term in the UCC"?[139] The use of the word limited has been interpreted by some authorities to indicate that the section 552(b)(1) definition of proceeds is broader than the UCC definition.[140] However, that is not a correct reading of the sentence because the term "limited" is used in the sentence to modify the term "definition."[141] Limited, as used here, means restricted,[142] as in "the proceeds definition is not restricted to the UCC definition." It says nothing about the content of the federal definition or whether the scope of proceeds under section 522(b) is broader or narrower than under the UCC. That question is addressed in the second half of the sentence, where the conversion test is articulated.[143] Thus, the term limited does not create any vagueness when the sentence is read correctly and in its entirety.

The use of the word technical does add some uncertainty to the sentence – but not on the critical point that the UCC definition does not control. It is unclear why the word technical was used at all. One reading is that the term technical was used to distinguish between a general lay understanding of the term proceeds and the specialized, or term of art, meaning of that term in the UCC.[144] While this reading eliminates any vagueness, the sentence would have the same meaning even if the word technical were omitted because the express reference to the UCC definition makes clear that the specialized UCC definition is what it refers to.[145] The most natural reading and one that also is consistent with the federal law interpretation is that the word is used to indicate that the specific details (i.e., the technicalities) of the UCC definition are not incorporated into section 552(b)(1),[146] although the general principle[147] behind the UCC definition is adopted. This avoids case law and uniform or nonuniform amendments that might narrow or expand the scope of the UCC

139. *Id.* (emphasis added).

140. *Bumper Sales*, 907 F.2d at 1437 (citing NORTON, *supra* note 115, an early edition of *Norton's* for this proposition). Several courts have since erroneously adopt that view. *See, e.g.*, James Cable Partners v. Citibank (*In re* James Cable Partners), 141 B.R. 772, 776 (Bankr. M.D. Ga. 1992).

141. *See supra* note 118 and accompanying text.

142. This is a common meaning of limited. *Webster's* defines limited as "confined within limits: restricted in extent, number, or duration." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1312 (3d ed. 1993).

143. H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333.

144. This is the common meaning of technical. *Webster's* defines it as "marked by or characteristic of specialization." WEBSTER'S *supra* note 142, at 2348.

145. H.R. REP. NO. 95-595, at 377.

146. This is also a common meaning of the term. *Webster's* includes as one definition of technical, "according to a strict legal interpretation." WEBSTER'S *supra* note 142, at 2348.

147. The conversion principle stated in the committee report is almost indistinguishable from the "received upon . . .disposition" principle used in the Article 9 definition at the time. Both embody a replacement analysis. *C.f.* H.R. REP. NO. 95-595, at 377, *with* U.C.C. § 9-306(1) (1972).

definition, such as the 1994 amendment[148] that overruled the *Hastie* decision[149] and the expansion of the proceeds definition in revised Article 9.

The problematic reading, which is only a little harder to explain, is that the term technical is used to suggest that the UCC definition is very detailed and complicated and that the language in the committee report indicates that the Bankruptcy Code's rejection of that definition was intended to replace the UCC definition with a simpler concept like the conversion principle. The difficulty presented by this reading is that the basic UCC proceeds definition at the time was not a highly technical definition, nor was it very different from the conversion alternative. Instead it was a fairly simple to understand definition based on the fairly general disposition concept.[150] Viewed in this fashion, the statement in House Report 595 seems nonsensical.

There was, however, one aspect of former Article 9's proceeds definition that was highly technical and that Congress likely did want to avoid. That was the insolvency limitation on proceeds set forth in section 9-306(4) of former Article 9.[151] Applied to a bankruptcy case, that section could have the effect of negating the very

148. U.C.C. § 9-306(1) (1994).

149. *See* 2 F.3d 1042, 1046 (10th Cir. 1993) (holding that cash dividends are not proceeds of stock).

150. The core definition read, "'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." U.C.C. § 9-306(1) (1972). The definition also covered certain insurance payments, but that provision also was not very complicated. *Id.*

151. Section 9-306(4) of former Article 9 read:

> (4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:
>
> (a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;
>
> (b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;
>
> (c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and
>
> (d) in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is
>
> (i) subject to any right of set-off; and
>
> (ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).

U.C.C. § 9-306(4) (1972).

postpetition proceeds lien that section 552(b)(1) was intended to preserve.[152] Interestingly, although the *Bumper Sales* court called the legislative statement vague, it recognized that section 9-306(4) was precisely what the supposedly vague statement referred to.[153] By adopting the state law of proceeds, the *Bumper Sales* court had to address the unsecured creditors' committee's argument that former Article 9 section 9-306(4) destroyed the secured creditor's security interest in the postpetition proceeds.[154] Here the court had no difficulty understanding the statement in House Report 595 or relying on it to reject the committee's argument. The court stated, "We feel that [our interpretation] avoids an overly technical definition of proceeds (such as in Section 9-306(4)) that the legislative history expressly rejects."[155] Thus, contrary to the assertion of the *Bumper Sales* court, the statement in the committee report is not vague. It is clear and it clearly rejects incorporation of the UCC definition of proceeds into section 552(b)(1).

The *Bumper Sales* court also labeled the statement in the committee report an "isolated piece of legislative history."[156] The statement is not a stray comment made by a senator during the floor debate, but is part of an official committee report on a very well-vetted piece of legislation.[157] Further, it is in the part of the report devoted to the postpetition lien section of the statute, and not some isolated statement inserted into an unrelated part of the report.[158]

If what the court meant to suggest by calling the statement isolated is that it was not carefully considered, that position also is not supportable. The section 552(b)(1) proceeds exception was not included in either the Commission Bill or the Judges' Bill.[159] It was added by H.R. 6, [160] which evolved into H.R. 8200, the bill to which House Report 595 relates. Thus, the statement in the report was not general commentary, but rather an explanation of an important change in the proposed legislation. Further, it is very clear from the committee report that the drafters were

152. *See* Mercantile Nat'l Bank at Dallas v. Aerosmith Denton Corp. (*In re* Aerosmith Denton Corp.), 36 B.R. 116, 118 (Bankr. N.D. Tex. 1983).

153. Unsecured Creditors Comm. v. Marepcon Fin. Corp. (*In re* Bumper Sales, Inc.), 907 F.2d 1430, 1437 (4th Cir. 1990).

154. *Id.* at 1437-38.

155. *Id.* at 1438.

156. *Id.* at 1437.

157. *See* H.R. REP. NO. 95-595, at 377 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333. The care and attention to detail that went into the drafting process that led to the Bankruptcy Code is clear. *See generally,* Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941 (1979).

158. *See* Klee, *supra* note 157.

159. *Cf.* H.R. 31, 94th Cong. § 7-203(a)(2) (1975), *with* H.R. 32, 94th Cong. § 4-715(b) (1975).

160. H.R. 6, 95th Cong. § 552(b) (1977), *reprinted in* 11 BANKRUPTCY REFORM ACT OF 1978, *supra* note 91.

well aware of the proceeds and after acquired property provisions of the UCC and had given those provisions careful consideration.[161] In fact, section 552 was designed as a response to those UCC provisions.[162] The interplay between the section 552(a) prohibition and the section 552(b)(1) exception represented a carefully calibrated balancing of the rights of secured creditors and the estate. The line was drawn at proceeds, so the meaning of that term was critical. Thus the statement rejecting the UCC definition and articulating a conversion model was not a vague and isolated piece of legislative history, but was instead a carefully considered explanation of the intended operation of section 552(b)(1).

Further support for the proposition that Congress rejected the UCC definition of proceeds and for the view that section 552(b)(1)'s use of the term proceeds is intended to impose a federal limitation on postpetition liens that is based on a replacement model comes from section 541 of the Bankruptcy Code.[163] That section defines property of the estate and also uses the phrase "[p]roceeds, product, offspring, rents, or profits."[164] Just as the predecessors to section 552 did not contain a proceeds exception, neither the Commission Bill nor the Judges' Bill included a "proceeds" provision in the predecessors to section 541. Instead, both bills addressed the proceeds idea by adding to the property of the estate in reorganization cases "all other property of the types specified [in the property of the estate provision] acquired by the debtor after the date of the petition and before the case is closed, dismissed, or converted."[165] Thus, in both of the early bills, this language was used to expand the property of the estate in reorganization cases, but not in liquidation cases, to include property acquired postpetition. The very next section of each of the early bills contained the prohibition on postpetition liens that now appears in section 552(a).[166] In H.R. 6 (which became H.R. 8200) these two previously contiguous statutory provisions were separated, with the provision that expanded the property of the estate moved to section 541(a)(6),[167] and the prohibition on postpetition liens moved to

161. *See* H.R. REP. NO. 95-595, at 377.

162. Many of the secured credit provisions of the 1978 Bankruptcy Code were in response to the enhancement of secured creditor rights in the 1972 revision of Article 9. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 627-28 (1981); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1464-65 (1997).

163. 11 U.S.C. § 541(a)(6) (2006).

164. 11 U.S.C. § 541(a)(6). Originally the wording of the list in section 541(a)(6) was identical to its wording in section 552(b). Subsequent amendments to section 552(b) added an "s" to "product" and pulled "rents" out of the list and moved it to new section 552(b)(2). This list also appears in the section 363(a) definition of cash collateral and the section 543 turnover provision. *See* 11 U.S.C. §§ 363(a), 543(a)-(c).

165. H.R. 31, 94th Cong. § 7-202 (1975); H.R. 32, 94th Cong. § 4-714 (1975).

166. *See* H.R. 31 §7-203(a)(2); H.R. 32 § 4-715(b).

167. Section 541(a)(6) of H.R. 6 added to property of the estate "proceeds, product, offspring,

section 552(a).[168] The "proceeds, product, offspring, rents, or profits" language also was added by H.R. 6 and used in both sections 541 and 552.[169] In both instances, the committee report makes clear that the UCC definition of proceeds does not apply to that term as used in the Bankruptcy Code. With respect to the property of the estate provision, House Report 595 states, "Proceeds here is not used in a confining sense, as defined in the Uniform Commercial Code, but is intended to be a broad term to encompass all proceeds of property of the estate."[170] Thus, the legislative statement rejecting the UCC definition in the section of House Report 595 discussing postpetition liens is not an isolated statement, but instead is confirmed by a comparable statement rejecting the UCC definition in the section of that report discussing the change to the property of the estate provision.

While the committee report explanation of the section 541(a)(6) property of the estate provision confirms that the UCC definition is not controlling, the explanation suggests that the bankruptcy law proceeds concept is much broader than the proceeds definition under former Article 9 of the UCC.[171] Indeed, since the Bankruptcy Code's property of the estate provision was intended to be all encompassing and as inclusive as possible,[172] the term proceeds as used in section 541 should be read to include postpetition property generated by property of the estate and postpetition property into which property of the estate is converted.[173] Thus, the term proceeds as used in section 541 likely is at least as broad as the proceeds definition under revised Article 9.

Nonetheless, House Report 595 discussion of section 552(b)(1) makes clear that a much narrower meaning is intended in that section. How can these apparently contradictory statements be reconciled? While *Dewsnup v. Timm* supports the position that it is possible for a term to have different meanings in different sections of

rents, and profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case." H.R. 6, 95th Cong. § 541(a)(6) (1977), *reprinted in* 11 BANKRUPTCY REFORM ACT OF 1978, *supra* note 91. This language was carried forward into H.R. 8200 without any changes. *See* H.R. 8200, 95th Cong. § 541(a)(6) (1977), *reprinted in* B COLLIER ON BANKRUPTCY, *supra* note 91, at app. pt. 4-941.

168. H.R. 6 § 552(a). The phrase "or by the debtor" was added by H.R. 8200, but otherwise the language was carried forward without change. *See* H.R. 8200 § 552(a).

169. *See* H.R. 6 § 552(a).

170. H.R. REP. NO. 95-595, at 368 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323-24.

171. Unlike the "not limited to" phrasing used in the postpetition lien section of House Report 595, the "not used in a confining sense" phrasing and the "broad term" language used in the property of the estate section clearly envision a broader reach of proceeds than under the UCC. *Id.* at 368, 377.

172. 1 COLLIER ON BANKRUPTCY, *supra* note 77, ¶ 541.01. Collier's states that "it is necessary and desirable that the property included in the bankruptcy estate be as inclusive as possible. Congress's intent to define property of the estate in the broadest possible sense is evident in the language of the statute." *Id.*

173. Presumably the *Norton's* statement of the breadth of the proceeds that was cited by *Bumper Sales* was based on the expansive meaning of that term in section 541.

the Code,[174] and the different policies behind section 541 and section 552 could justify such a reading, reliance on *Dewsnup* is not necessary to reach that result. Instead differences in the language used in the two sections support a narrow reading in section 552(b)(1) and a broad reading in section 541(a)(6). As discussed above, section 552(b)(1) adopts a restricted conversion model for proceeds. Consequently that section permits a secured creditor's lien to extend only to "proceeds . . . *of* such property."[175] Section 541(a)(6), in contrast, uses different language. It brings into the estate "proceeds . . . of *or from* property of the estate."[176] The use of different wording in two otherwise identical phrases, both of which were added at the same time, strongly suggests that different meanings were intended for proceeds in these provisions and that the extra "or from" words in section 541(a)(6) were the vehicle used to make that section more expansive than section 552(b)(1). This is confirmed by clear statements to that effect in the accompanying House Report 595. Section 541(a)(6)'s addition of the term "from" shows that it incorporates a generation model of proceeds in addition to the conversion model. Similarly, the absence of the term "from" in section 552(b)(1) shows that use of a generation approach to proceeds is not appropriate under that section.

IV. CONCLUSION

Section 552(b)(1) of the Bankruptcy Code reflects a careful balancing of the rights of secured creditors and the bankruptcy estate. Properly construed, that section permits a prepetition security agreement to create a security interest in postpetition assets that replace the secured creditor's prepetition collateral. Revised Article 9's expansion of the proceeds definition to include assets generated by collateral should be limited to the nonbankruptcy realm and should not be incorporated into section 552(b)(1). The asset generation model upsets the balance created by section 552(b)(1) and is contrary to the language of that section, its legislative history and bankruptcy policy.

174. 502 U.S. 410, 417 (1992) (adopting different meanings for "allowed secured claim" in Bankruptcy Code section 506(a), (d).

175. 11 U.S.C. § 552(b)(1) (2006).

176. 11 U.S.C. § 541(a)(6) (emphasis added).