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Code to Code

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Pre-Petition Liens in “Accounts” May Not Survive Post-Petition Sales



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In *In re Burts Construction Inc.*,¹ the U.S. Bankruptcy Court for the Southern District of Texas recently addressed the applicability of a secured creditor's lien rights in the debtor's "accounts" under Article 9 of the Uniform Commercial Code (UCC). Specifically, the court considered whether the proceeds from a court-authorized post-petition sale of the debtor's real estate created an "account" that would be subject to the creditor's pre-petition lien. Ultimately, the court concluded that under Texas UCC law, proceeds from a real estate sale are accounts that could be subject to an Article 9 lien; however, the court also concluded that because the sale occurred post-petition, the proceeds were after-acquired property that were free of any liens (including a lien on accounts) under § 552 of the Bankruptcy Code.

This article examines the *Burts Construction* decision and compares it to two other decisions analyzing the interplay between the Bankruptcy Code and Article 9 liens. An Article 9 lienholder's rights are greatly impacted by the nature of the security agreement, the applicable state's UCC definitions and the timing of any sale or disposition of the collateral.

Factual and Procedural History

In *Burts Construction*, the debtor was a family-owned and operated commercial construction company. In 2022, the debtor filed a voluntary chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Texas.² Shortly after, the debtor obtained the court's authorization to sell certain real property free and clear pursuant to § 363 of the Bankruptcy Code.³ The real property was an airport

hangar and office located in Spring, Texas, and was unencumbered by any pre-petition mortgages.⁴ The sale was ultimately consummated, with the debtor's estate receiving \$494,000 in net proceeds.⁵

The debtor then sought to use the proceeds from the sale to pay off one of its secured creditors, Allegiance Bank, which claimed that the debtor owed it approximately \$152,000 secured by a pre-petition Article 9 lien against the debtor's accounts.⁶ The lien was perfected through the filing of a UCC-1 financing statement with all accounts "whether ... owned now or acquired later" as collateral, as well as "the proceeds of such collateral."⁷

In the debtor's view, the proceeds from the sale of real property had created a post-petition "account" that was subject to Allegiance Bank's lien. An unsecured creditor, Ag Pay LLC, objected, arguing that Allegiance Bank was not entitled to payment because Article 9 liens do not apply to real estate or the proceeds of the sale.

Bankruptcy Code and UCC Article 9

It is axiomatic that the commencement of a bankruptcy case creates an estate comprising all of the legal and equitable interests of the debtor at the time of the petition.⁸ This includes "[a]ny interest in property that the estate acquires after the commencement of the case."⁹ Under § 552(a) of the Bankruptcy Code, any property acquired post-petition "is not subject to any lien resulting from any [pre-petition] security agreement," and this provi-

⁴ *Id.* at ECF 67.

⁵ *In re Burts Constr.*, 648 B.R. at 187.

⁶ *Id.*

⁷ *Id.*

⁸ 11 U.S.C. § 541. Section 541(b) and (c)(2) carve out certain interests, primarily those held for the benefit of a nondebtor third party, which are not material for purposes of this article.

⁹ 11 U.S.C. § 541(a)(7) (emphasis added).

¹ 648 B.R. 185 (Bankr. S.D. Tex. 2023).

² *In re Burts Constr. Inc.*, Case No. 22-31700 (Bankr. S.D. Tex. June 20, 2022), ECF 1.

³ *Id.* at ECF 48.

sion is intended to provide debtors with a fresh start that is clear of pre-petition liens or other encumbrances.¹⁰

Section 552(b) provides an exception to the general rule set forth in subsection (a): “[W]hen a pre-petition security agreement covering pre-petition property extends to proceeds, products, offspring or profits of that collateral, the terms of the security agreement and ‘applicable nonbankruptcy law’ will be enforced against proceeds, products, offspring, or profits.”¹¹ In short, when encumbered property is liquidated or sold during the course of a bankruptcy case, the secured creditor retains its pre-petition rights to the proceeds from the sale.

The scope and enforceability of a secured interest is generally governed by applicable state law. Texas’s version of Article 9 of the UCC provides that a lien on “proceeds” includes the “right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of.”¹² However, Article 9 is inapplicable to interests in, or liens on, real property.¹³

State of the Case Law

In *Burts Construction*, the court analyzed two other bankruptcy decisions. In *In re Nittolo Land Development*,¹⁴ the U.S. Bankruptcy Court for the Southern District of New York considered whether a perfected security interest in “accounts” entitled a creditor to the “proceeds” of a pre-petition sale of real property.¹⁵ The dispute arose from an earlier chapter 7 case involving two individual debtors who jointly owned Nittolo Land Development.¹⁶ The chapter 7 trustee sold certain real estate and intended to distribute the proceeds to general unsecured creditors.¹⁷ However, a secured creditor objected to the distribution, claiming that it was entitled to the proceeds as the lienholder of Nittolo Land Development’s “accounts” and “proceeds.”¹⁸

The chapter 7 trustee commenced an involuntary chapter 7 case against Nittolo Land Development and argued that the secured creditor’s lien did not apply to the proceeds from the real property sale. The *Nittolo* court applied New York’s version of Article 9 of the UCC, which was the same as Texas law, and concluded that the lien applied because the term “proceeds” includes “a right to payment of proceeds from the sale of real property where the real property ‘has been or is to be sold.’”¹⁹ Further, the court recognized that because the sale of the real property had occurred *prior* to Nittolo Land Development’s bankruptcy, a § 552(b) exception applied and the secured creditor was entitled to the proceeds of the sale.²⁰

A few years after *Nittolo*, the U.S. Bankruptcy Court for the Southern District of Florida took up a similar question related to the “proceeds” of earnest money deposits on condominiums.²¹ In *Harbour East Development Ltd.*, the debtor sought to avoid a pre-petition security interest held by a mortgagee in the debtor’s condominium development. Specifically, certain “earnest money” deposits by prospective condominium purchasers had been forfeited and ordered to be turned over to the debtor.²² The bankruptcy court held that under Eleventh Circuit precedent, earnest money deposits “constitute proceeds of the underlying real property and are therefore encumbered by the mortgage thereon.”²³

Because the forfeited deposits were encumbered by the mortgage, which the mortgagee had perfected under Florida law, the debtor could not avoid the lien.²⁴ The bankruptcy court rejected the debtor’s reliance on *Nittolo* because that case did not concern liens on real property.²⁵ In other words, where *Nittolo* concerned “proceeds” of “accounts,” *Harbour East* only addressed “proceeds” because the underlying security interest was in real property.

Analysis

In *Burts Construction*, the debtor argued that the sales contract for the real property “created an ‘account’ as defined under” the Texas Business and Commerce Code (TBCC) § 9-102(a)(2) “because it created a right to payment from the sale of real property.”²⁶ Ag Pay objected on the grounds that Article 9 did not apply to proceeds from the sale of real estate.²⁷ In resolving the issue, the court considered two issues: (1) whether the sale proceeds constituted an account subject to Allegiance Bank’s liens; and (2) whether the Bankruptcy Code permitted Allegiance Bank’s lien to extend to the sale proceeds.²⁸

First, the court rejected Ag Pay’s argument that proceeds from the sale of real estate could not be covered by an Article 9 lien. While § 9-109(d)(11) of the TBCC “excludes from Article 9 the creation or transfer of an interest in, or lien on, real property,” the court recognized that Allegiance Bank’s lien was on “accounts,” not a mortgage on the real property.²⁹ Thus, the court had to consider whether the proceeds from the sale agreement created an account under Texas law. Although the previous version of Texas’s Article 9 had limited the definition of “accounts” to payments of goods sold or services that had been rendered, the statute’s revised version expanded the definition to include any right to payment “for property that has been or is to be

21 *Harbour East Dev. Ltd. v. 7935 NBV LLC (In re Harbour East Dev. Ltd.)*, No. 10-03584, 2011 WL 3035287 (Bankr. S.D. Fla. July 22, 2011).

22 *Id.* at *2; see also Complaint to Determine Amount, Validity and Priority of Liens, *Harbour East Dev. Ltd. v. 7935 NBV LLC (In re Harbour East Dev. Ltd.)*, No. 10-03584 (Bankr. S.D. Fla. Sept. 10, 2010), ECF 191.

23 *Harbour East*, 2011 WL 3035287, at *4.

24 Notably, the Florida UCC excludes interests in real property, unlike the New York UCC in *Nittolo*. *Id.* at *5; *Nittolo*, 333 B.R. at 240.

25 *Harbour East*, 2011 WL 3035287, at *6.

26 *Burts Constr.*, 648 B.R. at 188. Pursuant to an agreed cash-collateral order, Allegiance Bank was also entitled to, *inter alia*, “replacement liens and a superpriority administrative claim equal to any diminution in the value of its cash collateral.” *Id.* While the debtor argued adequate protection as an alternative ground to pay Allegiance Bank, the court found “no evidence in the record of a diminution in the value of Allegiance’s lien on cash” and no “commingling issues.” “[a]s the sale proceeds were deposited into a separate debtor in possession account.” *Id.* at 191. Accordingly, it did not grant the motion on the alternative grounds.

27 *Id.* at 188.

28 *Id.*

29 *Id.* at 189.

10 5 *Collier on Bankruptcy* ¶ 552.01[1] (2022).

11 *Id.* at ¶ 552.02[1].

12 Tex. Bus. & Comm. Code, § 9.102(a)(65) (West 2022).

13 *Id.* at § 9.109(d)(11).

14 333 B.R. 237 (Bankr. S.D.N.Y. 2005).

15 *Id.* at 238.

16 *Id.* at 238-39.

17 *Id.* at 239.

18 *Id.* at 238.

19 *Id.* at 241. The revised statute became effective in New York during the proceedings, and the court concluded the revised statute applied. *Id.* at 240.

20 *Id.* at 241. Although the court concluded that a properly perfected security interest would grant Fleet a lien in the proceeds, it requested “further submissions” regarding alleged deficiencies in the financing statement. *Id.* at 242.

sold, leased, licensed, assigned, or otherwise disposed of.”³⁰ The broad term “property” included real property; therefore, a lien on “accounts” encompasses a right to any monies received from property sales — real or otherwise.

Second, having concluded that Allegiance Bank held a right to monetary payment for property sales,³¹ the court turned to the effects of the Bankruptcy Code. The court specifically considered whether § 552(a) shielded the proceeds of the sale from Allegiance Bank’s lien, or whether the proceeds fell within the exception in § 552(b). As § 552(b)(1) only applies “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 ... of such property,”³² the issue turns on the timing of the sale and the state of the collateral at the time of the bankruptcy filing. The court noted that where “a creditor held a security interest in inventory acquired by the debtor pre-petition and proceeds of the inventory, the security interest in proceeds extends to cash generated by a post-petition sale of the inventory.”³³ Allegiance Bank merely held a lien on “accounts” rather than the real property, and the debtor did not acquire its interest in the “accounts” until the real property sale was consummated (*i.e.*, post-petition). Thus, the right to monetary payment was after-acquired property, and Allegiance Bank’s lien did not apply. Accordingly, the court denied the debtor’s motion to pay Allegiance Bank’s debt from the sale proceeds under § 552(a).

Conclusion

Nittolo, *Harbour East* and *Burts Construction* demonstrate the interplay between the underlying security interest and “proceeds” of that security interest. In *Nittolo* and *Burts Construction*, the security interest was in “accounts.” Because the sale of the real property occurred pre-petition in *Nittolo*, the proceeds became money in accounts prior to the commencement of the bankruptcy case, whereas in *Burts Construction*, the sale occurred after the bankruptcy was initiated. This had a dramatic impact on the Article 9 lienholder’s rights. *Harbour East* addressed slightly different facts: The underlying security interest was in the real property, and so although the funds were disbursed post-petition, the proceeds were subject to the lien pursuant to § 552(b). As these cases make clear, it is critical for bankruptcy practitioners to consider the exact nature of a security interest, the applicable Article 9 provisions related thereto, and the timing of when the proceeds became available to the debtor or the estate. **abi**

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³⁰ *Id.* at 188-89; Tex. Bus. & Comm. Code Ann. § 9-102(a)(2)(i) (West 2022).

³¹ *Burts Constr.*, 648 B.R. at 189.

³² Emphasis added.

³³ *Burts Constr.*, 648 B.R. at 190.