



Lenders' Security Interest
in UCC Accounts May
UNLOCK VALUE
in Retail Bankruptcy Cases

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Secured term loan and revolver lenders in retail bankruptcy cases often leave money on the table because they do not understand how their security interests in a debtor's "accounts" under the Uniform Commercial Code (UCC) extend to the proceeds of sale of a debtor's real property interests, including leases, lease designation rights,¹ and real property (collectively, real property interests).

The typical collateral package granted by retail company borrowers to revolver lenders and term loan lenders includes accounts, inventory, equipment, and other personal property. Those lenders perfect their security interest in that collateral by filing UCC-1 financing statements. The retailer's real property interests fall outside the usual collateral package in part because of the additional hurdles to perfect security interests in real property collateral: (a) a security interest in personal property covered by a UCC-1 financing statement does not cover the underlying real property interests and therefore would require local real estate recordings at each encumbered real estate site, and (b) landlords strongly resist a tenant's revolver and term loan lenders placing leasehold mortgages on any leaseholds. Therefore, in large retail cases, a debtor may have hundreds of unencumbered leases and other real property interests.

When a retail borrower files for bankruptcy and sells its assets, the unsecured creditors' committee typically asserts the right to the value of those unencumbered real property interests for the benefit of general unsecured creditors, and secured lenders often do not contest that assertion. As a result, secured revolver and term loan lenders often get a recovery of less

than par while unsecured creditors—although subordinated to the recoveries of the secured lenders to the extent of the lenders' collateral package—get at least a pro rata recovery from proceeds of sales of the debtor's real property interests.

However, in these instances, secured lenders may be unnecessarily and inadvertently letting value leak from their recovery to unsecured creditors. As set forth in this article, a careful reading and application of the UCC's definition of "accounts" should give those lenders a senior claim to the proceeds of any unencumbered real property interests.

Revised Article 9 Redefined 'Accounts'

Prior to July 1, 2001, Article 9 of the UCC defined "account" to cover:

"any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance. . . ."

Section 9-106. The Official Comment to Section 9-106 explained that "account" in this version of Section 9-106 means the "ordinary commercial account receivable." Further, Section 9-105(h) of that version of the UCC defined "goods" as follows:

"'Goods' includes all things which are movable at the time the security interest attaches or which are fixtures. . . ."

In other words, an "account" only constituted a right to payment for "goods" that were actually "sold or leased." Moreover, because an account could arise only from the sale or lease of a "good," a lender's

security interest could reach assets that could serve as collateral under the UCC (e.g., to which a "security agreement attaches," or fixtures). The UCC excludes from such collateral most real property interest, including real property leases and designation rights and parcels of real property.²

Based on the foregoing, many secured lenders in retail bankruptcy cases conclude that their security interest in accounts must be limited to the right to payment arising from the actual sale or lease of goods. Such secured lenders therefore do not make any claim to the proceeds of real property interests. This represents outdated and wrong analysis that leads those lenders unknowingly to consent to the transfer of value from them to general unsecured creditors.

The universe of assets to which a lender's lien on accounts can attach materially increased with the 2001 revisions to Article 9 of the UCC. Effective as of July 1, 2001,³ revised Article 9 of the UCC expanded the definition of account as follows:

"'Account', except as used in 'account for', means a 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, (ii) for services rendered or to be rendered. . . ."

Article 9-102(2). In plain terms, revised Article 9 expanded the scope of accounts for the benefit of secured lenders as follows:

1 Instead of limiting accounts to the right to payment related to UCC "goods," revised Article 9 now includes

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In retail cases where the debtor owns real property, the lender's security interest in accounts also should extend to the proceeds of a contract to sell that real property.

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the right to payment for "property"—a substantially broader category that includes goods and non-UCC categories of property.

2 Instead of limiting accounts to "any right to payment for goods sold or leased," revised Article 9 expands accounts temporally to include a present and future right to payment related to any sale, lease, license, assignment, or other disposition of property. This new text means that the definition of accounts extends to any property that *could be* "sold, leased, licensed, assigned, or otherwise disposed of" *at some point in the future.*⁴

3 Instead of limiting accounts to the right to payment related to the sale of goods, revised Article 9 expands accounts to include the right to payment for "services rendered or to be rendered."

Right to Sale Proceeds of Real Estate Interests

As noted, real property interests fall outside the scope of UCC collateral. Nonetheless, under revised Article 9, the definition of account includes the right to payment of proceeds from the sale of real property interests.

Retail Leases and Lease Designation Rights. The 3rd Circuit decision in *In re Tops Appliance City, Inc.*, 372 F.3d 510 (3d Cir. 2004), supports the right of a lender secured by accounts to collect the proceeds of sale of real property leases. In that case, the 3rd Circuit considered whether a pre-bankruptcy transfer of those proceeds from Tops, the debtor, to Congress Financial, the pre-bankruptcy lender, secured by accounts, constituted an avoidable preference under 11 USC 547. If Congress had a security interest in those proceeds, the transfer would not qualify as a preference. The 3rd Circuit framed the issue as follows:

"whether the transfer between Tops and Congress was a transfer of Tops' interest in leases, and thus of an interest in real property, subject to the New Jersey Recording Statute, or a transfer of the proceeds of the sales of the leases, and thus secured by the filing of a UCC-1 Financing Statement."

Id. at 5. Congress had filed a UCC-1 financing statement covering Tops' accounts but did not record any interest in real property under the applicable recording statute.

The 3rd Circuit ruled in Congress' favor, holding that the lender held an interest in the proceeds of sale through its lien on Tops' accounts, even though Congress lacked a property interest in the real property leases. *Id.* at 513. ("Congress never had any property right in the leases themselves"). Instead, Tops could and did only grant Congress "a simple contract right to the proceeds from the sale of those leases." *Id.*

The 3rd Circuit recognized that the "the acquisition of such a right to proceeds falls [within] the definition of accounts [under] Article 9 of the Uniform Commercial Code." *Id.*, citing N.J. Stat. Ann. 12A:9–109 (West 2003) (explaining that the scope of Article 9 extends to all accounts); N.J. Stat. Ann. 12A:9–102(2) (West 2003) (defining "account" in part as "a right to payment of a monetary obligation, whether or not earned by performance [] for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of"). According to the 3rd Circuit, Congress' "security interest in proceeds [from the sale of real property leases] was properly perfected when Congress filed their UCC-1 Financing Statement." *Id.*

The case of *In Re: PLEJ's Linen Supermarket*, Case No. 05-35484, Adv. Proc. 06-3018 (Bankr. W.D.N.C. 2006) is also illustrative.⁵ In *In re PLEJ's Linen*, Wells Fargo held a

perfected security interest only in UCC collateral, including accounts, owned by the debtor. The debtor filed a petition for relief under Chapter 11 and concurrently filed a motion to sell lease designation rights with respect to the debtor's non-residential real property retail leases. The official unsecured creditors' committee filed a declaratory relief action against Wells Fargo to determine the scope and extent of Wells' Fargo liens. In so doing, the creditors' committee argued that because Wells Fargo did not "validly perfect their interests in the debtors' non-residential real property leases," Wells Fargo's lien did not extend to the proceeds of sale of the lease designation rights. *Id.* at paragraph 14.

The Bankruptcy Court rejected the creditors' committee's argument and held on summary judgment that the proceeds from the sale of the lease designation rights constitute proceeds generated from prepetition contracts, which in turn constituted accounts pledged to Wells Fargo under the UCC. *Id.* at paragraph 24 ("the proceeds were generated from pre-petition contracts between the debtors and [the buyer], and those contract rights fall within the scope of Article 9"). Accordingly, such proceeds belonged to Wells Fargo and not the debtor's general unsecured creditors. In so finding, the Bankruptcy Court relied on Revised Article 9's definition of accounts:

"The debtors' rights under the contracts can be classified as an "account," which is defined as "a 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 [or] (ii) for services rendered or to be rendered . . ." See U.C.C. § 9-102(2)." *Id.* at paragraph 25.

The Bankruptcy Court explained further that "[t]he definition of 'accounts' was expanded

under Revised Article 9 to incorporate a wide variety of rights to payment, including the right to payment of proceeds from the sale of real property where the real property 'has been or is to be sold' as well as the right to payment for goods sold." Thus, the debtors' contract rights to the lease proceeds should be classified as an account under U.C.C. § 9-102(2) pledged to Wells Fargo, even though the underlying asset constituted non-UCC collateral.

"With respect to the leases which were sold to [the buyer], case law firmly establishes that the debtors' contractual right to sell the leases was personalty to which the Lenders' Article 9 security interest attached, despite the fact that the underlying asset to be sold was a lease of real property."

Id. at paragraph 28. See also, *e.g.*, *Mastro v. Witt*, 39 F.3d 238, 241 (9th Cir. 1994) (noting that courts generally agree that an interest in a land sale contract is subject to Article 9 of the UCC.).

Sale of Real Property. In retail cases where the debtor owns real property, the lender's security interest in accounts also should extend to the proceeds of a contract to sell that real property. In *In re Nittolo Land Development*, for example, Fleet National Bank held a security interest in the debtor's accounts, among other UCC-related collateral. The issue at bar involved the pre-bankruptcy sale of real property owned by the debtor, a post-sale Chapter 7 filing by the debtor before the debtor disbursed those proceeds, and a claim by Fleet to the proceeds of the real property sale based on Fleet's security interest in accounts.

The Bankruptcy Court agreed that Fleet's security interest attached to the proceeds of sale even though the real property did not constitute collateral under the UCC. According to the Bankruptcy Court, when the sale occurred and the debtor's right to payment of the proceeds arose, "in the parlance of Article 9 an 'account' was created." *Id.* at 241. Thus, upon the sale of the subject real property:

"an 'account' was created, and . . . Fleet's security interest extended to the account. UCC § 9-102(a) (2) defines "Account" to include: "a 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,



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assigned, or otherwise disposed of...." Although Former Article 9 restricted the definition of account to "any right to payment for goods sold or leased or for services rendered" (see Former Article 9-106), Revised Article 9 expanded the definition to a right to payment of proceeds from the sale of real property where the real property "has been or is to be sold."

Id. (emphasis added). Thus, even though Fleet did not have a mortgage on the subject real property, Fleet's application of revised Article 9 and security interest in the debtor's accounts led the Bankruptcy Court to award Fleet the proceeds of the sale of that real property.

Conclusion

An understanding of "accounts" as UCC collateral is essential for a secured lender to maximize its recovery in a retail bankruptcy case and avoid potentially unnecessary leakage of value to general unsecured creditors. That understanding also can provide additional benefits to a secured lender. For example, the proper application of the UCC's definition of accounts can render an undersecured lender oversecured by including in its collateral pool the proceeds of real estate interests, and therefore entitled to post-petition interest and, to the extent provided for under a loan agreement, related fees and charges as part of its secured claim in a bankruptcy. See 11 USC 506(b).

Such a result can also increase the value of any credit bid by a secured lender and the property that such lender can purchase in a bankruptcy sale under 11 USC 363. Accordingly, the well-advised secured lender in retail bankruptcy cases can and should

read and apply revised Article 9's definition of accounts. ■

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The views expressed in this article are the author's only and do not necessarily reflect the views of Gibson Dunn or any of Gibson Dunn's clients.

¹ In large retail bankruptcy cases, a debtor can sell a portfolio of potentially valuable but unwanted store leases by selling "designation rights" to potential assignees or real estate brokers, who thereby acquire the right to designate which leases will be assumed and assigned to new lessees and which leases will be rejected under 11 USC 363.

² Interests in real property generally fall outside the scope of UCC collateral. See UCC § 9-109(d)(11). See also *e.g.*, *In re Nittolo Land Development Ass'n, Inc.*, 333 B.R. 237, 240 (Bankr. S.D.N.Y. 2005) ("UCC Article 9 does not apply to "the creation or transfer of an interest in or lien on real property").

³ Note that not all states immediately adopted Revised Article 9. For example, Revised Article 9 became effective in New York on July 1, 2005. See *In re Nittolo Land Development*, 333 B.R. 237, 240 (Bankr. S.D.N.Y. 2005).

⁴ The plain language of the statute supports the conclusion that post-petition proceeds of a post-petition sale of property constitutes an account that existed prepetition. However, some courts have held that the proceeds of a post-petition sale would fall outside the scope of any prepetition account under 11 USC 552(a). See, *e.g.*, *In re Nittolo Land Development*, 333 B.R. at 241 ("Section 552(a) provides the normal rule, that a creditor's pre-petition security interest in accounts will not extend to the post-petition proceeds of a trustee's sale of real property."). An analysis of Section 552(a) is beyond the scope of this article.

⁵ www.ncwb.uscourts.gov/sites/ncwb/files/opinions/ncwb.3.6.ap_3018.4024543.0.pdf