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Security Interests in Proceeds of Collateral

By [Cindy J. Chernuchin](#)

This article discusses two recent bankruptcy cases that determine whether the secured party's security interest attaches to assets acquired after the debtor files for bankruptcy as proceeds of a Federal Communications Commission (FCC) license if the security interest did not attach to the underlying FCC license. Whether an asset is after-acquired collateral or proceeds of collateral is critical to both decisions. Section 552(a) of the U.S. Bankruptcy Code (Code) limits the secured party's lien generally to the collateral in existence on the petition date. It prevents the grant of a security interest in after-acquired property from attaching to property acquired after the bankruptcy is filed. However, section 552(b) provides that if the postpetition property is proceeds of the secured party's prepetition collateral, then the secured party's lien will attach to the postpetition property. This article concludes with "best practices" for drafting a security

agreement as learned from these cases. But first, to fully understand these cases, we will review the meaning of "proceeds," including identification, attachment, and perfection of a security interest in proceeds, and the anti-assignment override provisions of Article 9 of the Uniform Commercial Code (UCC).

What are Proceeds?

Section 9-102(a)(64) of the UCC provides that proceeds are whatever is received upon the sale, lease, license, exchange, or other disposition or collection of, or distribution on account of, collateral. This includes (1) claims arising out of the loss or nonconformity of, or interference with, defects in, or damage to, the collateral, (2) collections on account of "supporting obligations," such as guarantees, (3) corporation, partnership, and limited liability company interest

distributions, (4) rentals for the lease of goods, and (5) licensing royalties.

Attachment of a Security Interest

Upon the disposition or collection of collateral, a secured party's security interest continues in any "identifiable" proceeds. If the proceeds are cash, common law principles of tracing proceeds, including the "equitable principle" of the "lowest intermediate balance rule," are used to identify the cash proceeds. Commingled cash proceeds are identifiable within the meaning of UCC § 9-315(a)(2) as long as the balance in the bank account into which the cash proceeds are deposited does not drop below the amount of the cash proceeds initially deposited. If the balance drops below the amount that was initially deposited, the secured party may treat as identifiable proceeds only the lowest intermediate balance in the account.

Perfection of a Security Interest

If the proceeds are not identifiable cash proceeds, the perfection of the secured party's security interest in such proceeds continues for a period of 20 days. The secured party must take steps within this 20-day period to continue the perfection of its security interest beyond such period if the proceeds constitute a collateral type that is not already perfected.

Attachment

To be prepetition property, the security interest must attach to the property. A security interest attaches to personal property upon satisfaction of three requirements: (1) the parties have an adequate security agreement, (2) the secured party gives value, and (3) the debtor has rights or the power to transfer rights in the personal property.

Generally the parties have an adequate security agreement if the debtor makes an agreement to transfer a security interest in the collateral, the collateral is reasonably described, and the debtor authenticates the security agreement. The secured party is deemed to have given value when the security interest secures an obligation. The debtor needs to have rights in the collateral and the power to transfer the rights in the collateral because the secured party can obtain only the rights that the debtor has in the collateral.

If there are contractual or legal limitations on assignment of the personal property, such limitations may not be effective due to the UCC

anti-assignment override provisions. If the anti-assignment provisions are not effective, the secured party's security interest will attach, but to protect the third-party obligor, the secured party may not enforce the security interest. The secured party benefits from the anti-assignment override even though it cannot enforce its security interest because it attaches to the collateral and, if properly perfected, the secured party will have a perfected security interest in the proceeds of a sale of the collateral that occurs after the initiation of a bankruptcy proceeding, since the proceeds are of prepetition collateral. The ability to obtain a security interest in the underlying nonassignable right is critical in bankruptcy proceedings because if the secured party has a security interest in the underlying nonassignable right, then the proceeds exception in section 552(b) of the Code would allow the secured party's security interest to attach to the proceeds of a postpetition transfer. But if the anti-assignment provision is effective, can the secured party's security interest attach to the proceeds of personal property? Courts are not in agreement on this issue.

A security interest in the proceeds of personal property attaches automatically pursuant to UCC § 9-315(a)(2) only if there is a properly perfected security interest in the original personal property. UCC anti-assignment override provisions do not override all anti-assignment provisions. A statute or regulation of the United States preempts the UCC. For example, federal statutory law specifically prohibits the assignment

or other transference of FCC licenses absent the FCC's consent. Prior to 1992, the FCC took the position that a lien could not be placed on an FCC license in any manner.

The Communications Act (Act) provides that "[n]o . . . station license, or any rights thereunder shall be transferred, assigned, or disposed of in any manner" without the advance approval of the FCC. Thus, prior to a transfer of a security interest in an FCC license, the FCC must approve such sale. UCC § 9-408 does not override this anti-assignment provision because federal law trumps the UCC. Thus, an FCC license cannot be original collateral.

In response to cases on the issue, in 1994 the FCC issued a clarifying order in which it concluded that a creditor could take a security interest in the proceeds of a broadcast license. The FCC distinguished between a security interest in a broadcast license and a security interest in the proceeds of the sale of the broadcast license. If a secured party foreclosed on a security interest in the broadcast license, the license would transfer without the approval of the FCC. However, if the secured party had a security interest in the proceeds of the sale of a license, there would be no transfer without the FCC's prior approval.

In re Tracy Broadcasting Corp.

Relying on the FCC's clarifying order, many lenders take a security interest in the future proceeds of the borrower's FCC licenses, rather than in the licenses themselves. The effectiveness of this practice is in

doubt due to the *In re Tracy Broadcasting Corp.* decision.

In re Tracy Broadcasting Corp., 438 B.R. 323 (Bankr. D. Colo. 2010) (10th Cir.), decided on October 19, 2010, by the U.S. Bankruptcy Court of Colorado and confirmed on appeal on August 31, 2011, in *In re Tracy Broadcasting Corp.*, 2011 WL 3861612 (D. Colo. 2011), held that for a security interest in a future license transfer to attach, (1) the debtor has to have a prepetition agreement to transfer the license, and (2) the FCC has to approve the transfer prepetition.

Tracy Broadcasting Corporation, a Nebraska corporation (Debtor), owned and operated a radio station under an FCC license. On or about May 5, 2008, Valley Bank & Trust Company made a loan to Debtor, secured by a security interest in Debtor's general intangibles and proceeds thereof, and perfected its security interest by properly filing an effective UCC-1 financing statement. On August 19, 2009, Debtor filed a petition for relief under Chapter 11 of the Code. On February 16, 2010, the court appointed a Chapter 11 trustee. The bank filed a secured claim against Debtor asserting that its perfected security interest in Debtor's general intangibles and the proceeds thereof extended to any proceeds from the future sale of Debtor's FCC license. Spectrum Scam LLC, an unsecured creditor of Debtor, initiated an adversary proceeding for a determination of the extent of the bank's security interest, arguing that the bank did not have a security interest in the FCC license or its future proceeds. Spectrum relied on

the Act (which prescribes FCC powers), which prohibits a security interest from attaching to an FCC license without the FCC's consent. Since there was no security interest in the FCC license, there could be no security interest in the proceeds of a sale of the FCC license after the filing of the petition for bankruptcy. The parties agreed that the bank did not have a security interest in the FCC license so there was only a question of law: Did the bank's security interest extend to proceeds received by the trustee upon a future transfer of Debtor's interest in the FCC license if there was no contract for transfer of the license in existence when the Chapter 11 proceeding was filed?

The court stated that an FCC license holder has both "public rights" and "private rights." The license holder's right to transfer its license subject to FCC approval is a public right. The right to receive compensation for a transfer of its license is a private right. A license holder can grant a security interest only in its private rights because these rights do not interfere with the FCC's regulatory role. The court then considered section 552 of the Code which set forth the general rule that property acquired by a debtor after the commencement of a case is not subject to any lien resulting from any security agreement entered into by the debtor before commencement of the case. The exception to this rule is that if the security interest attached to property prior to the commencement of the case, then the security interest extends to proceeds of such property acquired postpetition. The court held that Debtor's private right to receive the

proceeds from a license transfer did not exist prepetition because any such right, without an existing agreement to transfer and FCC approval, was too remote. The court said that for a security interest in a future license transfer to attach prepetition: (1) Debtor must have an agreement to transfer the license, and (2) the FCC must approve the transfer. Neither occurred, and in light of the Code section 552(a) prohibition on security interests in after-acquired property, Debtor could not grant a security interest in future proceeds of a license transfer to the bank, so the court denied the bank's motion and granted Spectrum's motion for summary judgment.

The court endorsed the following propositions: (1) a security interest cannot attach to FCC licenses without the FCC's approval, (2) a security interest can be granted in the right to future proceeds from an approved sale of an FCC license, and (3) if on the petition date there is no contract for sale of the license approved by the FCC, a security interest cannot attach to postpetition sale proceeds.

In re TerreStar Networks, Inc.

Judge Sean H. Lane of the U.S. Bankruptcy Court for the Southern District of New York held that the secured noteholders of TerreStar Networks, Inc., and certain of its affiliates had a valid lien on the economic value of TerreStar's FCC licenses, notwithstanding the abundance of court decisions prohibiting a secured party from having a lien on an FCC license itself (including the *Tracy* decision). *In re*

TerreStar Networks, Inc., 2011 WL 3654543 (Bankr. S.D.N.Y. 2011).

TerreStar, a provider of mobile satellite services, held various FCC licenses. TerreStar granted a lien on the proceeds of a disposition of the licenses including the economic value of the licenses to the noteholders.

In 2008, Sprint filed suit against TerreStar and other licensees in the U.S. District Court for the Eastern District of Virginia to recover the relocation costs allocable to certain licenses. On October 19, 2010, TerreStar filed for Chapter 11 bankruptcy relief. Thereafter Sprint filed proofs of claim for \$104 million of bandwidth clearing costs allegedly allocable to TerreStar. In addition, Sprint filed an adversary proceeding seeking a judicial determination that the noteholders had no lien on the economic value of TerreStar's FCC licenses. If Sprint were successful, the value attributable to TerreStar's FCC licenses would be available for distribution to unsecured parties of TerreStar, including Sprint.

In July 2011, the Bankruptcy Court approved a sale of substantially all of TerreStar's assets, including, subject to FCC approval, its FCC licenses. After that sale the noteholders and the unsecured creditors filed motions for summary judgment to obtain the proceeds from the sale.

The unsecured creditors used the *Tracy* court's reasoning: the noteholders' lien could not attach to the proceeds of the sale of the FCC licenses because (1) the noteholders did not have a lien on the FCC licenses themselves, and (2) the sale

agreement for the licenses was entered into and approved by the FCC after TerreStar filed for bankruptcy, so pursuant to section 552(a) of the Code a lien cannot attach to the proceeds because it is postpetition after-acquired collateral.

The noteholders argued that section 552 of the Code was not applicable because the lien attached to the economic value of the FCC licenses prepetition, when the parties entered into an adequate security agreement and the noteholders gave value.

Judge Lane rejected Sprint's argument and, persuaded by the reasoning in the FCC's 1994 declaratory ruling and related case law, held that the TerreStar noteholders had a valid lien on the economic value of TerreStar's FCC licenses even if they could not have a lien on the FCC license itself.

Practice Points

These decisions affect how creditors secure their broadcaster financings to ensure the priority of their liens against third parties in bankruptcy. It is best practice for secured parties to get a pledge of both (1) the equity interest in the company that owns the FCC license (have the transfer of the equity interest occur upon the approval of the FCC), and (2) the economic interests of the FCC license. Experience confirms that it is best to require the broadcaster to opt into Article 8 of the UCC and be a special-purpose entity with no other voluntary liabilities or liens.

To obtain a perfected security interest in (1) the equity interest of a

company that owns an FCC license, secured parties should (a) require broadcaster to opt into Article 8 of the UCC, (b) have the parent of the broadcaster grant a security interest in all its general intangibles and investment property, and (c) perfect such security interest by properly filing a UCC-1 financing statement and taking possession (along with instruments of transfer executed in blank) of the securities; and (2) the economic interests of an FCC license, secured parties should (a) require that the grantor be a special-purpose entity with no other voluntary liabilities or liens, and (b) include in the granting clause all general intangibles and proceeds derived from the personal property, including all economic rights, and exclude from the granting clause the FCC license. To ensure that the transaction does not violate the FCC rules, the pledge and security agreements need to include (1) a prohibition on transfers of an FCC license in any way that could violate the Act, (2) requirements that any transfer of an FCC license be made in compliance with the Act, (3) covenants that upon the occurrence of an event of default, the debtor will take any action the secured party requests in order to transfer the FCC license, (4) appointment of the secured party as debtor's attorney-in-fact to take such actions on debtor's behalf, (5) an agreement that these provisions may be specifically enforced, and (6) an exclusion of the FCC license from collateral.

The security agreement for the TerreStar noteholders granted a security interest in

[a]ll General Intangibles . . . and all FCC License Rights . . . including all FCC Licenses, including, without limitation, the right to receive monies, proceeds, or other consideration in connection with the sale, assignment, transfer, or other disposition of any FCC Licenses, the proceeds from the sale of any FCC Licenses or any goodwill or other intangible rights or benefits associated therewith, including without limitation all rights of each Grantor to (A) transfer, assign, or otherwise dispose of its rights, title and interests, if any, under or in respect of such FCC Licenses, (B) exercise any rights, demands and remedies against the lessor, licensor or other parties thereto, and (C) all rights of such Grantor to receive proceeds of any insurance, indemnities, warranties, guaranties or claims for damages in connection therewith. . . .

Licenses, and the right to receive monies, consideration and proceeds derived from or in connection with the sale, assignment, transfer, or other disposition of FCC Licenses. . . .

Conclusion

Whereas some courts have encouraged financing to broadcasters by ruling that a security interest attaches to the proceeds of a sale of an FCC license even if the contract for sale and FCC approval of the sale become effective after a bankruptcy proceeding is initiated, there can be no assurance of this result given the diversion in court decisions. Whereas *TerreStar* gives hope, secured parties must proceed with caution because *Tracy* was confirmed on appeal 12 days after *TerreStar* was decided.

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In addition, the *TerreStar* security agreement specifically carved out the FCC license from the lien:

[S]uch security interest does not include at any time any FCC License to the extent (but only to the extent) that at such time the Collateral Agent may not validly possess a security interest directly in the FCC License pursuant to applicable federal law, including the Communications Act of 1934, as amended, and the rules, regulations and policies promulgated thereunder, as in effect at such time, but such security interest does include at all times all proceeds of the FCC