

Client Alert

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US Seventh Circuit Considers "What Are Collateral Proceeds?" and "What Is an Adequate Collateral Description?"**Areas of Interest**

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In *Helms v. CPC Acquisition* (2008 WL 5396852 (C.A.7 (Ill.)), decided on December 30, 2008, the United States Court of Appeals for the Seventh Circuit addressed two issues of interest to secured lenders. The first issue was the extent to which recoveries for losses due to business interruption constitute proceeds of collateral. The second issue revolved around the legal sufficiency of collateral descriptions in a loan agreement and a

financing statement.

Background

The loan agreement at issue in *Helms* granted the lender a security interest in, among other things, the debtor's equipment and the "Commercial Tort Claims listed on Schedule B." Although Schedule B initially was blank, the loan agreement gave the lender authority to amend it from time to time. The UCC financing statement filed against the debtor described the collateral as all of the debtor's assets, expressly including a reference to "Commercial Tort Claims."

Prior to the debtor's bankruptcy a fire broke out at one of its manufacturing plants damaging equipment and shutting down the plant for several weeks. In the wake of the fire the debtor brought two lawsuits. The first was against its insurance broker for negligence in failing to list the plant on a business-losses insurance policy. The second was against the utility company for negligence in maintaining its power lines. The suit against the broker was settled for \$88,000. The suit against the utility, which was still pending at the time of the Seventh Circuit's decision, claimed damages of \$2 million, 10 percent of which was for loss or damage to equipment with the balance attributed to business losses. After the debtor filed for bankruptcy, the Bankruptcy Trustee and lender both claimed a right to any amounts received as a result of the two suits.

Seventh Circuit's Analysis

On the first issue the court held that the amounts received in connection with the suit against the insurance broker for failing to list the plant on a business-losses insurance policy could not be considered proceeds of equipment damaged in the fire. While money received as compensation for a diminution in the value of the equipment due to the fire clearly constitutes proceeds of the collateral, replacing a business loss does not restore the value of damaged collateral. Thus, the amounts received as part of a settlement relating to the business loss did not constitute proceeds of the collateral damaged in the fire. Similarly, with respect to the suit against the utility company, the court held that the portion of the \$2 million damage claim that related to business losses was not proceeds of the damaged equipment.

The lender argued that, even if the amounts claimed were not proceeds of damaged equipment, it had a perfected security interest in the damage claims via its blanket security interest in the debtor's assets. Further, the lender claimed that, even though Schedule B to the loan agreement was blank, a prudent person would have seen the reference to commercial tort claims in the financing statement and would

have contacted the lender to request more specific information. The court rejected these arguments, holding that the loan agreement was the controlling document and that a prudent potential lender should not be expected to look beyond the collateral description in the loan agreement. Because the schedule referred to in the loan agreement had never been amended to include either of the two lawsuits, the court held that they were not collateral for the loans.

The court also rejected the lender's argument that the grant of security interest covered the debtor's after-acquired property. Citing UCC §9-108(e), the court stated that reliance on an after-acquired property provision was inappropriate where the collateral was commercial tort claims, which the UCC requires must be described with greater than usual specificity.

Comment

The Seventh Circuit's decision on the proceeds issue highlights the limitations on what is included within the UCC's definition of "proceeds." An interesting issue not addressed by the court — perhaps because accounts receivable and general intangibles may not have been included in the collateral — is whether the lender would have prevailed on the "proceeds" argument if it had argued that amounts received in satisfaction of damage claims for losses due to business interruption were proceeds of the debtor's account receivable and general intangibles. The decision in *In re Kroehler Cabinet Co.*, 129 BR 191 (Bankr. WD Mo. 1991), rev'd, No. 91-0615-CV-W-2 (WD Mo. 1992), appeal dismissed, No. 93-1038 (8th Cir. 1993), which held that payments under a business interruption insurance policy were proceeds of the debtor's accounts receivable and general intangibles, would appear to support this position.

On the second issue, the court's discussion of the relationship between the collateral description in the loan agreement and in the financing statement is noteworthy for at least two reasons. If nothing else, it is a reminder of the importance of adequately describing the collateral in the transaction agreement in which the security interest is granted. In addition, it gives some indication of the Seventh Circuit's view of the extent to which a UCC financing statement can be relied upon to provide a potential creditor with notice of a claimed security interest in collateral.

If you have any questions or require further information on any matter discussed in this publication, please contact your usual regular contact at Mayer Brown or Marshall C. Stoddard, Jr., at mstoddard@mayerbrown.com.

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