

## Court Issues Decision Concerning Proceeds of Collateral and Granting Debtor Rights to Interest Notwithstanding Collateral Agreement's Express Statement

### Introduction

A recent Federal District Court decision from the Southern District of New York, *Universal Bonding Insurance Company v. Bay Property Associates, et al.*, No. 09 Civ. 10030(FM), 2011 WL 4790885 (S.D.N.Y. Oct. 5, 2011), addresses two issues of interest to secured parties and debtors:

- Does a debtor have rights to interest received by a secured party on cash collateral?
- Are the proceeds of proceeds of collateral included in collateral?

The case involved the resolution of competing claims between a surety and a developer's successor-in-interest to cash collateral held by the surety for approximately 15 years with respect to a failed property development in Brooklyn.

### DOES A DEBTOR HAVE RIGHTS TO INTEREST RECEIVED BY THE SECURED PARTY ON CASH COLLATERAL?

The district court held that the debtor had rights to interest actually received by the secured party on the cash collateral notwithstanding an express provision disclaiming any obligation on the part of the secured party to pay interest on the cash collateral. This ruling is important because many cash collateral arrangements expressly disclaim (as apparently in this case) any obligation on the part of the secured party or collateral agent to pay to the debtor interest on the cash collateral.

### ARE PROCEEDS OF PROCEEDS OF COLLATERAL INCLUDED IN COLLATERAL?

The district court also held that "proceeds" as defined by UCC Article 9 do **not** include certain proceeds of proceeds of the original collateral, namely, investment income earned on interest received on cash collateral. In ruling this way, the court relied on a surprisingly narrow reading of the UCC Article 9 definition of "proceeds." The scope of the UCC Article 9 "proceeds" definition is important because it is used (by incorporation by reference) in security interest grant provisions in security agreements in many transactions and can be relevant in determining the scope, perfection and priority of a security interest under UCC Article 9.<sup>1</sup>

### Background

Bay Property proposed to develop a property near Gravesend Bay in Brooklyn. Permits issued by the City of New York (the "City") required that Bay Property build sewers, pave curbs and sidewalks and install fire hydrants and a fire alarm box. The City required that Bay Property post with the City performance bonds from a surety to ensure completion of that work. Bay Property obtained the performance bonds from Universal Bonding and provided Universal Bonding with collateral in the form of a \$500,000 letter of credit issued by Chase Manhattan Bank, N.A. ("Chase").

Bay Property failed to complete the property development and defaulted on its construction debt. In 1996, Universal Bonding drew down the remaining amount available on the Chase letter of credit and held the drawn funds as cash collateral.

When the Brooklyn development did not proceed, Universal Bonding was apparently not required to complete the related sewer, paving and fire-protection work covered by the performance bonds. However Universal Bonding continued to hold the cash collateral because the City did not release the performance bonds.

Although the collateral agreement between Universal Bonding and Bay Property included an express provision that Universal Bonding “shall pay no interest on the collateral security,” the cash collateral did earn interest for some or all of the period it was held by Universal Bonding. That interest, when received by Universal Bonding, was commingled and invested with other funds in Universal Bonding’s investment portfolio, generating investment income.

Universal Bonding commenced the litigation to obtain a declaratory judgment determining the parties’ respective rights to the cash collateral. Following commencement of the litigation, the City agreed to release the performance bonds, so the parties did not dispute that Bay Property’s successor-in-interest was entitled to return of some or all of the cash collateral from Universal Bonding. At dispute was (i) to what extent Universal Bonding could first apply the cash collateral to unpaid premiums and to its legal expenses in connection with the litigation over the cash collateral and (ii) whether the cash collateral to be returned included the interest received by Universal Bonding on the cash collateral and the investment income generated from investing that interest.

## Court Decision

### COLLATERAL INCLUDES INTEREST RECEIVED BY UNIVERSAL BONDING

The district court found that the interest received by Universal Bonding on the cash collateral did constitute part of the collateral security as “proceeds.” Although the collateral agreement stated that Universal Bonding would pay no interest to Bay Property on the pledged cash, the collateral agreement referred to such cash and “income thereon” as security for the obligations owing to Universal Bonding.<sup>2</sup> The collateral agreement also included an express provision requiring Universal Bonding to “return said collateral security or the proceeds thereof, less any deductions pursuant to the terms of th[at] agreement, to the party then designated as [the] Owner” of the “collateral security” or “the proceeds thereof” upon release of the performance bonds.

Consequently, while Universal Bonding was not required, under the collateral agreement, to pay interest to Bay Properties for the cash collateral, the court interpreted the references to “income” in the collateral security description in the collateral agreement and the reference to “proceeds” in the collateral agreement provision requiring return of the collateral security upon release of the performance bonds to mean that if Universal Bonding actually received interest on the cash collateral, that interest became part of the cash collateral and subject to the return provision. The court cited in support UCC Section 9-207(c) to the effect that proceeds received from collateral in the form of money or funds need to be applied to reduce the secured obligation or remitted to the debtor.<sup>3</sup>

### COLLATERAL DOES NOT INCLUDE INVESTMENT INCOME EARNED ON THE INTEREST RECEIVED BY UNIVERSAL BONDING

The district court rejected the argument of Bay Property’s successor that the investment income earned by Universal Bonding on the interest it

received was also “proceeds” of the cash collateral and included in the cash collateral. In support, the court cited the definition of “proceeds” in UCC Section 9-102(a)(64). That definition reads in part as follows:

“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** ...

[emphasis added]

The district court stated that the investment income earned on the interest paid on the cash collateral could not be “proceeds” under clause (A) of the UCC Article 9 definition because there had been no sale, lease, license, exchange or other disposition of the original cash collateral; nor could it be “proceeds” under clause (B) of the definition because the investment income was not collected on, or distributed on account of, the original cash collateral itself, but rather was earned on the interest and so was “one step removed” from being “collected on” the cash collateral. The court stated that “[c]onsequently, ‘interest on interest’ that may have accrued is too attenuated to be considered part of the collateral security to which [Bay Property’s successor] is entitled.”

## Analysis

The facts of this case present an unusual scenario in that it was the secured party (and not the debtor or a competing creditor) that argued for a more limited scope of its collateral in challenging the inclusion in the collateral of interest and income earned on the cash collateral. Also, the secured party in this case was a surety and did not hold the cash collateral itself, but deposited or invested the cash collateral with other financial institutions.

This decision is noteworthy for its holding that the debtor had rights to interest actually received by the secured party on cash collateral, notwithstanding the collateral agreement’s express statement that the secured party was not obligated to pay interest on the cash collateral. Cash collateral documentation in many transactions has a combination of provisions similar to those in this case, with an express statement that the cash collateral is not earning interest but including references to income and proceeds in descriptions of the cash collateral.

The district court cited UCC Section 9-207(c) in support of this ruling (in addition to its interpretation of the collateral agreement provisions). We note that Official Comment 3 to UCC Section 9-207 indicates that the rule of UCC 9-207(c) may be varied by agreement of the parties, which the parties seem to have done in this case.

A more surprising aspect of this decision, however, is the exclusion of “proceeds of proceeds” (the investment income earned on the interest received) from the cash collateral. There is clear language in the definitions of “collateral” and “proceeds” in UCC Article 9, as well as in the Official Comments to Article 9, that indicates that the court’s reasoning is questionable.

UCC Article 9 defines “collateral” to mean “the property subject to a security interest or agricultural lien. The term includes: (A) **proceeds** to which a security interest attaches; (B) accounts, chattel paper, payment intangibles, and promissory notes that have been sold; and (C) goods that are the subject of a consignment.” [emphasis added]<sup>4</sup> Thus, in this case, the interest received on the original cash collateral was, by definition, “collateral,” and the investment income earned on such collateral was, by definition, “proceeds.”<sup>5</sup> The district court’s assertion that the investment income attributable to the interest was too attenuated to constitute proceeds is not supported by the text of Article 9.

If the court instead had concluded that the investment income earned on the interest was included in the collateral, issues of determining whether the proceeds were “identifiable” for UCC purposes and tracing the investment income out of the commingled funds of the secured party would need to have been resolved.<sup>6</sup>

As the decision of a trial court, the court’s decision is not binding, as a precedential matter, on any other court, and therefore it is unclear to what extent the court’s conclusions and reasoning in this decision will be followed in other cases, in particular given the unique facts of this case. In addition, we note that this decision, even if it were to be followed, should not affect many transactions where the cash collateral is in the form of an identified securities or other cash collateral account and investment income credited to the identified cash collateral account is clearly included in the scope of the pledged collateral. In such transactions, the secured party would have a security interest in such investment income as original collateral and would not need to establish that such investment income constituted proceeds.

## Endnotes

<sup>1</sup> See UCC Sections 9-203(f), 9-315 and 9-322.

<sup>2</sup> The district court interpreted the collateral agreement in this way: “While the [collateral agreement] relieves [Universal Bonding] of the *obligation* to earn income on the [cash collateral], it does not entitle [Universal Bonding] to keep any interest that actually accrued” (emphasis in original). The court noted that Universal Bonding could have deposited the cash in a non-interest-bearing account, and been obligated to pay no interest to Bay Property.

<sup>3</sup> New York’s UCC §9-207(c) provides: “Except as otherwise provided in [UCC §9-207(d)], a secured party having possession of collateral or control of collateral under Section 9-104, 9-105, 9-106, or 9-107: (1) may hold as additional security any proceeds, except money or funds, received from the collateral; (2) shall apply money or funds received from the collateral to reduce the secured obligation, unless remitted to the debtor; and (3) may create a security interest in the collateral.”

<sup>4</sup> See UCC Section 9-102(a)(12).

<sup>5</sup> This analysis is supported by Official Comment 13.c to UCC Section 9-102 (captioned “Proceeds of Proceeds”), which reads as follows: “The definition of ‘proceeds’ no longer provides that proceeds of proceeds are themselves proceeds. That idea is expressed in the revised definition of ‘collateral’ in Section 9-102. No change in meaning is intended.” Under Section 9-306(1) of the pre-2001 UCC Article 9, “proceeds” was defined as follows: “‘Proceeds’ includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. . . .” The definition of “collateral” in Section 9-105(1)(c) of pre-2001 UCC Article 9 did not contain a specific reference to proceeds.

<sup>6</sup> See UCC Section 9-315.

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