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# From the Bankruptcy Courts

*Benjamin Weintraub\* and Alan N. Resnick\*\**

## THE SECURED CREDITOR'S RIGHTS TO COMMINGLED CASH PROCEEDS UPON THE DEBTOR'S BANKRUPTCY

A secured creditor ordinarily has an interest in cash and noncash proceeds of the collateral.<sup>1</sup> Commingling of funds in the debtor's general deposit account of cash proceeds of goods held for resale, however, may present difficult problems of recovery for the creditor with a security interest in inventory in the event that bankruptcy ensues.

Prior to the adoption of the Uniform Commercial Code, the secured creditor's rights to cash proceeds usually depended on the ability to trace all or part of commingled funds directly to the sale of the collateral. In essence, the secured creditor's rights to a general deposit account was limited to the extent that the balance of the account contained

identifiable proceeds derived from the collateral.<sup>2</sup>

### Section 9-306(4)(d)—A Limited Right to Proceeds

The process of tracing commingled funds was so difficult, if not impossible, in insolvency cases, that the drafters of the UCC attempted to avoid its necessity. Section 9-306(4)(d), which represents a significant departure from pre-UCC rules, provides that in the event of an insolvency proceeding the secured creditor has a perfected security interest in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds. This right is limited, however, to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency case. This amount is to be reduced by (1) any cash proceeds received by the debtor and paid to the secured party during the ten-day period, (2) any identifiable cash proceeds received during the ten-day period and contained in a separate noncommingled account, (3) identifiable cash proceeds in the form of money received during the ten-day period which are not commingled or deposited in an

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<sup>1</sup> See U.C.C. § 9-306(2). This article is based on the Official Text of the UCC as amended as of 1972. "Cash proceeds" is defined to include checks and deposit accounts as well as money. U.C.C. § 9-306(1).

<sup>2</sup> See *In re C.E. Pontz & Son, Inc.*, 2 U.C.C. 1120, 1128 (E.D. Pa.), *aff'd* 11 U.C.C. 1131 (E.D. Pa. 1965), *aff'd mem.* 359 F.2d 436 (3d Cir. 1966); *White & Summers, Uniform Commercial Code* 1011-1012 (2d ed. 1980).

account, and (4) identifiable checks received during the ten-day period which are not deposited. Additionally, the secured creditor's rights in these funds are subject to diminution by any right of setoff which the bank has against the debtor.<sup>3</sup>

### The Ten-Day Rule

It is important to note at the outset that Section 9-306(4)(d) deprives the secured party of the right to trace identifiable proceeds which were deposited in the debtor's general account more than ten days prior to bankruptcy. "The idea evidently is that the right to trace [cash proceeds received prior to the ten-day period] does not survive unless the debtor has been required to segregate the cash proceeds from his other cash assets."<sup>4</sup> An illustration of this rule is the recent case of *In re Cooper*.<sup>5</sup> The debtor made a deposit of \$34,356 in a general account on September 7, 1976 and filed a Chapter XI petition on September 26 of the same year. A secured creditor claimed that the September 7 deposit constituted cash proceeds of its collateral and wanted the opportunity to establish that the balance of the account on the date of bankruptcy could be identified as such proceeds despite the commingling of other funds in the account. The court held, however, that Section 9-306(4)(d) deprives the se-

cured creditor of the pre-UCC right to trace proceeds in a general account unless such proceeds were received within ten days prior to the commencement of the bankruptcy case. Since the deposit was made more than ten days before bankruptcy, the secured creditor has no rights in the account.

### Ambiguities in Section 9-306(4)(d)

The secured creditor's rights in the debtor's general account with respect to proceeds received within ten days prior to bankruptcy are governed by Section 9-306(4)(d). Ambiguity in that section makes possible three different interpretations.<sup>6</sup> To illustrate, assume that within ten days prior to bankruptcy a debtor receives \$10,000 as proceeds of inventory in which the inventory financier has a perfected security interest. The debtor deposits \$2,000 of such proceeds into the general deposit account and spends the remaining \$8,000. On the date of bankruptcy, the balance of the account is \$15,000, which also includes proceeds received upon the sale of collateral of other secured creditors. According to Section 9-306(4)(d), the inventory financier is entitled to the deposit account "limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days" prior to bankruptcy. Does "any cash proceeds received by the debtor" within such ten-day period mean (1) the cash proceeds from the inventory financier's collateral which is deposited in the account (\$2,000), (2) all cash proceeds from the inventory financier's collateral, whether or not

<sup>3</sup> U.C.C. § 9-306(4)(d)(i). Since setoffs are recognized by Section 553 of the Bankruptcy Code, a bank having a deposit of such commingled funds may have a right of setoff which would be superior to the rights of the secured creditor.

<sup>4</sup> 2 Gilmore, *Security Interests in Personal Property* 1338 (1965).

<sup>5</sup> 2 B.R. 188 (S.D. Tex., 1980).

<sup>6</sup> See White & Summers, note 2 *supra*, at 1014.

deposited in the account (\$10,000), or (3) all cash proceeds received from collateral of all creditors within the ten-day period (\$15,000)?

Professor Gilmore, chief draftsman of Article 9, is of the opinion that the secured creditor is entitled to the balance of the general account in which his proceeds were commingled to the extent of the amount of proceeds received from his collateral within the ten-day period, whether or not deposited in the account.<sup>7</sup> If faced with the above hypothetical, Professor Gilmore would give the inventory financier the right to take \$10,000 from the general account. This interpretation undoubtedly is based upon the UCC drafters' intention to eliminate the need for tracing proceeds in bank accounts containing commingled funds and a compromise for the elimination of the secured creditor's common-law rights in commingled but traceable cash proceeds received prior to the ten-day period.

Unfortunately for secured creditors, courts have not carried out Professor Gilmore's intention regarding Section 9-306(4)(d). Although the rationale is not always the same, courts have been consistent in depriving the secured creditor of the right to take general deposit accounts except to the extent that the secured creditor is able to trace identifiable proceeds derived from his collateral and deposited within ten days prior to bankruptcy.

courts is found in a 1976 court of appeals case. In *In re Gibson Products of Arizona*,<sup>8</sup> a secured creditor sold electrical appliances to the debtor and retained a perfected security interest in such goods. Within the ten-day period prior to the filing of a Chapter XI petition, the debtor had deposited \$19,505 in its general bank account derived from the sale of inventory, although only \$10 of that amount was derived from the sale of the secured party's appliances. Under Section 9-306(4)(d), the secured creditor asserted a right to receive the entire \$19,505 balance of the account to pay part of its \$28,800 claim. The trustee argued that the secured creditor's right to the balance of the account was limited to cash proceeds received from the secured creditor's collateral only and deposited in the account within the ten-day period (i.e., \$10).

The Ninth Circuit opinion recognized the broadest interpretation of Section 9-306(4)(d) and agreed that the section permits the secured creditor to take the proceeds of all inventory deposited in the account within the ten-day period (i.e., \$19,505). "The intent was to eliminate the expense and nuisance of tracing when funds are commingled and to limit the grasp of secured creditors to the amount received during the last ten days before insolvency proceedings. . . ." <sup>9</sup> Nonetheless, the court stated that to give the secured cred-

### The Court's Application of Voidable Preference Principles

An illustration of how Section 9-306(4)(d) has been applied by the

<sup>7</sup> 2 Gilmore, note 4 *supra*, at 1339; See White & Summers, note 2 *supra*, at 1014.

<sup>8</sup> 543 F.2d 652 (9th Cir.), cert. denied 430 U.S. 946 (1976). For further comment on this case, see Comment, "In re Gibson Products: Commingled Proceeds, The Uniform Commercial Code, and the Bankruptcy Act," 125 U. Pa. L. Rev. 1379 (1977).

<sup>9</sup> *In re Gibson Prods. of Ariz.*, note 8 *supra*, at 655.

itor an interest in the \$19,505 balance in effect could authorize a preference under Section 60 of the Bankruptcy Act; the secured creditor was undersecured and allowing it to take funds which are not proceeds of its own collateral would permit the preferential payment of an antecedent debt. The secured creditor "only loses his claim to the amounts in excess of his proceeds because only that amount is a preference."<sup>10</sup>

Judge Hufstедler, writing for the court in remanding the case for further proceedings, stated: "To the extent that a creditor is able to identify his proceeds to trace their path into the commingled funds, he will be able to defeat *pro tanto* the trustee's assertion of a preference."<sup>11</sup>

Following this line of thought, the court held that although a secured creditor's interest in the whole amount is *prima facie* valid, that as to a bankruptcy trustee, it is presumptively preferential. This means that the secured creditor must rebut this presumption by tracing the proceeds. The court in balancing the equities put this burden on the secured creditor as being the party that is in a better position to trace its proceeds.

The application of voidable preference principles to require secured creditors to trace cash proceeds deposited within ten days of bankruptcy in the debtor's general account from the sale of their collateral has also been used by the Seventh Circuit in *Fitzpatrick v. Philco Finance Corp.*,<sup>12</sup> a case which was cited in the *Gibson* case,<sup>13</sup> and, most recent-

ly, by a Rhode Island Bankruptcy Court *In re Dexter Buick-GMC Truck Co.*<sup>14</sup> In the *Dexter Buick* case the secured creditor had the burden of tracing the cash proceeds into the corporate checking account, the production of evidence consisting of cash receipt journals, car sale invoices, and bank statements of deposits at the debtor's bank.

Although all of these cases were decided under the voidable preference provisions of the former Bankruptcy Act, there is no reason to think that cases posing the same issue will not have the same result when the secured creditor collides with the preference section of the new Bankruptcy Code.<sup>15</sup>

#### A Different Theory, Similar Result

A departure from the foregoing case law in theory, but not result, occurred in the recent case of *In re Guaranteed Muffler Supply Co., Inc.*<sup>16</sup> The bankruptcy judge took the position that the *Gibson* court could have avoided the use of preference principles to limit the secured creditor's rights to traceable proceeds if it had interpreted Section 9-306(4)(d) correctly. Citing Section 9-306(2), which contains the general rule that a security interest "continues in any *identifiable* proceeds" of collateral, the court reasoned that the secured creditor may assert a lien on proceeds only "upon a show-

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and achieved the same results, they differed in the interpretation of Section 9-306(4)(d). See Note, "Bankruptcy Proceeds Section: Recent Interpretations of Section 9-306(4)(d) of the Uniform Commercial Code," 55 Tex. L. Rev. 891-897 (1977).

<sup>14</sup> 2 B.R. 242 (D.R.I. 1980).

<sup>15</sup> 11 U.S.C. § 547.

<sup>16</sup> 5 B.R. 236 (N.D. Ga. 1980).

<sup>10</sup> *Id.* at 657.

<sup>11</sup> *Id.*

<sup>12</sup> 491 F.2d 1288 (7th Cir. 1974).

<sup>13</sup> Although both *Fitzpatrick* and *Gibson* employed preference principles

ing that the property claimed is identified as the fruit of a sale or other disposition of the original collateral."<sup>17</sup> Thus, limitations upon cash proceeds under Section 9-306(4)(d) "include, by definition, the identifiability limitations which apply to all claims made to all proceeds."<sup>18</sup>

The necessity for tracing funds received and deposited within the ten-day period receives even greater importance in view of Section 363(c)(2) of the Bankruptcy Code, which prohibits the use of cash collateral by the debtor except upon notice to the secured creditor and a hearing or upon the secured creditor's consent. An unreported case pending under the Bankruptcy Code, *In re Allbrand Appliance & T.V. Co., Inc.*,<sup>19</sup> provides an illustration of the problem. The debtor had on deposit in its general account at the commencement of a Chapter XI case proceeds resulting from sales within the ten-day period of inventory purchased by the debtor from six different vendors subject to security agreements, as well as proceeds from merchandise free from liens. The necessity of utilizing the cash for immediate current operations caused the debtor in possession to assume the burden of identifying and segregating the proceeds belonging to each secured creditor, as well as its own merchandise, so as to have the availability of the free cash. This procedure was facilitated by the fact that no disbursements had been made from the account during the ten-day period. Had such disbursements been made, it would have been impossible

to determine whose proceeds had been disbursed.

### Lessons to Be Learned

In sum, the judicial application of Section 9-306(4)(d) and voidable preference principles have serious adverse consequences for secured creditors regarding commingled cash proceeds. Section 9-306(4)(d) has the effect of wiping out the secured creditor's rights in commingled proceeds deposited prior to the ten-day period prior to bankruptcy, whether or not such proceeds may be identified by tracing. Moreover, despite the intended purpose of Section 9-306(4)(d) as expressed by its chief draftsman, the secured party will lose rights in proceeds received and deposited in a general account within the ten-day period to the extent that the secured party is unable to sufficiently trace such proceeds to the sale of its own collateral.

Finally, there is another section of the Bankruptcy Code which may provide an additional collision for the secured creditor claiming an interest in cash proceeds. Section 552(b) provides that a valid security interest which is not vulnerable under the trustee's avoiding powers extends to secured goods in the trustee's possession and their proceeds acquired *after* the commencement of the bankruptcy cases.<sup>20</sup> However, the secured creditor's rights to the proceeds are not greater than otherwise permitted by the security agreement and applicable nonbankruptcy law. Although the Bankruptcy Code requires the trustee or debtor in possession to

<sup>17</sup> *Id.* at 238.

<sup>18</sup> *Id.* at 238-239.

<sup>19</sup> Dkt. No. 80-B-11736 (S.D.N.Y. 1980).

<sup>20</sup> 11 U.S.C. § 552(b). See Weintrib & Resnick, *Bankruptcy Law Manual* § 5.11[5] (1980).

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“segregate and account for any cash collateral” in his possession, custody, or control,<sup>21</sup> the secured creditor who expects post-petition cash proceeds from collateral should make sure that such proceeds are actually segregated.

Another limitation on the secured creditor's right to receive post-petition proceeds under Section 552(b) is based on the equities of the particular case. The right to such proceeds does not apply “to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.” As indicated in *The Congressional Record*, “the court may evaluate any expenditures by the estate relating to proceeds and any related improvement

in position of the secured party.”<sup>22</sup> When a debtor sells goods for the retail price, he often incurs expenses such as disbursements to personnel, rent incurred in maintenance of the goods, advertising expenses, and the like. The payment of such expenses by the estate would prejudice the rights of unsecured creditors while improving the position of the secured creditor who receives the retail price as proceeds of the collateral. It would not be surprising, therefore, if bankruptcy courts find that the secured creditor's interest in cash proceeds received after the commencement of the bankruptcy case is limited to the wholesale price instead of the retail price.

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<sup>21</sup> 11 U.S.C. §§ 363(c)(4), 1107(a).

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<sup>22</sup> 124 Cong. Rec. H.11097, 95th Cong., 2d Sess. (1978), reprinted in *17 Bankruptcy Reform Act of 1978: A Legislative History* (Document 58) (Resnick & Wypyski, 1979).

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