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PROCEEDS IN BANKRUPTCY: UNITED VIRGINIA BANK v. SLAB FORK COAL COMPANY

JEFFREY L. TARKENTON*

I. Introduction

The success or failure of a reorganization under Chapter 11 of the Bankruptcy Code may hinge on whether the debtor's postpetition earnings are subject to a prepetition security interest. As a general rule, property that a Chapter 11 debtor acquires postpetition is not subject to a lien arising from a security agreement the debtor entered into before the commencement of the bankruptcy case. Because the filing of a bankruptcy petition cuts off any "after-acquired property" clause in a security agreement, the debtor usually can use, lease, or sell estate property that, without the filing of the bankruptcy petition, would have been subject to a security interest.

The Bankruptcy Code attempts to strike a fair balance between the need to facilitate a debtor's "fresh start" in bankruptcy and the rights of secured parties in property in which they have valid security interests. On the one hand, section 552(a) prevents prepetition security interests from attaching to property that a debtor acquires postpetition. On the other hand, section 552(b) permits prepetition security interests to attach to the postpetition proceeds, products, offspring, rents,


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2 11 U.S.C. § 552(g) (1982), provides in pertinent part:

Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.


4 The Supreme Court enunciated the "fresh start" policy of federal bankruptcy law in Local Loan Co. v. Hunt, 292 U.S. 234 (1934).
and profits of collateral a debtor acquires before bankruptcy. As a result, revenue that a debtor receives during bankruptcy may be subject to a prepetition security interest if the revenue constitutes proceeds of prepetition collateral.

Whether property constitutes proceeds of prepetition collateral or after-acquired property is a critical issue in many bankruptcy cases. If the property is subject to a prepetition security interest, the debtor is barred from using or selling it without the consent of the secured party or an order of the bankruptcy court. The court can permit the debtor to use the collateral, absent the secured party's consent, only if the debtor has provided the secured party with adequate protection for its interest in the collateral. On the other hand, if the property is after-acquired property and, therefore, not subject to the prepetition interest, the debtor is free to use or sell the property in the ordinary course of its business.

Whether postpetition property is subject to a prepetition security interest has been a hotly contested issue in the context of farm bankruptcies. Allowing a farmer to sell his postpetition crops, milk, and calves without providing adequate protection to the Farmers' Home Administration or another secured lender may determine the outcome of the farmer's reorganization effort. The determination of these issues can be equally critical to the outcome of non-farm Chapter 11 reorganization efforts.

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5 11 U.S.C. § 552(b) provides in pertinent part:

Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds . . . of such property, then such security interest extends to such proceeds . . . acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. (Emphasis added).


10 Because of the changes to the Bankruptcy Code that Congress wrought in the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, the requirements regarding the methods debtors can use to afford secured creditors adequate protection in farm bankruptcies are much more liberal than they are in non-farm bankruptcy cases. A new section, 11 U.S.C. § 1205, provides that section 361 does not apply to farm bankruptcies brought under new Chapter 12 of the Bankruptcy Code. Instead, section 1205 sets forth alternative methods of providing a secured creditor with adequate protection for its interest in collateral. In particular, section 1205 eliminates the need of the debtor to pay lost opportunity costs and permits the debtor to pay reasonable market rent for the collateral as adequate protection. See H. CONF. REP. NO. 958, 99th Cong., 20 Sess. 49-50, *reprinted in*, 1986 U.S. CODE CONG. & ADMIN. NEWS 5227, 5250 -51.
In United Virginia Bank v. Slab Fork Coal Company, the Fourth Circuit Court of Appeals examined whether payments on a coal supply contract which were subject to a prepetition security interest constituted after-acquired property not subject to a lender's prepetition security interest. The Fourth Circuit concluded that the payments for the debtor's postpetition performance of the contract were proceeds of a prepetition contract and accordingly, were subject to a valid prepetition security interest.

Other circuit courts have also recently affirmed that postpetition payments on prepetition contracts are proceeds subject to prepetition security interests. The Seventh and Eighth Circuits have held that postpetition payments made pursuant to prepetition payment-in-kind contracts with the Department of Agriculture are subject to prepetition security interests. This Comment examines these recent decisions and the effect they will have on the financing of coal companies and on coal company bankruptcies.

II. THE EFFECT OF BANKRUPTCY ON AFTER-ACQUIRED PROPERTY CLAUSES

Article 9 of the Uniform Commercial Code enables lenders to obtain security interests in a borrower's existing and future assets. A security interest attaches only when there is an agreement that it attach, value is given, and the debtor has rights in the collateral. As a result, a security interest cannot attach to future assets until the debtor acquires the assets. However, Article 9 grants the secured creditor a security interest in the proceeds the debtor receives in exchange for secured collateral.

Section 552(a) of the Bankruptcy Code, dealing with prepetition security interests, bars prepetition liens from encumbering property acquired by the estate.

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12 Id. at 1190.

13 Payment-in-kind contracts are contracts entered into between farmers and the Department of Agriculture by which farmers agree to leave their fields fallow in exchange for receiving the replacement of the ungrown crops after the growing season. See, e.g., In re Mattick, 45 Bankr. 615 (Bankr. D. Minn. 1985).

14 See J. Catton Farms, Inc. v. First Nat'l Bank, 779 F.2d 1242 (7th Cir. 1985); In re Sunberg, 729 F.2d 561 (8th Cir. 1984).

15 U.C.C. § 9-204(1) provides in pertinent part: "Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."


17 See infra note 21.


The legislative history states that a security interest includes any lien created by an agreement and not just security interests arising under the Uniform Commercial Code.
or by the debtor after the commencement of the case.\textsuperscript{20} Thus, a security interest will not attach to assets acquired during the postpetition period that, if acquired prepetition, would have served as collateral.\textsuperscript{21}

Section 552(b)\textsuperscript{22} provides the sole exception. A security interest that attaches prepetition can be traced to postpetition proceeds,\textsuperscript{23} products, offspring, profits, or rent from the prepetition collateral. Section 552(b) thereby validates the proceeds coverage found in many security agreements. For example, a mortgagee's prepetition security interest in real estate and the rents the real estate produces entitles the mortgagee to the postpetition rents.\textsuperscript{24} Similarly, a lender's prepetition security interest in a debtor's milk production and the proceeds from that production extend to milk the debtor's cows produce postpetition and the payments the debtor receives for the milk.\textsuperscript{25}

III. THE ISSUE IN SLAB FORK

A. SECURITY INTEREST ATTACHED PREPETITION TO CONTRACT AND ITS PROCEEDS

Prior to Slab Fork's bankruptcy, three banks collectively extended credit to Slab Fork\textsuperscript{26} and obtained a security interest in nearly all of its assets, including

\textsuperscript{20} Section 552(a) does not affect security interests existing in collateral at the commencement of a bankruptcy case.


\textsuperscript{22} See supra note 5.

\textsuperscript{23} The term 'proceeds' is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted." H.R. Rep. No. 595, supra note 21 at 377.

\textsuperscript{24} United States v. Landmark Park & Assoc., 795 F.2d 683, (8th Cir. 1986).

\textsuperscript{25} Smith v. Dairymen, Inc., 790 F.2d 1107, 1112 (4th Cir. 1986). But see In re Lawrence, 41 Bankr. 36 (Bankr. D. Minn.), aff'd, 56 Bankr. 727 (Bankr. D. Minn. 1984). (The court held that prepetition interest in after-acquired farm products did not attach to milk produced postpetition.) The extent to which prepetition security interests in farm products extend to farm products acquired postpetition has been hotly litigated. See also Kunkel, Farmer's Relief Under the Bankruptcy Code: Preserving the Farmers' Property, 29 S.D.L. REV. 303 (1984).

\textsuperscript{26} When the bankruptcy petition was filed, Slab Fork owed the banks approximately $11,693,882. Motion to Prohibit Use of Cash Collateral, In re Slab Fork Coal Co., No. 83-50050 (Bankr. S.D. W. Va. 1983).
its contracts and the proceeds of those contracts.27 Prior to bankruptcy, Slab Fork entered into a long-term contract to supply Armco, Inc. each month with coal.28 After filing bankruptcy, Slab Fork ceased its mining operations but, because the contract with Armco was profitable, assumed the contract and hired a firm to mine and supply Armco with the coal.29 Slab Fork earned approximately $1,000,000 less expenses, by supplying Armco with coal after the commencement of the bankruptcy case. Slab Fork attempted to characterize the contract payments as after-acquired property and, therefore, not subject to the banks’ lien. The company also contended that the payments were not subject to the lien because it earned the payments through its postpetition efforts. The banks filed a motion to prohibit Slab Fork from using the proceeds from the Armco contract on the ground that the proceeds constituted the banks’ cash collateral.30 Both the bankruptcy court and the district court agreed with Slab Fork. The district court stated that:

The postpetition proceeds of the sale of coal by the Debtor to Armco, Inc. pursuant to a coal sales contract subject to a prepetition security interest held by the Banks, is “property acquired by the estate or by the debtor after the commencement of the case” under § 552(a); further none of the exceptions set forth in § 552(b) apply.31

The Fourth Circuit held that although Slab Fork received the payments after bankruptcy, they were proceeds of prepetition collateral and, therefore, were subject to the banks’ prepetition security interest.32 Because the underlying asset and all of its proceeds were subject to a valid prepetition security interest, whether the right to payment was generated by Slab Fork’s postpetition efforts was relevant only as to the balancing of equities in the case.33

27 The banks had a security interest in substantially all of the Slab Fork’s assets, including “[a]ll accounts arising from the sale of coal . . . and the proceeds thereof” and “[a]ll accounts, general intangibles, chattel paper, documents, instruments . . . and inventory . . . and the proceeds thereof.” Joint Appendix at 6, Slab Fork, 784 F.2d 1188 (No. 85-1228). The term “accounts,” as defined in W. Va. Code § 46-9-106 (1966), includes “rights to payment not yet earned” (contract rights) and “rights to payment earned” (accounts receivable). Thus, since section 46-9-106 defines account as including contract rights, by obtaining a security interest in accounts and their proceeds, the banks obtained a security interest in Slab Fork’s contracts and the contract’s proceeds. See In re Varney Wood Prod., Inc., 458 F.2d 435 (4th Cir. 1972); George W. Ulitch Lumber Co. v. Hall Plastering, Inc., 477 F. Supp. 1060 (W.D. Mo. 1979); Fine Builders, Inc. v. U.S., 413 F. Supp. 77 (E.D. Va. 1976).

28 Slab Fork, 784 F.2d at 1189.
29 Id.
30 11 U.S.C. § 363(c)(2) prohibits a debtor from using, selling, or leasing cash collateral unless “each entity that has an interest in such cash collateral consents; or the court, after notice and a hearing, authorizes such use, or lease. . . .”
32 784 F.2d at 1191.
33 See infra note 55 and accompanying text.
In reaching its decision in *Slab Fork*, the Fourth Circuit relied on the decision in *In re Sunberg*, in which the Eighth Circuit held that postpetition proceeds of a contract were subject to a prepetition security interest. In *Sunberg*, several farmers entered into payment-in-kind ("PIK") contracts with the Department of Agriculture under which they agreed to let their farmland lie fallow in return for crops or payments. The Production Credit Association ("PCA") obtained a security interest in the PIK contracts and the proceeds of the PIK contracts. Later, after the farmers filed bankruptcy, they claimed that the PIK payments were property acquired after the commencement of their bankruptcy case and, under section 552(a), were not subject to the PCA's lien. The Eighth Circuit held that the rights to the PIK benefits were in existence prior to bankruptcy and thus, were subject to the creditors prepetition interests.

Similarly, shortly before the Fourth Circuit rendered its decision in *Slab Fork*, the Seventh Circuit held in *J. Catton Farms, Inc. v. First National Bank* that postpetition proceeds of a contract subject to a prepetition security interest were subject to that prepetition security interest. As in *Slab Fork* and *Sunberg*, the lender in *J. Catton Farms* had a prepetition security interest in the debtor's contract rights and the proceeds from the contract. Furthermore, as in *Sunberg*, the proceeds in *J. Catton Farms* arose out of a PIK contract.

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34 *Sunberg*, 729 F.2d 561.
35 *Id.* at 563.
36 *Id.* at 561.
37 *Id.*
38 *Id.* at 562.
39 *Id.*
40 *J. Catton Farms, Inc.*, 779 F.2d 1242.
41 *Id.* at 1247.
42 *Id.*
43 In *Slab Fork*, *J. Catton Farms, Inc.*, and *Sunberg*, the contracts from which the postpetition proceeds arose were executed prior to bankruptcy. Because the collateral was in existence prior to bankruptcy and because value had been given prior to bankruptcy, the prepetition security interests attached prior to bankruptcy. Had the contracts been executed postpetition, section 552(a) would have prevented the prepetition security interests from attaching to the contracts or the proceeds of the contracts. For example, the debtors in *In re Fowler*, 41 Bankr. 962 (Bankr. N.D. Iowa 1984), granted a creditor a security interest in their accounts and contract rights prior to filing bankruptcy. After the debtors filed bankruptcy, they executed a new contract. Because the debtors did not enter into the contract until after the filing of the bankruptcy petition, no property existed prior to bankruptcy to which the creditor's security interest could attach. Thus, the accounts receivable which arose out of the postpetition contract constituted after-acquired property, not proceeds of property in which the creditor held a prepetition security interest.

Similarly, the lender with a security interest solely in existing and future accounts receivable will fail to obtain an interest in postpetition accounts receivable. Accounts receivable are created only when a right to payment is earned under a contract. *Pine Builders, Inc. v. U.S.*, 413 F. Supp. 77, 82 (E.D. Va. 1976). Because a security interest cannot attach until the collateral is in existence, a security interest in accounts receivable cannot attach until the accounts have been earned. Thus, unlike a security interest in a contract and its proceeds which can attach prepetition, a security interest cannot attach to accounts receivable arising postpetition.
B. Postpetition Proceeds as Cash Collateral

Characterization of the payments as proceeds of prepetition collateral was critical in determining whether Slab Fork could use the proceeds in the ordinary course of its business without court approval. Often, at the commencement of their cases, debtors desperately need cash to meet daily operating expenses such as payroll, rent, and utilities. However, section 363 of the Bankruptcy Code prohibits debtors from using this cash collateral without court approval.\footnote{11 U.S.C. § 363(c)(2).} The term "cash collateral" includes, by definition, cash proceeds\footnote{11 U.S.C. § 363(a) provides: (a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.} and thus, cash proceeds are unavailable for use without specific prior court authorization.\footnote{One commentator contends that in enacting section 363, Congress intended that postpetition cash proceeds should not be treated as cash collateral, but could be used without prior court approval. See Levit, Use and Disposition of Property Under Chapter 11 of the Bankruptcy Code: Some Practical Concerns, 53 AM. BANKER. L. J. 2705, 282 (1979). Levit suggests that if a debtor can use cash proceeds only upon court approval pursuant to section 363, then "the general blanket grant of authority to use property in the ordinary course of business, will, in many cases, become a sham, and the debtor's prospects of reorganization will be almost completely at the mercy of the secured lender." Id. at 282. In support of this argument, Levit cites the following joint statement issued by Representative Edwards and Senator DeConcini regarding section 363: "Although this section grants a security interest in proceeds, product, offspring, rents or profits, the section is explicitly subject to other sections of title 11. For example, the trustee or debtor-in-possession may use, sell or lease proceeds, products, offspring, rent or profits under section 363." Levit, supra at 282, n.20, (quoting 124 Cong. Rec. H11,098 daily ed. Sept. 28, 1978); S17, 414 (daily ed. Oct. 6, 1978)). At the time Levit's article was published, section 363 did not include cash proceeds in the definition of cash collateral; however, Congress subsequently supplemented the definition of section 363(a) to include as an example of cash collateral "proceeds . . . of property subject to a security interest as provided in 552(b) . . . ." Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. No. 98, 98 Stat. 353 (1984). Thus, the 1984 amendments erased any doubt that proceeds constitute cash collateral. Slab Fork, 784 F.2d at 1191.} Because the postpetition payments Slab Fork received under the contract were proceeds subject to the banks' prepetition security interest, they constituted cash collateral and the Fourth Circuit concluded that Slab Fork was barred from using the funds without court approval.\footnote{Id. at 1191.}

When a debtor seeks court authorization to use cash collateral, the court must prohibit or condition its use upon the debtor providing the secured creditor with
adequate protection\(^4\) for its interest.\(^5\) Security interests are "property rights" protected by the fifth amendment from public taking without just compensation, thus the court cannot allow the debtor to use cash collateral unless the creditor's security interest is adequately protected.\(^6\) Although the Bankruptcy Code does not define "adequate protection," it suggests ways by which a debtor can provide adequate protection.\(^7\) It is clear, though, that the creditor's existing interest in its collateral must be protected before the debtor can use cash collateral.\(^8\)

In *Slab Fork*, because the debtor claimed that the Armco contract proceeds were not subject to the banks' prepetition security interest, the debtor never offered the banks adequate protection for their interest in the proceeds.\(^9\)

C. *Balancing the Equities*

Even when a security interest extends to postpetition proceeds of prepetition collateral, section 552(b) gives bankruptcy courts wide latitude in applying prepetition security interests to postpetition proceeds.\(^10\) The final clause in section 552(b) permits bankruptcy courts to limit a creditor's interest in postpetition proceeds "based on the equities of the case."\(^11\)

In *Slab Fork*, the court remanded the case for the trial court to determine whether equitable considerations should permit the debtor to retain part of the postpetition proceeds.\(^12\) The court explained:

It appears clear from the legislative history related to 552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code. The latitude af-

\(^4\) 11 U.S.C. § 363(e) provides in pertinent part that "at any time, on request of an entity that has an interest in property. . .proposed to be used, sold, or leased, by the trustee, the court, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."

\(^5\) In an action to use cash collateral, the trustee has the burden of establishing that the secured party's interest is adequately protected. 11 U.S.C. § 363 (o)(1).

\(^6\) In re George Ruggiere Chrysler-Plymouth, 727 F.2d 1017, 1019 (11th Cir. 1984); See also Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940), reh'mg denied, 312 U.S. 711 (1941).


\(^9\) *Slab Fork*, 784 F.2d at 1191.

\(^10\) Id.

\(^11\) 4 COLLIER ON BANKRUPTCY § 552.02 (L. King 15th ed. 1979). Note that section 552(b) which preserves prepetition liens is limited but only by the equities of the case but also by the terms of the security agreement and applicable nonbankruptcy law.

\(^12\) *Slab Fork*, 784 F.2d at 1191.
forded the bankruptcy court seems . . . to indicate that such a balancing of interests was intended in the framing of 552.97

The equity exception is intended for cases in which the trustee or debtor in possession uses the bankruptcy estate’s other assets to increase the value of the collateral.98 Thus, the court can preserve valid security interests in proceeds and, at the same time, protect the interests of unsecured creditors. For instance, if the debtor invests $100,000 to turn raw materials worth $1,000,000 into a finished product that sells for $1,500,000 the court may divest the creditor of its security interest in a portion of the proceeds of the finished product.99 Otherwise, assets that would have benefitted unsecured creditors will, instead, benefit only a secured creditor whose collateral has increased in value.60

Notwithstanding the equities option,61 the debtor may recover from the collateral “the reasonable, necessary costs and expenses of preserving, or disposing of, such property” to the extent the secured party is benefitted.62 In the case of the debtor performing its obligations under a contract and earning payments that constitute postpetition proceeds of prepetition collateral, the debtor may be able to recover its costs of performance.63

IV. Slab Fork’s Effect on Coal Company Bankruptcies

A. Lender Precautions

By carefully drafting loan agreements and security documents, a lender can substantially enhance its status in its borrower’s subsequent bankruptcy proceeding. Slab Fork, Sunberg, and J. Catton Farms teach that, by taking security

97 Id.
98 The House Report provides: “The exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors.” H.R. REP. No. 595, supra note 21, at 371. See also J. Catton Farms, 779 F.2d at 1246; In re Village Properties, Ltd., 723 F.2d 441, 444 (5th Cir.), cert. denied, 466 U.S. 974 (1984); but cf., In re Bohne, 57 Bankr. 461 (Bankr. D. N.D. 1985) (debtors were not allowed to offset against value of bank’s interest in cash collateral for expenses incurred in raising calves.).
99 J. Catton Farms, Inc., 779 F.2d at 1247.
60 Id.
61 Courts have also applied the “equity exception” in the following cases: In re Serbus, 48 Bankr. 5 (Bankr. D. Minn. 1984); In re Johnson, 47 Bankr. 204 (Bankr. W.D. Wis. 1985); U.S. v. Hollie, 42 Bankr. 111 (Bankr. M.D. Ga. 1984).
63 See Springs v. Hamilton, 18 Bankr. 868 (Bankr. D. Colo. 1982), in which a lender had a security interest in a farmer debtor’s existing crops. Upon the sale of the crops, the court permitted the debtor to retain from the proceeds the reasonable, necessary costs of maintaining, harvesting, and marketing the crops.
interests in contracts and the proceeds of contracts, a lender will have an interest in the proceeds generated by the debtor's prepetition and postpetition performance under the contracts. Of course, the value of a security interest in contracts and the proceeds from such contracts will vary according to the type of business in which the debtor is engaged and the size and length of the contracts to which it is a party. It also will depend upon whether the debtor is willing to assume the contract and perform postpetition its obligations under the contract.

In Slab Fork, the benefit to the lender was substantial. The debtor elected to assume and perform its obligations under the Armco contract and received payments. The benefits to the lenders in Sunberg and J. Catton Farms were substantial as well.

The consequences for failing to obtain a security interest in contracts are obvious. The lender who relies solely on its interest in accounts receivable may find that the commencement of a bankruptcy case renders his collateral valueless. For example, in In re Schmaling, the lender failed to obtain a security interest in its borrower's payment-in-kind revenues although it could have done so by including government entitlements, general intangibles, or contract rights as collateral for the loan. Instead, the lender's security interest covered only "machinery and equipment, livestock and... corn and all other crops grown or growing." Thus, when the borrower filed bankruptcy, the lender held no security interest in the debtor's payment-in-kind revenues.

B. Strategic Choices Facing Debtors

If a lender obtains a prepetition security interest in a debtor's contract and the proceeds from the contract, the debtor can assume the contract and attempt to recover some compensation for its labors from the proceeds it receives. Alternatively, the debtor can reject the prepetition contract and thereby deprive the lender from recovering potential proceeds of the contract. In a case under Chapter 11, the debtor may, subject to several limitations, assume or reject an executory

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46 See supra note 43.
45 See supra note 58.
66 In J. Catton Farms, Inc., the court affirmed an order of a lower court directing the farming operation to pay the secured creditor more than $300,000. J. Catton Farms 779 F.2d at 1250. In Sunberg, the court denied the debtor's application to incur debt secured by a lien on PIK benefits. Sunberg, 729 F.2d at 562.
67 See supra note 43.
68 In re Schmaling, 783 F.2d 680 (7th Cir. 1986).
69 Id. at 681.
70 Id. at 684.
71 See supra note 58.
contract at any time before confirmation of a plan. Generally, a contract is executory if it involves substantial future performance by each party to the contract. The contracts in Slab Fork, Sunberg, and J. Catton Farms were executory. Thus, the debtors could have defeated the creditors' security interest by rejecting the contracts. Had the debtors rejected the contracts, they would have earned no postpetition payments that would have constituted proceeds of prepetition collateral. As the court in J. Catton Farms stated: "It is true that the bankruptcy judge can (with limitations unnecessary to go into here) allow a debtor to disaffirm an executory contract. But that was not done here. The bank was lucky that it was not done. But for the 'PIK' contract, it might have lost its lien."

Because section 552(a) bars prepetition security interests from attaching to contracts entered into postpetition, the proceeds of postpetition contracts are free and clear of creditors' prepetition security interests. Thus the debtor is free to use the contract's proceeds in the operation of its business without court approval and without any obligation to protect secured creditors' interest in its collateral.

A debtor whose contracts are encumbered should examine whether to seek court approval to reject them. The debtor must recognize that payments which are proceeds of encumbered contracts will constitute cash collateral which it cannot use without court approval and without providing adequate protection for the secured party's interest. The debtor must also recognize that the court may award the secured party the bulk of the contract's proceeds. On the other hand, the debtor can reject the prepetition contract and enter into a postpetition contract. A security interest will not encumber payments received under the postpetition contract, thus directly benefitting the debtor.

If the prepetition contract is especially favorable, the debtor may not want to reject it; yet the debtor may use the threat of rejecting the contract as a

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72 An executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." In re Speck, 798 F.2d 279, 279-80 (8th Cir. 1986) (quoting Countryman, Executory Contracts in Bankruptcy (pt. I), 57 MINN. L. REV. 439, 460 (1972-73)).
73 11 U.S.C. § 365 (Supp. II 1984), governs the circumstances under which a debtor may assume or reject an executory contract.
74 See supra note 72.
75 See Slab Fork, 784 F.2d at 1189; J. Catton Farms, Inc., 779 F.2d at 1247; Sunberg, 729 F.2d at 561.
76 Schmaling, 783 F.2d at 681.
77 J. Catton Farms, Inc., 779 F.2d at 1247 (citations omitted).
79 Id.
80 See supra note 48 and accompanying text.
81 See supra note 59 and accompanying text.
bargaining chip with the secured party and thereby reach an agreement with the secured party that entitles the debtor to use a portion of the contract’s proceeds free and clear of the creditor’s security interest.

V. CONCLUSION

Long-term coal contracts and the proceeds of coal contracts are obvious sources of collateral for lenders. Although security interests in such contracts can substantially enhance a lender’s position in a coal company’s bankruptcy case, a debtor may reject its executory contracts, and, as a result, deprive its lender of its collateral. Only a foolish lender would rely substantially on the proceeds of a long-term contract as its collateral, yet contracts and contract proceeds can serve as valuable sources of collateral that lenders should not overlook.