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ORDERED PUBLISHED

**UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT**

In re:) BAP Nos. OR-15-1141-KiFJu)
) OR-15-1190-KiFJu)
) (cross-appeals))
MICHAEL W. ENDRESEN and))
JOANNE MAUREEN ENDRESEN,))
))
) Bk. No. 11-35396-RLD)
Debtors.))
) Adv. No. 14-3131-RLD)

STEPHEN P. ARNOT, Chapter 7)
Trustee,)
)
Appellant,)

v.)

O P I N I O N

MICHAEL W. ENDRESEN; JOANNE)
MAUREEN ENDRESEN; GREEN TREE)
SERVICING, LLC; THE BANK OF)
NEW YORK MELLON, f/k/a THE)
BANK OF NEW YORK, as Trustee)
for the Holders of First)
Horizon Mortgage Pass-Through)
Certificates, Series FHAMS)
2004-AA7; THE BANK OF NEW)
YORK MELLON, as Successor to)
JPMorgan Chase Bank, as)
Trustee for the Holders of)
Bear Stearns Alt-A Trust)
2005-1 Mortgage Pass-Through)
Certificates, Series 2005-1;)
THE BANK OF NEW YORK MELLON,)
f/k/a THE BANK OF NEW YORK,)
as Trustee for the Holders of)
American Home Mortgage)
Investment Trust 2004-4; U.S.)
BANK, NATIONAL ASSOCIATION,)
as Trustee for Adjustable)
Rate Mortgage Trust 2005-2,)
Adjustable Rate Mortgage-)
Backed Pass-Through)
Certificates, Series 2005-2,)
)
Appellees.)

Argued and Submitted on March 17, 2016,

1 at Pasadena, California

2 Filed - April 8, 2016

3 Appeal from the United States Bankruptcy Court
4 for the District of Oregon

5 Honorable Randall L. Dunn, Bankruptcy Judge, Presiding

6 Appearances: David A. Foraker of Greene & Markley, P.C. argued
7 for appellant/cross-appellee Stephen P. Arnot,
8 Chapter 7 Trustee; Michael R. Blaskowsky of
9 Columbia River Law Group argued for
appellees/cross-appellants Michael and Joanne
Endresen; and David Elkanich of Holland & Knight
LLP argued for appellee Bank of New York Mellon.

10
11 Before: KIRSCHER, FARIS and JURY, Bankruptcy Judges.

12
13 KIRSCHER, Bankruptcy Judge:

14
15 Stephen P. Arnot, chapter 7¹ trustee, appeals a judgment
16 determining that appellees Green Tree Servicing, LLC; The Bank of
17 New York Mellon, f/k/a The Bank of New York, as Trustee for the
18 Holders of First Horizon Mortgage Pass-Through Certificates,
19 Series FHAMS 2004-AA7; The Bank of New York Mellon, as Successor
20 to JPMorgan Chase Bank, as Trustee for the Holders of Bear Stearns
21 Alt-A Trust 2005-1 Mortgage Pass-Through Certificates, Series
22 2005-1; and The Bank of New York Mellon, f/k/a The Bank of New
23 York, as Trustee for the Holders of American Home Mortgage
24 Investment Trust 2004-4 (collectively, "Lenders") were entitled to
25 settlement funds awarded to debtors Michael and Joanne Endresen in

26
27 ¹ Unless specified otherwise, all chapter, code and rule
28 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and
the Federal Rules of Bankruptcy Procedure, Rules 1001-9037. The
Federal Rules of Civil Procedure are referred to as "Civil Rules."

1 connection with construction defect claims the couple litigated in
2 state court nearly two years after their chapter 7 bankruptcy case
3 had closed. Debtors cross-appeal the bankruptcy court's decision
4 to award a portion of the settlement funds to Trustee and not to
5 lender U.S. Bank, N.A., which failed to appear in the case. We
6 AFFIRM as to the bankruptcy court's determination that the
7 settlement funds were part of Lenders' collateral and REVERSE as
8 to the bankruptcy court's award of U.S. Bank's share of the
9 settlement funds to Trustee.

10 I. FACTUAL BACKGROUND AND PROCEDURAL HISTORY

11 A. Prepetition events

12 The facts are not in dispute. In 2004, Debtors purchased ten
13 rowhomes in Portland, Oregon for the purpose of producing rental
14 income (the "Properties"). To purchase the Properties, Debtors
15 obtained several loans from the Lenders² which were secured by
16 deeds of trust ("Trust Deeds") recorded on each of the Properties
17 in November 2004. Each of the Trust Deeds is modeled after the
18 Fannie Mae/Freddie Mac Uniform Instrument with MERS for an Oregon
19 Single Family Residence, identified as Form 3038 1/01. The
20 provisions relevant to these appeals are identical in each Trust
21 Deed. Specifically, among the defined terms is "Miscellaneous
22 Proceeds:"

23 **(N) Miscellaneous Proceeds** means any compensation,
24 settlement, award of damages, or proceeds paid by any
25 third party (other than insurance proceeds paid under the
26 coverages described in Section 5) for: (i) damage to, or
destruction of, the Property; (ii) condemnation or other
taking of all or any part of the Property;

27 ² Lenders either originated the loans made to Debtors or
28 acquired their claims by assignment. No one has questioned the
validity of these assignments.

1 (iii) conveyance in lieu of condemnation; or (iv)
2 misrepresentations of, or omissions as to, the value
and/or condition of the Property.

3 Section 11 of each Trust Deed, entitled "Assignment of
4 Miscellaneous Proceeds; Forfeiture," provides in relevant part:

5 All Miscellaneous Proceeds are hereby assigned to and
6 shall be paid to Lender.

7 If the Property is damaged, such Miscellaneous Proceeds
8 shall be applied to restoration or repair of the
9 Property, if the restoration or repair is economically
10 feasible and Lender's security is not lessened. During
11 such repair and restoration period, Lender shall have
12 the right to hold such Miscellaneous Proceeds until
13 Lender has had an opportunity to inspect such Property
14 to ensure the work has been completed to Lender's
15 satisfaction, provided that such inspection shall be
16 undertaken promptly. Lender may pay for the repairs
17 and restoration in a single disbursement or in a series
18 of progress payments as the work is completed. Unless
19 an agreement is made in writing or Applicable Law
20 requires interest to be paid on such Miscellaneous
21 Proceeds, Lender shall not be required to pay Borrower
22 any interest or earnings on such Miscellaneous
23 Proceeds. If the restoration or repair is not
24 economically feasible or Lender's security would be
25 lessened, the Miscellaneous Proceeds shall be applied
26 to the sums secured by this Security Instrument,
27 whether or not then due, with the excess, if any, paid
28 to Borrower. Such Miscellaneous Proceeds shall be
applied in the order provided for in Section 2.

19 In the event of a total taking, destruction, or loss in
20 value of the Property, the Miscellaneous Proceeds shall
21 be applied to the sums secured by this Security
22 Instrument, whether or not then due, with the excess,
23 if any, paid to Borrower.

22 Unbeknownst to either Debtors or Lenders, the Properties had
23 defects in their construction that resulted in significant water
24 and mold damage.

25 **B. Postpetition events**

26 Debtors filed their chapter 7 bankruptcy case on June 21,
27 2011. On October 17, 2011, Debtors received their discharge and
28 the case was closed as a "no asset" case.

1 On November 9, 2011, Debtors filed a chapter 13 petition.
2 The claims of the Lenders are provided for in Debtors' confirmed
3 chapter 13 plan and remain unsatisfied.

4 In May 2013, Debtors were added as co-plaintiffs in a civil
5 action pending against the builder of the rowhomes in Oregon state
6 court. The plaintiffs alleged that the Properties, built in 2003,
7 were negligently constructed and that the construction defects in
8 the Properties and related damage were discovered in 2012 after a
9 consultant's evaluation.

10 The bankruptcy court reopened Debtors' chapter 7 bankruptcy
11 case on February 3, 2014. On that same date, Debtors' part of the
12 state court action for the construction defect claims was settled
13 for \$318,200. The bankruptcy court entered an order approving the
14 settlement. After payment of attorney's fees and costs, the
15 balance of the proceeds to Debtors was \$185,525.47 ("Settlement
16 Proceeds"). The Settlement Proceeds are being held in trust by
17 Debtors' state court attorney pending the outcome of this appeal.

18 **1. Trustee's adversary complaint and the cross-motions for**
19 **summary judgment**

20 Trustee sought a determination that Lenders had no
21 enforceable security interests in the Settlement Proceeds.³
22 Trustee contended that the description of Lenders' personal
23 property collateral in the definition of "Miscellaneous Proceeds"
24 in the Trust Deeds did not reasonably identify the construction
25

26 ³ Trustee also contended that the Settlement Proceeds were
27 property of the estate, which Debtors and Lenders opposed.
28 Ultimately, the bankruptcy court agreed with Trustee, granting him
summary judgment on that issue. Because no party has appealed
that ruling, we do not address it or discuss it any further.

1 defect claims and, for that reason, the Trust Deeds did not create
2 an enforceable security interest in those claims or the derived
3 Settlement Proceeds. Alternatively, Trustee argued that even if
4 the description in the Trust Deeds reasonably identified the
5 construction defect claims as collateral, Lenders had no
6 enforceable security interest in the Settlement Proceeds because
7 (1) the construction defect claims were commercial tort claims
8 that did not exist when Debtors executed the Trust Deeds, (2)
9 under Oregon law, an after-acquired property clause in a security
10 agreement is ineffective to create an enforceable security
11 interest in a commercial tort claim that is after-acquired
12 collateral, and (3) the Settlement Proceeds were proceeds of, or a
13 right arising out of, these commercial tort claims.

14 Debtors and Lenders (except for U.S. Bank) filed answers
15 denying Trustee's claims, contending that the Trust Deeds gave
16 Lenders an enforceable interest in the Settlement Proceeds, which
17 was superior to Trustee's interest. Despite being properly served
18 with the complaint, lender U.S. Bank did not respond to Trustee's
19 amended complaint, and a default order was entered.

20 Trustee then moved for summary judgment. He contended that
21 the Uniform Commercial Code ("UCC"), as adopted in Oregon,
22 determined the validity and scope of the security interest granted
23 by Debtors in their personal property under the Trust Deeds.
24 Trustee argued that because the definition of Miscellaneous
25 Proceeds in the Trust Deeds did not identify the Settlement
26 Proceeds sufficiently to create an enforceable security interest
27 in them and because the Settlement Proceeds were derived from
28 commercial tort claims (the construction defect claims), the tort

1 claims and derived proceeds constituted "after-acquired" property
2 of the estate. Accordingly, the Settlement Proceeds were
3 "property acquired by the estate . . . after the commencement of
4 the case" as that phrase is used in § 552(a).⁴ Trustee argued
5 that Lenders' Article 9 security interests, if any, were not
6 created until after Debtors filed their chapter 7 petition.
7 Therefore, their purported interests did not "attach" – and thus
8 could not have become enforceable against Debtors – until Debtors
9 collected the Settlement Proceeds postpetition. Thus, argued
10 Trustee, Lenders' security interest in the Settlement Proceeds,
11 even if otherwise enforceable under Oregon law, did not attach
12 until "after the commencement of the case." Consequently, the
13 Settlement Proceeds were "not subject to any lien resulting from"
14 the prepetition Trust Deeds within the meaning of § 552(a).

15 Debtors and Lenders opposed Trustee's motion and filed cross-
16 motions for summary judgment. Lenders contended they had a
17 continuing security interest in the Settlement Proceeds under
18 § 552(b)(1)⁵ because they were "proceeds" of the original, damaged

19

20 ⁴ Section 552(a) provides:

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

26 ⁵ Section 552(b)(1) provides, in relevant part:

27 [I]f the debtor and an entity entered into a security
28 agreement before the commencement of the case and if the
29 security interest created by such security agreement extends
30 to property of the debtor acquired before the commencement of
31 the case and to proceeds, products, offspring, or profits of
32 such property, then such security interest extends to such

(continued...)

1 collateral. Lenders maintained that the Settlement Proceeds fell
2 within the definition of "proceeds" under Oregon Revised Statutes
3 § 79.0102(kkk) (B) & (D).⁶ Oregon law further provided that a
4 security interest in proceeds is a perfected security interest if
5 the security interest in the original collateral was perfected.
6 Or. Rev. Stat. § 79.0315(3). Lenders argued that because they had
7 perfected their security interests in the Properties by recording
8 the Trust Deeds, they had also perfected their security interests
9 in the Settlement Proceeds intended to be an award for damage to
10 and diminution in value of the original collateral Properties.

11 Trustee disputed Lenders' contention that the Settlement
12 Proceeds were "proceeds" of their original, damaged collateral.
13 He maintained that Oregon UCC law applied only to the extent
14 Lenders were granted security interests in the Miscellaneous
15 Proceeds as original collateral; it did not apply to the extent
16 they were granted a lien on real property as original collateral.

17

18

19 ⁵(...continued)
20 proceeds, products, offspring, or profits acquired by the
21 estate after the commencement of the case to the extent
22 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.

23 ⁶ Or. Rev. Stat. § 79.0102(kkk) (B) and (D) provide that
"proceeds" means:

24 (B) Whatever is collected on, or distributed on account of,
25 collateral;

26

27 (D) To the extent of the value of collateral, claims arising
28 out of the loss, nonconformity or interference with the use
of, defects or infringement of rights in, or damage to, the
collateral.

1 Lenders' personal property collateral was that which was described
2 in the definition of "Miscellaneous Proceeds" contained in the
3 Trust Deeds. Thus, argued Trustee, to the extent the definition
4 of "Miscellaneous Proceeds" could be interpreted to encompass the
5 Settlement Proceeds, which Trustee disputed, the Settlement
6 Proceeds themselves constituted the Lenders' original personal
7 property collateral, and Article 9 applied only if Lenders had
8 enforceable security interests in the construction defect claims
9 as original collateral, as opposed to the real property. Because
10 Lenders never had a security interest in the defect claims, argued
11 Trustee, they could not have an interest in the Settlement
12 Proceeds as "proceeds" of those claims.

13 Accordingly, Trustee disputed that § 552(b)(1) applied
14 because Lenders did not have enforceable security interests in the
15 Settlement Proceeds as "proceeds" of any original collateral.

16 **2. The court's tentative ruling and the parties'**
17 **supplemental briefing**

18 After the bankruptcy court issued its tentative ruling in
19 favor of Lenders, it invited supplemental briefing before issuing
20 its final decision.

21 Trustee filed his supplemental brief along with a motion for
22 leave to file a second amended complaint. In his supplemental
23 brief, Trustee argued that for the proceeds exception under
24 § 552(b)(1) to apply, the court had to determine that (1) the
25 Settlement Proceeds are "proceeds" of Lenders' prepetition
26 collateral (as that term is used in § 552(b)(1)) and (2) their
27 security interests under the Trust Deeds "extend" to the
28 Settlement Proceeds as "proceeds" of such prepetition collateral.

1 Trustee contended that the § 552(b)(1) exception did not apply
2 because Lenders' security interests in the Settlement Proceeds
3 attached to that postpetition estate property as original
4 collateral for the loan, not as proceeds of their prepetition real
5 property collateral.

6 To explain, Trustee contended that although under Oregon law
7 a secured party with a security interest in personal property has
8 an automatic right to proceeds of that personal property
9 collateral, no comparable Oregon statute gives a mortgagee an
10 automatic right to proceeds of real property collateral.
11 Specifically, asserted Trustee, UCC Revised Article 9 did not
12 apply to the "creation or transfer of an interest in or lien on
13 real property . . . and the proceeds thereof." Or. Rev. Stat.
14 § 79.109(4)(k). Trustee contended that liens on real property
15 were governed generally by the laws relating to mortgages and
16 trust deeds. Thus, it followed that the automatic proceeds
17 provision in UCC Revised Article 9 did not apply to Lenders' real
18 property collateral.

19 Trustee contended that if Lenders had a security interest in
20 any proceeds of their prepetition real property collateral, it
21 could be only because Debtors granted them such interest under the
22 Trust Deeds. Trustee maintained that only two grant clauses
23 existed in the Trust Deeds, and arguably the only one applicable
24 here was the Assignment of Miscellaneous Proceeds clause, wherein
25 Debtors assigned any Miscellaneous Proceeds to Lenders. Trustee
26 argued that the "proceeds" described there essentially consisted
27 of proceeds realized from causes of actions relating to real
28 property - e.g., tort claims for "damage to, or destruction of,

1 the Property," or fraud-based or breach of contract claims for
2 "misrepresentation of, or omissions as to, the value and/or
3 condition of the Property." Trustee argued that because the Trust
4 Deeds failed to include the necessary "link" between the real
5 property collateral and the Settlement Proceeds - i.e., Lenders'
6 right to Debtors' tort causes of action - the Settlement Proceeds
7 could not be traced to any collateral from which the tort claim
8 might have derived.

9 In summary, Trustee contended that in construing § 552(b)(1)
10 in the context of real property collateral, "proceeds" should mean
11 proceeds under state common law principles, as opposed to the UCC.
12 In Oregon, which has no statute defining the scope of proceeds for
13 secured transactions in real property, Trustee contended that the
14 term "proceeds," as used in § 552(b)(1), means proceeds under
15 applicable state common law principles. Under Oregon common law,
16 as argued by Trustee, proceeds of a payment intangible that arises
17 from the settlement of commercial tort claims for construction
18 defects are not "proceeds" of the real property collateral that
19 was defectively constructed. Accordingly, Lenders' security
20 interest did not "extend" to the Settlement Proceeds as "proceeds"
21 of any of their prepetition collateral, and the requirements of
22 § 552(b)(1) had not been met.

23 Lenders maintained that the bankruptcy court's tentative
24 ruling correctly categorized the Settlement Proceeds as a
25 prepetition assignment to Lenders, which was bargained for by the
26 parties in the Trust Deeds. Lenders contended that nothing in
27 Oregon UCC law prevented the parties from assigning the Settlement
28 Proceeds to Lenders under the Trust Deeds. Furthermore, Oregon

1 law provided that the provisions of the UCC may be varied by
2 agreement. Or. Rev. Stat. § 71.3020(1). Thus, argued Lenders,
3 even if a provision of Oregon's UCC law arguably conflicted with
4 the assignment of the Settlement Proceeds as "Miscellaneous
5 Proceeds," the parties could agree to modify the effect of any
6 such provisions via their agreement in the Trust Deeds.

7 Debtors contended that even though U.S. Bank had not
8 appeared, it still had an enforceable security interest in the
9 Settlement Proceeds based on the Trust Deeds. Debtors maintained
10 that U.S. Bank's failure to participate did not terminate or
11 affect that interest and argued that the court would exceed its
12 authority by holding otherwise.

13 Before the bankruptcy court was also Trustee's motion for
14 leave to file a second amended complaint, which Debtors and
15 Lenders opposed on both procedural and substantive grounds.
16 Trustee explained that while working on his post-hearing brief, he
17 identified a "new theory" for obtaining relief against Lenders.
18 Under Or. Rev. Stat. § 79.0317(1)(a), Trustee as "lien creditor"
19 had priority over the Lenders' security interests in the
20 Settlement Proceeds, because those security interests were
21 unperfected. Thus, under this new theory, explained Trustee, his
22 rights to the Settlement Proceeds were senior to those of Lenders,
23 even if the bankruptcy court determined that their security
24 interests in the Settlement Proceeds were not cut off under
25 § 552(a).

26 In opposition, Debtors contended that Trustee's "new theory"
27 failed, because as proceeds from the damaged real property
28 collateral, Lenders' security interests in the Settlement Proceeds

1 were perfected when the Trust Deeds were recorded. Debtors noted
2 that Trustee's new theory was also inconsistent with his argument
3 that Lenders did **not** have a security interest in the Settlement
4 Proceeds. Lenders argued that Article 9 did not apply in this
5 case because the parties agreed to operate outside of the UCC. If
6 it did apply, Lenders argued that, relying on Wiersma v. O.H.
7 Kruse Grain & Milling (In re Wiersma), 324 B.R. 92, 106 (9th Cir.
8 BAP 2005), rev'd on jurisdictional grounds, 483 F.3d 933 (9th Cir.
9 2007), they had perfected security interests in one of two ways.
10 First, lawsuit settlement funds stemming from destruction of
11 collateral are considered to be proceeds of the original, damaged
12 collateral. Second, if a creditor has a perfected security
13 interest in after-acquired general intangibles, it also has a
14 secured interest in the settlement funds stemming from a tort
15 claim, because once a lawsuit in tort is settled for money, the
16 debtor's right to payment is converted to a "payment intangible"
17 to which the tort exclusion does not apply.

18 **3. The bankruptcy court's decision on the cross-motions for**
19 **summary judgment**

20 In its published opinion on the cross-motions for summary
21 judgment, the bankruptcy court determined that Lenders had a valid
22 and continuing security interest in the Settlement Proceeds as
23 proceeds of their real property collateral. Arnot v. Endresen (In
24 re Endresen), 530 B.R. 856 (Bankr. D. Or. 2015).

25 The court first determined that the Trust Deeds provided for
26 assignment of the Miscellaneous Proceeds for security purposes,
27 thereby creating a security agreement, rather than an assignment
28 of those proceeds outright. Id. at 866. The court further

1 concluded that the definition of "Miscellaneous Proceeds" in the
2 Trust Deeds "provide[d] an adequate description of the Settlement
3 Proceeds as a settlement or proceeds paid by a third party for
4 damage to the Properties." Id. at 867. In reaching that
5 conclusion, the court disagreed with Trustee's contention that the
6 Miscellaneous Proceeds definition failed to "reasonably identify"
7 the Settlement Proceeds. As an initial matter, the court did not
8 believe the Trust Deeds were designed to create a security
9 interest in personal property under Article 9 of the UCC. Id. at
10 866. Moreover, only the Settlement Proceeds remained at issue,
11 not any commercial tort claims; those claims had been settled long
12 before the adversary complaint was filed. Therefore, all the
13 court had to determine was whether the definition of
14 "Miscellaneous Proceeds" in the Trust Deeds, as a matter of
15 general contract interpretation, reasonably identified the
16 Settlement Proceeds as subject to Lenders' alleged secured claim,
17 which it determined in the affirmative. Id. at 866-67.

18 The bankruptcy court's conclusion that Lenders had a valid
19 security agreement that properly described the Settlement Proceeds
20 prompted its consideration of (1) whether the Lenders' security
21 interest properly attached to the Settlement Proceeds and
22 (2) whether that interest was cut off by § 552(a) or saved by the
23 exception in § 552(b) (1). The court concluded that Lenders'
24 security interest in the Settlement Proceeds attached by virtue of
25 the security arrangements for the assignment of Miscellaneous
26 Proceeds in the Trust Deeds. Id. at 869. In other words, the
27 Settlement Proceeds were identifiable Miscellaneous Proceeds under
28 the Trust Deeds to which Lenders' security interests attached for

1 purposes of § 552(b) (1) as "proceeds" of their original, damaged
2 collateral. Relying on Wiersma and Ninth Circuit authority that
3 the term "proceeds" in § 552(b) (1) be given the "broadest possible
4 definition," the court rejected Trustee's argument that Lenders'
5 failure to have an identifiable, properly attached and perfected
6 security interest in the construction defect claims, as commercial
7 tort claims, at the intermediate stage prior to settlement of
8 those claims automatically vitiated their security interest in the
9 Settlement Proceeds vis-a-vis the estate. Id. at 868-69.

10 The bankruptcy court further held that Lenders' interest in
11 the Settlement Proceeds was perfected because (1) Article 9's
12 requirement that a secured party file a UCC-1 financing statement
13 did not apply to Trust Deeds, and (2) even if Article 9 did apply
14 to Trust Deeds in general, a financing statement was not required
15 here. Id. at 869-871. The court reasoned that Lenders perfected
16 their interest in the Properties by recording the Trust Deeds in
17 2004. The Trust Deeds in turn contained provisions concerning the
18 assignment of Miscellaneous Proceeds which functioned as a
19 security agreement and created a valid security interest that
20 attached to the Settlement Proceeds. Thus, because the security
21 interest in the original real property collateral was perfected,
22 so were the Settlement Proceeds intended for repair of that
23 damaged collateral. Accordingly, Lenders were entitled to summary
24 judgment. Because the court believed that its decision addressed
25 Trustee's "new theory" regarding perfection, it denied his motion
26 for leave to file a second amended complaint.

27 Finally, based on the "equities of the case" exception in
28 § 552(b) (1), the bankruptcy court determined that Trustee was

1 entitled to U.S. Bank's share of the Settlement Proceeds. Id. at
2 871. In the court's view, U.S. Bank should not benefit as a "free
3 rider" from the significant efforts expended by Lenders after it
4 failed to appear and was defaulted. The court noted that U.S.
5 Bank had ample opportunity to appear and defend its interest in
6 the Settlement Proceeds and had chosen not to do so. As such, it
7 entered a default judgment against U.S. Bank. Id.

8 **II. JURISDICTION**

9 The bankruptcy court had jurisdiction under 28 U.S.C. §§ 1334
10 and 157(b)(2)(A), (B), (C), (K) and (O). We have jurisdiction
11 under 28 U.S.C. § 158.

12 **III. ISSUES**

13 1. Did the bankruptcy court err in determining that the
14 Settlement Proceeds were "proceeds" of Lenders' real property
15 collateral and thus "proceeds" for purposes of § 552(b)(1)?

16 2. Did the bankruptcy court abuse its discretion in awarding
17 U.S. Bank's share of the Settlement Proceeds to Trustee under the
18 "equities of the case" exception in § 552(b)(1)?

19 **IV. STANDARDS OF REVIEW**

20 We review a bankruptcy court's grant of summary judgment de
21 novo. Fresno Motors, LLC v. Mercedes-Benz USA, LLC, 771 F.3d
22 1119, 1125 (9th Cir. 2014); Good v. Daff (In re Swintek), 543 B.R.
23 303, 306 (9th Cir. BAP 2015). Likewise, we review a bankruptcy
24 court's legal conclusions, including its interpretation of the
25 Bankruptcy Code and state law, de novo. Rund v. Bank of Am. Corp.
26 (In re EPD Inv. Co., LLC), 523 B.R. 680, 684 (9th Cir. BAP 2015).

27 The decision whether to apply the equitable exception under
28 § 552(b)(1) is reviewed for abuse of discretion. See J. Catton

1 Farms, Inc. v. First Nat'l Bank of Chi., 779 F.2d 1242, 1247 (7th
2 Cir. 1985). Accordingly, we reverse where the bankruptcy court
3 applied an incorrect legal rule or where its application of the
4 law to the facts was illogical, implausible or without support in
5 inferences that may be drawn from the record. Ahanchian v. Xenon
6 Pictures, Inc., 624 F.3d 1253, 1258 (9th Cir. 2010) (citing United
7 States v. Hinkson, 585 F.3d 1247, 1262 (9th Cir. 2009) (en banc)).

8 We may affirm on any ground supported by the record,
9 regardless of whether the bankruptcy court relied upon, rejected
10 or even considered that ground. Fresno Motors, LLC, 771 F.3d at
11 1125.

12 V. DISCUSSION

13 A. Summary judgment standards

14 Under Civil Rule 56, applicable here by Rule 7056, "[t]he
15 court shall grant summary judgment if the movant shows that there
16 is no genuine dispute as to any material fact and the movant is
17 entitled to judgment as a matter of law." Civil Rule 56(a). When
18 deciding a motion for summary judgment, the court does not weigh
19 the evidence to determine the truth of the matter asserted but
20 simply determines whether a genuine issue for trial exists.
21 Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249 (1986). "Only
22 disputes over facts that might affect the outcome of the suit
23 under the governing law will properly preclude the entry of
24 summary judgment." Id. at 248.

25 No material facts are disputed in this case. We agree with
26 the parties that the issues presented before this Panel are purely
27 questions of law.

28

1 **B. Analysis**

2 We agree with the bankruptcy court's conclusion that Lenders'
3 have valid and continuing security interests in the Settlement
4 Proceeds, but on a slightly different basis. The question before
5 us is whether the Miscellaneous Proceeds provisions in the Trust
6 Deeds include the Settlement Proceeds as proceeds of Lenders'
7 original collateral. If so, did Lenders' prepetition lien extend
8 to those postpetition proceeds absent a filed UCC-1 financing
9 statement? We conclude the answer to both of these questions is
10 yes.

11 **1. Section 552**

12 Section 552(a) provides the general rule that property
13 acquired postpetition by the debtor or the estate is not subject
14 to any lien resulting from any prepetition security agreement.
15 However, § 552(b)(1) provides certain exceptions from this general
16 rule. If the security interest created by a prepetition agreement
17 extended to property of the debtor acquired prepetition, and to
18 "proceeds, products, offspring, or profits of such property," then
19 the security interest extends to such proceeds, products,
20 offspring, or profits of such property acquired postpetition to
21 the extent provided by the security agreement and applicable
22 nonbankruptcy law. § 552(b)(1). In other words, "if a
23 pre-petition security interest encumbers collateral and its
24 proceeds, any proceeds of that pre-petition collateral remain
25 subject to the security interest even if they are received
26 post-petition." Arkison v. Frontier Asset Mgmt., LLC (In re
27 Skagit Pac. Corp.), 316 B.R. 330, 335 (9th Cir. BAP 2004). The
28 exceptions found in § 552(b)(1) are, in turn, subject to the

1 exception that the court may order otherwise based on the
2 "equities of the case."

3 "[T]he purpose of § 552 is to permit a debtor 'to gather into
4 the estate as much money as possible to satisfy the claims of all
5 creditors[;]' but § 552(b) 'balances the Code's interest in
6 freeing the debtor of prepetition obligations with a secured
7 creditor's rights to maintain a bargained-for interest in certain
8 items of collateral. It provides a **narrow** exception to the
9 general rule of [§] 552(a).'

10 Fin. Sec. Assurance, Inc. v. Days
Cal. Riverside Ltd. P'ship (In re Days Cal. Riverside Ltd.
11 P'ship), 27 F.3d 374, 375 (9th Cir. 1994) (emphasis in original)
12 (quoting Philip Morris Capital Corp. v. Bering Trader, Inc. (In re
13 Bering Trader, Inc.), 944 F.2d 500, 502 (9th Cir. 1991) ("Section
14 552(b) clearly contemplates an exception where the parties have
15 bargained for an interest in one of the five types of property
16 listed therein.")).

17 **2. Definition of "Miscellaneous Proceeds" in the Trust**
18 **Deeds includes the Settlement Proceeds.**

19 The bankruptcy court correctly concluded that § 552(a)
20 applies. The Settlement Proceeds came into existence
21 postpetition; Lenders had a prepetition security agreement - i.e.,
22 the Trust Deeds - which created a lien on the collateral described
23 in the Trust Deeds.⁷ Trustee does not dispute that Lenders had
24 valid liens on the Properties by way of their recorded Trust
25 Deeds. His dispute is that the Settlement Proceeds are not

27 ⁷ The Trust Deeds are prepetition "security agreements" as
28 defined in § 101(50), and the security interests created by the
Trust Deeds are "liens" as defined in § 101(37).

1 "proceeds" of Lenders' real property collateral for purposes of
2 § 552(b) (1).

3 The nature and extent of security interests are determined by
4 state law. In re Bering Trader, Inc., 944 F.2d at 502 (citing
5 Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper
6 Sales, Inc.), 907 F.2d 1430, 1437 (4th Cir. 1990)). We note that
7 Oregon's UCC law does not govern in this case. Or. Rev. Stat.
8 § 79.109(4) (k) provides that Article 9 of the UCC does not apply
9 to the "creation or transfer of an interest in or lien on real
10 property . . . and the proceeds thereof." Put simply, it does not
11 govern trust deeds and mortgages. While that statute lists
12 certain exceptions to this exclusion, none of them apply here.⁸

13

14 ⁸ Or. Rev. Stat. § 79.0109(4) (k) provides, in full, that
15 this chapter does not apply to

15

16 "[t]he creation or transfer of an interest in or lien on
17 real property, including a lease or rents thereunder, or
18 a sellers or purchasers interest in a land sale contract
19 and the proceeds thereof, except to the extent that
20 provision is made for:

18

- 19 (A) Liens on real property in Or. Rev. Stat.
20 § 79.0230 and 79.0308 (exception for provisions
21 regarding security interests in which the parties'
22 agreement expressly postpones the time the security
23 interest attaches and the exception for provisions
24 regarding agricultural liens);
- 25 (B) Fixtures in Or. Rev. Stat. § 79.0334 (no
26 fixtures at issue here);
- 27 (C) Fixture filings in Or. Rev. Stat. § 79.0501,
28 79.0502, 79.0512, 79.0516 and 79.0519 (same as
(B));
- (D) Security agreements covering personal and real
property in Or. Rev. Stat. § 79.0604[.]

25

26 Arguably, Or. Rev. Stat. § 79.0109(4) (k) (D) is the only exception
27 that could apply. However, even if it did apply to the Trust
28 Deeds at issue, Or. Rev. Stat. § 79.0604, which covers a secured
party's default rights and procedure, makes clear that the
existence of a security instrument securing both real and personal
(continued...)

1 Under Or. Rev. Stat. § 86.715, “[a] trust deed is deemed to be a
2 mortgage on real property and is subject to all laws relating to
3 mortgages on real property” (with certain exceptions regarding
4 foreclosure not applicable here). Accordingly, we look to the
5 language of the Trust Deeds to begin our analysis.

6 The Trust Deeds provided for a lien on the real property and
7 the “Miscellaneous Proceeds” of that property, as defined in the
8 Trust Deeds. The Trust Deeds specifically defined what “proceeds”
9 of the real property would be covered by the Lenders’ liens. The
10 definition of “Miscellaneous Proceeds” includes “any compensation,
11 settlement, award of damages, or proceeds paid by any third
12 party . . . for: (i) damage to, or destruction of, the Property .
13 . . .” Debtors’ state court action involved claims against the
14 builder that the Properties were negligently constructed,
15 diminishing the value of the Property. Those claims were settled
16 and reduced to the Settlement Proceeds. We conclude, as did the
17 bankruptcy court, that the definition of “Miscellaneous Proceeds”
18 in the Trust Deeds includes the Settlement Proceeds as a
19 settlement or proceeds paid by a third party for damage to the
20 Properties.

21 **3. The Settlement Proceeds are “proceeds” of Lenders’ real**
22 **property collateral and are “proceeds” for purposes of**
23 **§ 552(b)(1).**

24 Now we must determine whether the Settlement Proceeds are
25 “proceeds” of Lenders’ real property collateral and whether
26 Lenders acquired, through their Trust Deeds, a security interest

27 ⁸(...continued)
28 property does not “prejudic[e] any rights with respect to the real
property.” Or. Rev. Stat. § 79.0604(1).

1 in those proceeds. Again, we conclude the answer to both of these
2 questions is yes.

3 The bankruptcy court noted it was “treading in virgin
4 territory” with this precise issue. Case law on the matter is
5 essentially (and surprisingly) nonexistent. However, we have
6 located persuasive authority that supports our conclusion that the
7 Settlement Proceeds are proceeds of Lenders’ real property
8 collateral and, thus, are “proceeds” for purposes of § 552(b)(1).

9 In Farmer v. Citizens National Bank of Athens (In re Davis),
10 528 B.R. 757 (Bankr. E.D. Tenn. 2015), issued two weeks before the
11 bankruptcy court’s opinion here, the debtors owned real property
12 subject to two deeds of trust held by the bank. Id. at 759. The
13 property was damaged when a dike maintained by the Tennessee
14 Valley Authority was breached, filling the property with coal ash.
15 The debtors sued the TVA and filed for chapter 7 relief. The
16 chapter 7 trustee settled the claim postpetition for approximately
17 \$81,000 after attorney’s fees, which the bankruptcy court
18 approved. Id. at 759-60. The trustee then sought to avoid the
19 bank’s interest in the settlement proceeds. He argued the
20 settlement proceeds were personal property, general intangibles or
21 proceeds of litigation; the bank failed to take action to perfect
22 any liens to such personal property vis-a-vis a UCC-1 filing. Id.
23 at 760. Thus, argued the trustee, the bank’s deed of trust did
24 not have priority over his rights as a hypothetical judgment lien
25 creditor or postpetition lien holder under §§ 544 and 549. Id.
26 The bank argued that its lien under the deed of trust attached to
27 the settlement proceeds that arose from damage to the real
28 property collateral. Id.

1 The issue, as the court saw it, was whether the settlement
2 proceeds had the character of personalty or whether they were
3 substitute collateral for the value of the real property. Id.
4 The operative language in the deed of trust supporting the bank's
5 position was the definition of "Property," which included
6 "all . . . rights . . . now or hereafter existing in connection
7 with the property or derived therefrom." Id. at 762. As in the
8 instant case, the court noted that none of the cases cited by the
9 trustee in support of his argument that the proceeds were subject
10 to the UCC concerned settlement proceeds for damage to real
11 property subject to a deed of trust or mortgage. Id. After
12 reviewing cases analogous to the issue before it (which we discuss
13 below), and determining that the settlement proceeds fit within
14 the definition of "Property" under the deed of trust as a "right .
15 . . . derived therefrom," the court held that the settlement
16 proceeds were substitute collateral for the diminution in value of
17 the real property subject to the bank's lien under the deed of
18 trust; they were not a general intangible requiring lien
19 perfection under the UCC. Id. Thus, the bank's interest trumped
20 that of the trustee's.

21 Wilson v. Mellott (In re Wilson), 2010 WL 5341917 (Bankr. D.
22 Neb. Dec. 21, 2010), presented the same issue regarding the
23 respective rights in postpetition settlement proceeds from a
24 lawsuit involving defective construction claims. In 1997, the
25 debtors had purchased a home subject to a recorded deed of trust.
26 Id. at *2. In 2005, the plaintiff loaned the debtors money and
27 held as collateral a security agreement and assignment from the
28 debtors of certain causes of action against the contractors who

1 built the debtors' home. In particular, those claims alleged
2 losses based on deficiencies in the home's construction, resulting
3 in significant mold damage. Id. The plaintiff perfected his
4 security interest by filing a UCC-1 financing statement. Id.
5 After the debtors had commenced litigation against the builder,
6 they filed for chapter 7 relief in 2007. Id. A settlement was
7 reached postpetition in 2009, resulting in \$129,662.44 to the
8 debtors after attorney's fees. Id. at *1.

9 A fight ensued about who was entitled to the settlement
10 proceeds - the plaintiff or the defendant holding the trust deed.
11 The parties "characterize[d] the central question . . . as whether
12 the settlement proceeds are the debtors' personal property or
13 whether the proceeds are substitute collateral for the value of
14 the real property." Id. at *3. The court reasoned that if the
15 proceeds were personal property, then plaintiff's lien was
16 superior to defendant's deed of trust; if the proceeds were for
17 damage to the real property collateral, the defendant's lien had
18 priority. Id.

19 Relying on a California state court case, the court held that
20 settlement proceeds paid for damage to real property are subject
21 to a mortgagee's interest in the damaged real property:

22 When a monetary remedy is awarded for damage to real
23 property, it "takes the place of the reduced value of the
24 land." Am. Sav. & Loan Ass'n v. Leeds, 440 P.2d 933, 937
25 n.2 (Cal. 1968) (en banc). Accordingly, a lender holding
26 an interest in real estate as collateral would be
27 entitled to damages for injury to his security.
Therefore, to the extent any portion of the settlement
allocable to property damage represents a reduction in
the value of the [defendant's] collateral, it is subject
to the deed of trust lien, which is superior to
[plaintiff's] security interest.

28 Id. at *4.

1 Next is In re Gilley, 236 B.R. 448 (Bankr. M.D. Fla. 1999).
2 There, the chapter 12 debtor filed a motion under § 506 to
3 determine the secured status of the mortgagee's proof of claim.
4 The debtor contended that proceeds from the settlement of his
5 claims against a fungicide manufacturer for damage to his real
6 property were personal property not subject to the lien of the
7 mortgagee. Id. at 451. The mortgagee contended the settlement
8 proceeds represented an "interest" in the real property within the
9 meaning of the mortgage and, thus, were included in its
10 collateral. Id. The bankruptcy court rejected the debtor's
11 argument, noting that the legal description of the real property
12 in the mortgage included the following provision:

13 **[T]ogether with all rights, interests, easements,**
14 **hereditaments and appurtenances thereunto belonging, the**
15 **rents, issues, and profits thereof** and revenues and
16 income therefrom, all improvements and personal property
17 now or later attached thereto or reasonably necessary to
18 the use thereof, including, but not limited to, ranges,
19 refrigerators, clothes washers, clothes dryers, or
20 carpeting purchased or financed in whole or in part with
loan funds, all water, water rights, and water stock
pertaining thereto, **and all payments at any time owing to**
Borrower by virtue of any sale, lease, transfer,
conveyance, or condemnation of any part thereof or
interest therein - all of which are herein called "the
property".

21 Id. at 450 (emphasis in original).

22 In light of the mortgage's language describing the property
23 subject to the lien to include "all rights, interests, easements,
24 hereditaments and appurtenances thereunto belonging," the court
25 held that the mortgagee's lien attached to the settlement proceeds
26 "on the basis of the express terms of the mortgage contract." Id.
27 at 452-53. The claims against the manufacturer and the proceeds
28 of that claim constituted a "right or interest" belonging to the

1 real property within the meaning of the mortgage.

2 Finally, in Ferry Road Properties, LLC v. RL BB ACQ II-TN,
3 LLC (In re Ferry Road Properties, LLC), 2012 WL 3888201 (Bankr.
4 E.D. Tenn. Sept. 7, 2012), the debtor was a party to a state court
5 lawsuit filed prepetition against the builder of the debtor's
6 retail store, which sought damages resulting from the builder's
7 negligence. Id. at *1. The debtor's property was subject to a
8 deed of trust. The debtor filed for chapter 11 relief while the
9 lawsuit was still pending. Id. at *2. The issue was whether the
10 mortgagee's lien on the real property extended to the debtor's
11 cause of action for damages to the real property and loss of
12 business income. The operative language in the deed of trust was
13 the following:

14 Grantor hereby conveys to Trustee, in trust, with power
15 of sale, the Real Property described in this Deed of
16 Trust, together with any improvements, equipment and
17 fixtures existing or hereafter placed on or attached to
18 this Real Property, all proceeds thereof and all other
appurtenant rights and privileges. The term "the
Property" shall include this Real Property, any such
improvements, fixtures, and also all appurtenant rights
and privileges.

19 Id. The mortgagee argued that based on its deed of trust, it had
20 a lien not only on the real property, but "all proceeds thereof."

21 Id. The mortgagee argued that the lawsuit represented "proceeds"
22 of the real property because it was a claim for damages and loss
23 associated with the realty. Id.

24 The court agreed with the mortgagee to an extent, limiting
25 its lien to the claim for damages to the real property, because
26 such "damages are viewed as a substitute for the realty itself."

27 Id. at *7. However, to the extent that the debtor's state court
28 action encompassed claims beyond property damage – i.e., the loss

1 of business income – the mortgagee had no interest absent a
2 properly filed UCC-1. Id. The court's holding with respect to
3 the business income is consistent with Oregon law. See In re
4 Nendels-Medford Joint Venture, 127 B.R. 658, 663-64 (Bankr. D. Or.
5 1991) (when mortgagee intended to obtain not only a lien on the
6 real property but also a security interest in revenue flowing from
7 operations of the business operated on the real property, the
8 function of the transaction changed and the purpose behind Oregon
9 law excepting a real estate interest from the provisions of
10 Article 9 no longer applied) (citing Sec. Bank v. Chiapuzio, 304
11 Or. 438, 448, 747 P.2d 335, 341 (1987), superseded by statute on
12 other grounds as stated in Bedortha v. Sunridge Land Co., Inc.,
13 213 Or. 308, 314 n.4, 822 P.2d 694 (1991)).

14 The holdings of these cases, that a mortgagee has a superior
15 interest in proceeds paid on account of damage to or diminution in
16 value of the real property collateral subject to the trust deed or
17 mortgage because such proceeds are a substitute for that realty
18 collateral, is consistent with the Restatement (Third) of Property
19 (Mortgages), which provides, in relevant part:

20 (a) Unless a different disposition is provided in the
21 mortgage, the mortgagee has a right to the following
22 funds paid on account of loss or damage to the mortgaged
real estate, to the extent that the mortgagee's security
has been impaired by the loss or damage . . .

23 (1) the proceeds paid by a casualty insurer due to the
24 occurrence of an insured loss to the real estate, if the
25 mortgagor promised the mortgagee, in the mortgage or
otherwise, to purchase the insurance; and

26 (2) an award resulting from a taking of all or part of
27 the real estate under power of eminent domain, or the
proceeds of a sale to a governmental body in lieu of such
taking.

28 Restatement (Third) of Property (Mortgages) § 4.7(a) (1997).

1 . . . Such funds are viewed as **substitute collateral, and**
2 **the mortgagee's claim on them is sometimes described as**
3 **an "equitable lien."** This means simply that the
4 mortgagee is entitled to recover the funds to the extent
5 necessary to compensate for the impairment of security
6 that results from the loss or damage, with a maximum
7 recovery equal to the balance owing on the mortgage debt.
8 This result is required to avoid unfairness to the
9 mortgagee through devaluation of the real estate as a
10 consequence of the loss or damage. . . .

11 **The principle of Subsection (a) is applicable to other**
12 **sorts of funds that represent recovery for loss or damage**
13 **to the mortgaged real estate.** For example, if a third
14 party commits waste and the mortgagor sues and recovers
15 damages, the recovery may be regarded as substitute
16 collateral and subjected to the mortgagee's claim. The
17 mortgagor will still benefit indirectly, since the funds
18 must be applied by the mortgagee toward the debt or made
19 available for restoration of the damage under Subsection
20 (b).

21 Id. cmt. a (emphases added).

22 Although the above cases did not deal expressly with
23 § 552(b)(1), their holdings are relevant and highly persuasive.
24 In each case, the court held that when the mortgagee's prepetition
25 deed of trust or mortgage lien against the debtor's real property
26 contains language encompassing the right to payment of settlement
27 proceeds for damages to or diminution in value of the debtor's
28 real property, the mortgagee's lien attaches to those proceeds by
way of its properly recorded deed of trust or mortgage. These
courts either expressly or implicitly found that such proceeds
were not personalty subject to the perfection requirements under
the UCC.

We see no reason why the outcome should be any different when
applying § 552(b)(1). Lenders each held prepetition Trust Deeds,
which placed a lien on Debtor's real property and extended to any
"Miscellaneous Proceeds" of that property, as defined by the Trust
Deeds. By way of the operative assignment language in the Trust

1 Deeds – “All Miscellaneous Proceeds are hereby assigned to and
2 shall be paid to Lender” – any such proceeds were assigned to
3 Lenders. The definition of “Miscellaneous Proceeds” included the
4 Settlement Proceeds as a settlement or proceeds paid by a third
5 party for damage to the Properties. Lenders’ security interest in
6 the real property and in such proceeds attached by virtue of the
7 security arrangements for the assignment of Miscellaneous Proceeds
8 in the Trust Deeds and were perfected upon recording the Trust
9 Deeds. The postpetition Settlement Proceeds were paid for the
10 purpose of repairing the damage to the real property collateral
11 and thus were substitute collateral subject to the Lenders’ liens
12 under the Trust Deeds. Accordingly, Lenders’ liens “extended” to
13 the Settlement Proceeds as “proceeds” of the real property
14 collateral and thus are “proceeds” for purposes of § 552(b)(1).

15 For these reasons, we AFFIRM the portion of the judgment
16 determining that Lenders have a valid and continuing security
17 interest in the Settlement Proceeds that was not cut off by
18 § 552(a), but saved by the exception in § 552(b)(1).

19 **4. The bankruptcy court abused its discretion when it**
20 **awarded U.S. Bank’s share of the Settlement Proceeds to**
21 **Trustee.**

22 Debtors contend in their cross-appeal that the bankruptcy
23 court erred in holding that based on the “equities of the case”
24 exception to § 552(b)(1), it could void U.S. Bank’s security
25 interest in the Settlement Proceeds because U.S. Bank failed to
26 participate in the litigation and had been defaulted. Debtors
27 contend that if some of the lenders had enforceable security
28 interests in the Settlement Proceeds, then all of them did based
on their identical Trust Deeds, regardless of their participation

1 in the litigation.

2 As noted above, § 552(b)(1) provides that a prepetition
3 security interest will attach to certain types of bankruptcy
4 estate property "except to any extent that the court, after notice
5 and a hearing and based on the equities of the case, orders
6 otherwise." Although "equities of the case" is not defined in the
7 Code, at least five courts of appeal have assigned a nearly
8 identical meaning to this provision. See Stanziale v. Finova
9 Capital Corp. (In re Tower Air, Inc.), 397 F.3d 191, 205 (3d Cir.
10 2005); N.H. Bus. Dev. Corp. v. Cross Baking Co., (In re Cross
11 Baking Co.), 818 F.2d 1027, 1033 (1st Cir. 1987); United Va. Bank
12 v. Slab Fork Coal Co., 784 F.2d 1188, 1191 (4th Cir. 1986); In re
13 J. Catton Farms, Inc., 779 F.2d at 1246-47; Wolters Vill. Ltd. v.
14 Vill. Props., Ltd. (In re Vill. Props., Ltd.), 723 F.2d 441, 444
15 (5th Cir. 1984). Essentially, these courts have held that the
16 principal purpose of the equities of the case exception is to
17 prevent secured creditors from reaping unjust benefits from an
18 increase in the value of collateral during a bankruptcy case
19 resulting from the (usually) reorganizing chapter 11 debtor's use
20 of other assets of the estate or from the investment of non-estate
21 assets. See Toso v. Bank of Stockton (In re Toso), 2007 WL
22 7540985, at *13 (9th Cir. BAP Jan. 10, 2007) (citing the above
23 cases and determining that "[n]o circuit case law attributes a
24 different meaning to this phrase."); All Points Capital Corp. v.
25 Laurel Hill Paper Co. (In re Laurel Hill Paper Co.), 393 B.R. 89,
26 93 (Bankr. M.D.N.C. 2008) ("The cases involving section 552(b)(1)
27 appear to place the most weight on whether a debtor expended
28 unencumbered funds of the estate, at the expense of the unsecured

1 creditors, to enhance the value of the collateral.”).

2 We agree with Debtors that the policy rationale behind the
3 equity exception is simply inapplicable to this case. Even
4 Trustee concedes that the bankruptcy court’s application of the
5 exception here was a “creative use” of that statutory provision.
6 Here, no rehabilitation of a debtor is at issue, and awarding U.S.
7 Bank its 20% share of the Settlement Proceeds does not afford it
8 any sort of “windfall” at the expense of unsecured creditors,
9 considering that the Settlement Proceeds are earmarked to repair
10 its damaged, real property collateral, which undoubtedly lost
11 value. Further, nothing in the record suggests that U.S. Bank was
12 on notice that its security interest in the Settlement Proceeds
13 would be extinguished if it failed to appear.

14 While we can certainly understand the bankruptcy court’s
15 frustration with a secured lender which failed to defend its
16 security interest, we believe it misapplied the equity exception
17 under § 552(b)(1). Accordingly, we REVERSE that portion of the
18 judgment.

19 **VI. CONCLUSION**

20 For the foregoing reasons, we AFFIRM the judgment in part and
21 REVERSE the judgment in part.

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