UNITED STATES BANKRUPTCY COURT
DISTRICT OF MAINE

In re:	)	
	)	
Montreal Maine & Atlantic Railway Ltd.,	)	**Case No. 13-10670**
	)	
Debtor.	)	
	)	

WHEELING & LAKE ERIE RAILWAY COMPANY'S MEMORANDUM OF LAW IN SUPPORT OF ENFORCEMENT OF ITS SECURITY INTEREST IN ALL PROCEEDS OF THE TRACK MAINTENANCE AGREEMENT, FILED PURSUANT TO THE COURT'S ORDER DATED DECEMBER 17, 2013

Following a hearing held before the Court held on December 11, 2013, with respect to the Trustee's Motion for Order (I) Authorizing Assignment of Tax Credits and (II) Granting Related Relief [D.E. 463] (the "Motion") and Wheeling & Lake Erie Railway Company's ("Wheeling") objection thereto [D.E. 470] (the "Objection"), the Court entered its order granting the Motion [D.E. 511] (the "Order"), subject to further proceedings to determine the validity, nature and extent of the security interest of Wheeling in and to the proceeds of the sale of the tax credits, the "Net Funds," as further defined in the Order. Accordingly, the Court set a discovery schedule, a schedule for briefing, and a hearing date for the purpose of determining the validity, priority, and extent of Wheeling's security interest in and to the Net Funds. This Memorandum of Law is filed pursuant to the Order and in support of the enforcement of Wheeling's valid, perfected and enforceable security interest in the entirety of the Net Funds.

INTRODUCTION

1. In a case that presents many complexities, the matter now before the Court and discussed in this Memorandum can be decided by the straightforward application of controlling

First Circuit precedent, as set forth in *Cadle v. Schlichtmann*, 267 F.3d 14 (1st Cir. 2001) to facts that are not in dispute.

2. In a nutshell, in 2009, Wheeling obtained a valid, perfected and first priority security interest in all accounts, payment intangibles, and other "rights to payment" owned or thereafter acquired by the Montreal, Maine & Atlantic Railway, Ltd. (the "Debtor"), as well as their proceeds. These accounts and other rights to payment included an agreement, the Track Maintenance Agreement (the "TMA"), that the Debtor had entered into with KM Strategic Investments, LLC ("KMSI"), in April of 2013, four months prior to August 7, 2013 (the "Petition Date"). Pursuant to the TMA, the Debtor assigned to KMSI the right to claim certain federal tax credits associated with the Debtor's performance of maintenance on its domestic railroad track and to which it would otherwise be entitled. In exchange, KMSI agreed to pay to the Debtor a portion of the value of the tax credits so assigned.

3. At the hearing held on December 11, 2013, the Court approved the Debtor's continued performance of this agreement and its acceptance of payments from KMSI arising thereunder. These payments, amounting to the net amount of $490,513 (*i.e.*, the "Net Funds"), are now held in escrow by the Debtor pending a ruling by this Court on Wheeling's claim that it is entitled to receive these payments as proceeds of its prepetition collateral. And that is exactly what *Schlictmann* (as well as the law as articulated in many other jurisdictions, including the Fourth, Seventh, and Eight Circuits) requires. Under *Schlictmann*, the Net Funds, including that portion attributable to post-petition maintenance expenditures, are proceeds of the TMA, which in turn is an account, a payment intangible and/or other right to payment in which Wheeling has a valid and perfected, pre-petition security interest. As proceeds, they are preserved for the benefit of Wheeling under § 552(b)(1) of Title 11 of the United States Code (the "Bankruptcy

Code"). Moreover, because no post-petition proceeds under the TMA were generated by the expenditure of assets that might otherwise have been distributed to unsecured creditors, there is no room for application of the "equitable" qualification in § 552(b)(1). This Court is required, by law, to order that the entirety of the Net Funds be turned over to Wheeling as proceeds of its prepetition collateral.

FACTUAL BACKGROUND

I. Facts Related To Wheeling's Valid, Perfected and First Priority Security Interest In The Debtor's Rights To Payments Under The Track Maintenance Agreement.

4. Wheeling claims a valid, perfected and first-priority security interest in and to all of the Debtor's accounts, payment intangibles, and all other rights to payments, as well as proceeds thereof, pursuant to that certain Security Agreement dated June 15, 2009, by and between, *inter alia*, the Debtor and Wheeling. The Security Agreement, a copy of which is attached hereto as **Exhibit A**, defines Wheeling's collateral (the "Collateral") as:

> the following personal property of Debtor [*i.e.*, defined as the Debtor and certain of its affiliates collectively], wherever located, and inuring to the benefit of or owned by the Debtor now, or arising at any time in the future and wherever located as follows: A. All Accounts and other rights to payment (including Payment Intangibles), whether or not earned by performance, including but not limited to, payment for property or services sold, leased, rented, licensed, or assigned. *This includes any rights and interests (including all liens) that Debtor may have by law or agreement against any account debtor or obligor of Debtor*. . . . C. All additions, accessions, substitutions, replacements, products to or for, and all cash or non-cash proceeds of any of the foregoing, including insurance proceeds.

See **Exhibit A**, § II (emphasis added). The Security Agreement is, by its terms, governed by Maine law. *See* **Exhibit A**, § XII.E. Terms used in the Security Agreement but not defined therein have the meanings of such term as used in the Maine Uniform Commercial Code (the "Maine UCC"), as amended from time to time, and codified in Title 11 of the Maine Revised

Statutes Annotated. *See* **Exhibit A**, § I.C. This includes, in relevant part, terms such as "account" and "payment intangible".

5. Under the Maine UCC, the term "account" is defined, in relevant part, as follows:

> "Account," except as used in "account for," means a right to payment of a monetary obligation, *whether or not earned by performance*: (a). For property that has been or is to be sold, leased, licensed, assigned or otherwise disposed of; (b). For services rendered or to be rendered; [. . .] "Account" does not include: rights to payment evidenced by chattel paper or an instrument[.]

11 MRSA 9-1102(2).

6. As defined in the Maine UCC, a payment intangible is a "general intangible under which the account debtor's principal obligation is a monetary obligation". 11 M.R.S.A. § 9-1102(61). In turn a "general intangible" is:

> any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas or other minerals before extraction. "General intangible" includes payment intangibles and software.

11 MRSA § 9-1102(42).

7. The Security Agreement secures indebtedness of the Debtor to Wheeling in the form of advances made under a line of credit, the principal balance of which, as of the Petition Date, was $6,000,000.

8. Wheeling perfected its security interest against the Debtor (a corporation organized under Delaware law, and therefore "located" in Delaware for the purposes of perfection, as provided by § 9-1307(5) of the Maine UCC) by filing a UCC-1 financing statement with the Secretary of State of Delaware on or about August 25, 2009. A true and accurate copy of that UCC-1 Financing Statement is attached hereto as **Exhibit B**.

II. Overview Of Section 45G Tax Credits And Facts Related To The Track Maintenance Agreement Between The Debtor And KMSI.

9. Under Section 45G of the Internal Revenue Code (Title 26 of the United States Code), certain classes of domestic railroads can earn tax credits that may be used to offset federal income tax liability. Such credits are based upon and tied to the taxpayer-railroad's making qualified expenditures for the repair and maintenance of domestic railroad track. The Internal Revenue Code recognizes, however, that some railroads may not have sufficient taxable income, or sufficient federal tax liability, to make such tax credits valuable. As such, it permits such railroads to "assign", for consideration, the right to take tax credits to other railroads so that these other entities may claim tax credits with respect to maintenance expenditures and thereby effectuate a valuable right of offset. That is precisely the situation in this case: the Debtor, not having appreciable federal tax liability, assigned its rights to KMSI, so that KMSI could claim the applicable tax credits. In exchange, KMSI agreed to pay money to the Debtor.

10. This agreement between the Debtor and KMSI is memorialized in the TMA dated April 26, 2013.[1] A copy of the TMA is attached hereto as **Exhibit C**. Under the TMA, the Debtor agreed to permit KMSI to claim federal tax credits under Section 45G with respect to qualified maintenance expenditures made by the Debtor, and certified by the Debtor to KMSI, with respect to the Debtor's track. The TMA did not obligate the Debtor to undertake any qualified maintenance expenditures, recognizing that the Debtor ordinarily budgets for and expects to undertake such expenditures in the ordinary course of its business to ensure the reliable and safe operation of its Track (including by avoiding regulatory sanctions that could halt business operations). Rather, the parties agreed that KMSI would be entitled to claim the tax credits arising from the expenditures both parties expected the Debtor to make in the ordinary

[1] MMA's parent, Montreal, Maine & Atlantic Corporation, guarantied MMA's obligations under the TMA.

course of its business (referred to in the TMA as "Qualified Expenditures"). *See* **Exhibit C**, Article 1.02(c)(v). In exchange for this exclusive right to claim the tax credits arising from the Debtor's Qualified Expenditures, KMSI agreed to pay the Debtor up to $2,884,000, subject to a pro-rata reduction of the purchase price if the actual Qualified Expenditures totaled less than what the parties expected.

11. Consistent with its historical practice, the Debtor planned for and undertook track maintenance work throughout 2013, thereby creating Qualified Expenditures that generate tax credits under Section 45G of the Internal Revenue Code. Pursuant to the TMA, KMSI paid the Debtor (and Trustee) as agreed, both before and after the Petition Date. On a net basis, KMSI ultimately paid the Debtor 47.5% of the Qualified Expenditures.[2] The Net Funds at issue in this case ($490,513.63) represent the payment by KMSI to the Debtor pursuant to the TMA of 47.5% of the Qualified Expenditures for the period June 1, 2013 through December 31, 2013 (less the sum of $19,000 previously disbursed by the Trustee to Wheeling pursuant to the Order of this court approving a settlement with the Irving Companies.).

III. KMSI's Payments To The Trustee Pursuant To The Track Maintenance Agreement.

12. It is undisputed that the Net Funds represent payments by KMSI to the Trustee pursuant to the TMA, and are therefore proceeds of the Debtor's right to payment under the TMA.[3] In the Motion, the Trustee expressly sought authority from this Court to continue the

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[2] Under the TMA, the Debtor was obligated to return 52.5% of that amount in the form of "shipping credits" that KMSI could use to transport freight on the Debtor's railroad line, or could redeem for cash.

[3] The Maine UCC defines the term "proceeds" as follows:

> "Proceeds" means the following property: (a). Whatever is acquired upon the sale, lease, license, exchange or other disposition of collateral; (b). Whatever is collected on or distributed on account of collateral; (c). Rights arising out of collateral[.]

11 M.R.S.A. § 9-1102(64)(a)-(c).

Debtor's performance under the TMA and to collect payments due thereunder. In the Order, that authority was granted. Discovery in this case reveals that indeed, the payments made by KMSI, the Net Funds, were payments made on account of and pursuant to the TMA.

13. For example, in post-petition e-mails between the Debtor's chief financial officer, Donald Gardner, and Mark Mickelson, the broker who arranged the TMA between the Debtor and KMSI (the "Broker"), the two said as follows:

> "Now that we are operating under the protection of [the] bankruptcy court, I would like to have [KMSI] consider continuing the funding of our current agreement." E-mail from the Debtor's chief financial officer, Donald Gardner, to Mark Mickelson, the Broker (as defined in the Motion), dated August 27, 2013, re: 45G.
>
> "So KMSI has proposed that the parties simply complete performance under the contract in 2013[.]" E-mail from M. Mickelson to D. Gardner, dated November 21, 2013, re: 45G KMSI go forward.

These e-mails are collectively attached hereto as **Exhibit D**.

14. Moreover, the Motion unequivocally reflects the intention of the Debtor and KMSI to seek permission from this Court for the *continued performance* under the TMA:

> 10. [. . .] *Pursuant to the Agreement* [referred to herein as the TMA], KMSI agreed to make payments to the Debtor in relation to 2013 in the aggregate amount of up to $2,884,000 (the "2013 Expenditure Commitment"). [. . .]
>
> 11. The Debtor has already certified the amount of qualified railroad track maintenance expenditures made during the first and second quarters of 2013, and currently needs to certify expenditures, and receive payment from KMSI, for July through October 2013.
>
> 12. The Trustee seeks authority *to continue operating under the Agreement* through the end of October 2013, as it will provide an additional source of revenue to the Debtor. The Trustee expects that the Debtor will certify $842,417.65 in qualified railroad track maintenance expenditures for the third quarter and October, and would receive payment of that amount from KMSI. [. . .]

Motion, ¶¶ 10-12 (emphasis added).

15. The Trustee's request was granted, and the Order (entered into with approval of the Trustee), set the discovery, briefing, and hearing schedule with respect to the present dispute:

> 6. The Trustee and Wheeling expressly reserve all of their respective rights with respect to the application and use of the money from the assignment of the 45G Tax Credits and the Remaining 45G Tax Credits obtained by the Trustee and/or the Debtor *pursuant to the Agreement* after payment of any commission earned by the Broker and segregation and payment of funds owed to KMSI *under the Agreement*. Any and all money received by the Debtor and/or the Trustee in relation to the assignment of the 45G Tax Credits and the Remaining 45G Tax Credits after payment of any commission earned by the Broker and Segregation and payment of funds owed to KMSI *under the Agreement* (the "Net Funds") shall be held in escrow pending determination of the Trustee's and Wheeling's respective rights in and to such Net Funds. [. . . .]

Order, ¶ 6 (emphasis added). The hearing set for January 23, 2013, "to determine the validity, priority, and extent of Wheeling's security interest in and to the Net Funds[,]" is, by virtue of the definition of Net Funds, a hearing to determine Wheeling's security interest in net payments received on account of the TMA. Order, ¶ 7.

16. Subsequently, the Debtor sent two certifications to KMSI, as required under the TMA, to provide the payment amount to KMSI (the "Certifications"). Like the certifications delivered to KMSI before the Petition Date, the Certifications were made using the same form attached to the TMA as Exhibit B. Copies of the Certifications and related invoices are attached hereto as **Exhibit E**. The Certifications requested payment of $842,418 (invoice 2013-03) and $274,937 (invoice 2013-04), respectively, but are otherwise the same in all material respects. One such Certification states as follows:

> The undersigned (the "Railroad") makes and delivers this certificate to request KM STRATEGIC INVESTMENTS, LLC ("KMSI") make payments for the assignment of track miles (solely for purposes of Section 45G) *under the terms of that certain Track Maintenance Agreement dated as of April 26, 2013*, among KMSI and the Railroad (the "Track Maintenance Agreement"). [. . .]
>
> The undersigned hereby requests KMSI to *make payments in the aggregate amount of $842,418 under the Track Maintenance Agreement* to Railroad in the

> amount identified on Schedule 1, and certifies that Railroad has made expenditures during 2013 that are Qualified Expenditures in the amounts specified thereon.

Exhibit E (emphasis added). The Debtor's financial records produced during discovery and excerpted in relevant part as **Exhibit F** attached hereto, reflect that the Trustee made the following two deposits of funds paid under the TMA following delivery of the Certifications: (i) deposit 10377 in the amount of $842,418, from Koch Minerals LLC (upon information and belief, this entity is an affiliate of KMSI), on December 19, 2013; and (ii) deposit 10378 in the amount of $274,937 from Koch Minerals LLC, on December 20, 2013.

17. Pursuant to the TMA and the Order, the Debtor refunded to KMSI 52.5% of these payments (the value of the shipping credits), resulting in Net Funds of $490,513 being retained by the Debtor. There can be no doubt that the payments made by KMSI to the Debtor, *i.e.* the "Net Funds," are "proceeds" of the TMA, as that term is defined in the Security Agreement and Maine UCC.

OVERVIEW AND SUMMARY OF WHEELING'S LEGAL ARGUMENT

18. The monies payable to the Debtor pursuant to the TMA meet the definitions of "account" or "payment intangible" or "right to payment" under the Security Agreement and the Net Funds are plainly proceeds thereof. Consequently, Wheeling's security interest extends to the Net Funds pursuant to the Security Agreement and § 552(b)(1) of the Bankruptcy Code. The TMA constitutes an agreement between the Debtor and KMSI pursuant to which KMSI purchases and pays for the right to claim tax credits on account of the Debtor's Qualified Expenditures for track maintenance. Under applicable definitions in the Security Agreement and the Maine UCC, the Debtor's rights to payment from KMSI pursuant to the TMA constitutes either an "account" (a "right to payment of a monetary obligation, whether or not earned by

performance"), a "payment intangible" ("a general intangible under which the account debtor's principal obligation is a monetary obligation"), or other "right to payment" as described in the Security Agreement. 11 M.R.S.A. § 9-1102(2) & (61). It does not matter which one it is; Wheeling has a valid, perfected and first priority security interest in all of them and proceeds. Further, the entirety of the Net Funds constitute payments made to the Debtor by KMSI pursuant to the TMA. This is evident from the Trustee's admissions in the Motion, the terms of the Order, and the foregoing review of materials produced by the Debtor in discovery. *See* ¶¶ 12-17, *supra*.

19. While there can be no doubt but that all of the Net Funds constitute payments "on account of" or "arising out of" the TMA, and thus "proceeds" of the TMA within the meaning of the Maine UCC, Wheeling expects that the Trustee may attempt to distinguish between payments that became due by reason of Qualified Expenditures made by the Debtor in different time periods. These time periods are likely to be (i) prior to the Petition Date; (ii) between the Petition Date and October 18, 2013, the date that the Debtor ceased using accounts receivable that were collateral for Wheeling to fund its operations; and (iii) after October 18, 2013 and through December 31, 2013, during which time the Debtor funded its operations primarily from the proceeds of a loan from Camden National Bank. While the Maine UCC makes no distinction, for the purpose of identifying "proceeds", among the various sources of funds that might have been used to pay for performance by a debtor under a contract and thereby create "proceeds", it is clear that virtually all maintenance expenditures made between June 1 and October 18, 2013, were funded from proceeds of Wheeling collateral. Wheeling has determined through discovery that the amount of such expenditures during this time period totals $355,381.07. Wheeling's collateral consisted of all of the Debtor's accounts receivable, its inventory, and all of its other rights to payment of every kind and nature that generated revenues

(such rights include "accounts" and "payment intangibles"). As such, virtually all revenues of the Debtor between June 1 and October 18, 2013 represented proceeds of Wheeling collateral and were the only source for Qualified Expenditures for track maintenance during such period. If the source of funds were at all relevant, then Wheeling's perfected lien in proceeds of the TMA would be not less than $355,381.07.

20. But, of course, under applicable law, the source of funds utilized by a debtor for its contract performance is irrelevant for the purpose of identifying the "proceeds" of contract performance. As such, payments based on Qualified Expenditures made between October 18, 2013 and December 31, 2013, a time period in which the Debtor presumably relied primarily (although not exclusively) on proceeds of borrowings under its line of credit from Camden National Bank, are nevertheless proceeds of the Debtor's rights to payment under the TMA and thus collateral for Wheeling. Simply put, under the Security Agreement and the Maine UCC, all of the Net Funds are "proceeds" of the Debtor's rights to payment under the TMA, and Wheeling has a valid, perfected, and first priority security interest in the entirety of these funds, no matter how performance of the underlying agreement, the TMA, was funded. The Court should enter an order directing payment of the Net Funds to Wheeling in partial satisfaction of its secured claims in these proceedings.

ARGUMENT

I. Wheeling Is Entitled To The Entirety Of The Net Funds Escrowed Pursuant To The Order Because Such Funds Are Wheeling's Collateral.

A. Wheeling Holds A Valid, Perfected and First Priority Security Interest In All Of The Debtor's Accounts, Rights To Payment, And Other Rights And Interests Against Account Debtors Or Obligors Of The Debtor.

21. As set forth above, Wheeling obtained a first priority, perfected security interest in payment rights of the Debtor, including accounts of the Debtor and/or payment intangibles of

the Debtor, and proceeds thereof, pursuant to the Security Agreement and the related UCC-1 financing statement.[4] The Security Agreement was entered into in consideration of Wheeling's agreement to advance funds to the Debtor, and as of the Petition Date, Wheeling had advanced $6,000,000 to the Debtor. By reason of the executed Security Agreement, the UCC-1 financing statement, and the actual advance of money, Wheeling acquired a valid, enforceable, binding and perfected security interest in all of the collateral described in the Security Agreement, including accounts, payment intangibles, and other rights to payment, whether then in existence or thereafter acquired by the Debtor. *See* **Exhibit A**, § II.[5]

22. Wheeling's security interests, pursuant to the Security Agreement and the provisions of the Maine UCC, extend to "proceeds" of its collateral, including proceeds of "accounts" and all other rights to payment, including "payment intangibles". *See* **Exhibit A**, § II. Such proceeds are thus Wheeling's collateral, pursuant to the Security Agreement and under the Maine UCC. *See* **Exhibit A**, § II; 11 M.R.S.A. § 9-1102(12)(a).

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[4] As set forth above, Wheeling's security interest also includes any and all "rights to payment," and "any rights and interests (including all liens) that Debtor may have by law or agreement against any account debtor or obligor of Debtor." **Exhibit A**, § II. "Right" includes remedy. 11 MRSA 1-1201(34). KMSI is an "account debtor" or "obligor" of the Debtor with respect to the TMA. *See* 11 M.R.S.A. §§ 1-1201(3) and 9-1102(3), (59).

Regardless of the nomenclature, the argument is the same: the Debtor's rights to payment came into existence upon execution of the TMA, and KMSI's payments are proceeds of such rights to payment and are, therefore, Wheeling's collateral.

[5] As discussed above, terms not defined in the Security Agreement but defined in the Maine UCC have the meaning set forth in the Maine UCC. Thus, an "account" is defined under the Maine UCC, and therefore under the Security Agreement, as:

> "Account," except as used in "account for," means a right to payment of a monetary obligation, *whether or not earned by performance*: (a). For property that has been or is to be sold, leased, licensed, *assigned or otherwise disposed of*; (b). For services rendered or to be rendered; [. . .] "Account" does not include: rights to payment evidenced by chattel paper or an instrument[.]

11 MRSA 9-1102(2). ("Depending on the context," the terms "assigned" or "transfer" in the Maine UCC "may refer to the assignment or transfer of an outright ownership interest or to the assignment or transfer of a limited interest, such as a security interest." Revised § 9-102, Official Comment 26.)

"Proceeds" are defined under Maine law, and accordingly the Security Agreement, as including: "(a). Whatever is acquired upon the sale, lease, license, exchange or other disposition of collateral; (b). Whatever is collected on or distributed on account of collateral; [or] (c). Rights arising out of collateral[.]" 11 M.R.S.A. § 9-1102(64)(a), (b), and (c).

23. Clearly, in accordance with the definition of "proceeds" provided in the Maine UCC and noted above (*supra*, n.5), payments made by KMSI to the Debtor under the TMA are proceeds of the Debtor's rights to payment under the TMA.[6] The Net Funds were "acquired upon the . . . disposition of collateral" or "collected on . . . account of collateral" or constitute "[r]ights"—a defined term in the Maine UCC including remedies—"arising out of collateral[.]" 11 M.R.S.A. § 9-1102(64)(a), (b), and (c). *Swanson v. Applied Process Tech.Int'l, LLC (In re Delta-T Corp.)*, 475 B.R. 495, 531 (Bankr. E.D. Va. 2012) (decided under Revised Article 9; "[b]y definition, the funds collected on the accounts created in favor of Delta-T by the sales of the steel to Central City and Pasco constitute proceeds of the accounts because the accounts constituted collateral under the Security Agreements at their creation."); *Johnson v. Cottonport Bank*, 259 B.R. 125, 129-30 (W.D. La. 2000) (decided under former Article 9's narrower definition of proceeds: "[p]roceeds may take a number of forms but include 'whatever is collected on, or distributed on account of, collateral.' La. Rev. Stat. Ann. §10:9-306(1)(a)(ii). This description applies to the money accounts receivable are converted into as they are paid."); *In re Megamarket*, 207 B.R. 527 (Bankr. E.D. Ky. 1997) (right to refund of insurance premiums constitutes general intangible and refund itself is proceeds of that right) (*cited in Cottonport* at 130); *Brever v. State Bank of Young America (In re Kohls)*, 94 B.R. 1006, 1009-10 (Bankr. D. Minn. 1987 (payments are proceeds of right to payment of dairy patronage credits which are accounts receivable or general intangibles) (*cited in Cottonport* at *id*.).

24. Further, Wheeling's rights to payments due under the TMA are enforceable and perfected even though at the time of execution of the Security Agreement or the time of

[6] Because the Debtor's rights to payment against KMSI were created when the TMA was executed, Wheeling's security interest attached at that time pursuant to the dragnet clause in the Security Agreement and Maine UCC. *See* 11 M.R.S.A. § 9-1203. "A security interest attaches to an account receivable under a valid security agreement, when the account comes into existence." *Swanson v. Applied Process Tech. Int'l, LLC (In re Delta-T Corp.)*, 475 B.R. 495, 512 (Bankr. E.D. Va. 2012) (quotation omitted).

execution of the TMA, the payments from KMSI were not then due and the amount of each payment had not been finally fixed. By definition, "accounts" include "a right to payment of a monetary obligation, whether or not earned by performance[.]" 11 M.R.S.A. § 9-1102(2). Moreover,

> Although both old and Revised Article 9 speak of a "right to payment," it is clear that the debtor's interest need not be matured or fixed in amount. The account can exist "whether or not it has been earned by performance." The account arises when a contract is entered into, not when the debtor performs the contract. Thus, *Utica National Bank & Trust Co. v. Associated Producers Co.* [1980 OK 172, 622 P.2d 1061 (Okla. 1980). *Accord In re Patio & Porch Systems, Inc.*, 194 B.R. 569, 29 U.C.C. Rep. Serv. 2d 574 (Bankr. D. Md. 1996)] correctly ruled that sales by a coal company had produced "accounts" even though the price was not finally determined until after a BTU test of the coal. And *Bank of Stockton v. Diamond Walnut Growers Inc*. [199 Cal. App. 3d 144, 244 Cal. Rptr. 744, 5 U.C.C. Rep. Serv. 2d 1147 (1988)] correctly held that a member of an agricultural marketing association held an account in "member proceeds" to be received from the association for the sale of the 1983 crop even though the sale had not yet occurred. In these cases the debtor held a real contractual interest that could eventually mature into a fixed claim.

1C-19 Secured Transactions Under the UCC § 19.02[2][b] (footnotes from original added in bracketed text above).

25. It is clear that under applicable state law, *i.e.* the Maine UCC, Wheeling has a valid, perfected, and first priority security interest in all payments that became due and payable to the Debtor under the TMA at any time—regardless of when they were earned, when they became payable or when they were to be received as "proceeds" by the Debtor. The language of the TMA established beyond doubt that the parties thereto agreed, when they signed the document, that KMSI was going to have the exclusive right to claim tax credits arising from Qualified Expenditures that the Debtor would make in the ordinary course, and that KMSI would pay the Debtor the agreed-upon sums for that right. KMSI's ultimate payments to the Debtor, made upon certification that track maintenance expenditures were made e (the net amount of

which are the "Net Funds" as defined above) are clearly payments made by KMSI to the Debtor on account of the TMA, whenever they were made.

B. Section 552(b)(1) of the Bankruptcy Code Extends Wheeling's Perfected Security Interest To The Net Funds.

26. There is nothing in the Bankruptcy Code that undermines Wheeling's security interest in the Debtor's rights to payment under the TMA and all proceeds thereof. It is axiomatic that a valid and perfected security interest created under applicable state law is enforceable as against a Chapter 11 debtor absent avoidance or modification under any provision of Chapter 5 of the Bankruptcy Code, or the provisions of a confirmed plan of reorganization. There have been no avoidance actions, nor has a plan been proposed or filed.[7] Wheeling expects the Trustee to focus on § 552 of the Bankruptcy Code, which governs the post-petition effect of pre-petition security interests. Section 552(a) provides that:

> 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.

11 U.S.C. § 552(a).

27. Were it not for the provisions of subsection (b)(1) of § 552, Wheeling's security interest would, arguably, not extend to that portion of the Net Funds generated under the TMA after the Petition Date. However, subsection (b) creates an applicable savings clause, as follows:

> [I]f 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, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits 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

[7] There is no plausible argument that the Wheeling Security Agreement is voidable in whole or in part by a lien creditor (§ 546); as a preference (§ 547); as a fraudulent transfer (§ 548); as an unauthorized post-petition transfer (§549) or otherwise under Chapter 5 of the Bankruptcy Code.

> extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(b)(1). The term "proceeds" is not defined in the Bankruptcy Code; however, for the purpose of determining the reach and extent of a prepetition security interest, § 552(b)(1) directs the Court to "applicable nonbankruptcy law". Thus, as used in § 552(b)(1), "applicable nonbankruptcy law"—for the purpose of determining whether a security interest would attach to property received by a Debtor after its filing—"will normally be Article 9 of the Uniform Commercial Code." 5-552 Collier on Bankruptcy P 552.02.

28. Section 552(b)(1)'s exception can be described as follows:

> In order to qualify as an exception, these conditions must be met: (a) there must be a pre-petition security agreement, (b) the security agreement by its terms must extend to the debtor's pre-petition property and to proceeds, product, offspring, etc. of such property, and (c) applicable non-bankruptcy law, i.e. state law, must permit the security agreement to extend to such after-acquired property. If these conditions are met, then the after-acquired property lien will be given effect in bankruptcy "except to the extent that the court, after a notice and a hearing and based on the equities of the case, orders otherwise."

1B-9 Secured Transactions Under the UCC § 9.09[3][a] (*quoting Smith v. Dairymen, Inc.*, 790 F.2d 1107, 1111 (4th Cir. 1986)).

29. Relevant case law under § 552(b)(1)—including decisions from the First Circuit, Fourth Circuit, Seventh Circuit, and Eight Circuit Courts of Appeals—validate Wheeling's security interest in proceeds of the TMA, whether generated pre or post filing. These cases hold that post-petition payments on pre-petition contracts constitute "proceeds" of such contracts within the meaning of § 552(b)(1) of the Bankruptcy Code, even where the post-petition payments are earned by post-petition conduct or expenditure by the debtor. Rather than turning on when performance or payment occurs, courts look to when the contract was created. When the contract pre-dates the bankruptcy filing, courts consistently hold that post-petition payments

under the contract—even when earned by post-petition action—are proceeds of the pre-petition right to payment to which a secured creditor's security interest will remain attached under § 552(b)(1) of the Bankruptcy Code.

30. For example, the First Circuit has held that a pre-petition security interest in a law firm's contingency fee agreement extended to the post-petition fee payment notwithstanding that that the right to payment under the contingent fee agreement did not mature until years after the debtor filed for bankruptcy and the debtor continued to perform services under the contingent fee agreement post-filing. *Schlichtmann, supra*. *Schlictmann* is on all fours with the present dispute and controls the outcome. As in this case, the secured lender took a valid and perfected security interest in a right to payment under an agreement—an "account" or a payment intangible under the Maine UCC. The original firm that had entered into the fee agreement dissolved, and the agreement was transferred to one of its attorney's, Schlichtman, subject to the lenders' security interest. That attorney filed a bankruptcy petition and, after filing, continued to do work under the fee agreement and eventually earned a fee. The First Circuit held that notwithstanding the post-petition rendition of legal services, the fee was nevertheless "proceeds" of the pre-petition contingent fee agreement, and thus collateral for the secured lender notwithstanding § 552(a) of the Bankruptcy Code:

> Because the security agreement covered the firm's accounts receivable—property acquired before the bankruptcy proceedings—and the resulting security interest attached to the proceeds known as the Groton fee, this security interest attached to the Groton fee received by Schlictmann post-bankruptcy. [. . .] Cadle held a security interest in the firm's contingency fee agreement relating to the Groton matter and the proceeds from that agreement. That Schlictmann performed much of the work after the firm's dissolution and his bankruptcy and before the right to payment arose does not alter the fact that Cadle held a security interest in that payment. We reject Schlictmann's argument that the post-petition Groton fees were after-acquired personal property, free of Cadle's security interest.

Cadle Co., 267 F.3d at 20-21.

31. In reaching this conclusion, the First Circuit cited with approval and relied upon the Fourth Circuit case of *United Virginia Bank v. Slab Fork Coal Co.*, 748 F.2d 1188 (4th Cir. 1986)—describing it as addressing "[a]n analogous situation[.]" *Cadle Co.*, 267 F.3d at 20. In *Slab Fork*, the Fourth Circuit held that cash proceeds generated post-petition under a pre-petition contract were subject to a pre-petition security interest in the right to payment created by the pre-petition contract. Before the bankruptcy, the debtor, Slab Fork, was a party to a contract with Armco, Inc. Pursuant to the contract, Slab Fork sold coal that it mined to Armco, Inc. *Slab Fork*, 748 F.2d at 1189. At some point before the bankruptcy, Slab Fork discontinued coal mining and made an agreement with another company to mine and supply coal for Armco for the account of Slab Fork. *Id.* The original contract between Slab Fork and Armco stayed in effect. *Id.* The Fourth Circuit noted certain undisputed facts:

> First, it is undisputed that shipping of coal by [the supplier for Slab Fork] to Armco post-petition was done pursuant to and in performance of the original supply contract between Armco and Slab Fork. It is similarly undisputed that the payment for the coal received by Armco post-petition was the payment called for under the same contract between Slab Fork and Armco. It is likewise undisputed that the pre-petition lien of UVB clearly covered the contract *and such proceeds* as might be derived from that contract.

Id. at 1190. The Fourth Circuit, relying on *In re Sunberg*, 729 F.2d 561, 563 (8th Cir. 1984), which held that post-petition payments-in-kind on account of a pre-petition contract were subject to a pre-petition lien, reasoned as follows:

> [T]he rights under Slab Fork's contract with Armco were likewise intangible rights, and were subject to UVB's lien before the filing of the bankruptcy petition. It is true that coal had to be supplied to Armco by or for Slab Fork before any right to payment arise, but that is true for all the payments under the contract, whether generated pre-petition or post-petition. No change in the right to payment under the Armco contract was brought about by the filing of a bankruptcy petition, where the underlying asset and all proceeds therefrom were subject to a valid pre-petition security interest. This case thus falls squarely within the reasoning of *Sunberg*, and we adopt and apply the Eighth Circuit's holding in *Sunberg* to the present case.

Id. at 1191.

32. The same rule that applies in the First Circuit, pursuant to *Schlichtman,* and in the Fourth and Eight Circuits under *Slab Fork* and *Sunberg,* has also been articulated by the Seventh Circuit Court of Appeals in an opinion written by Circuit Judge Posner. In the Seventh Circuit case, *J. Catten Farms, Inc. v First National Bank of Chicago,* 779 F.2d 1242 (7th Cir. 1985), the debtor, a farming corporation, granted its lender a security interest in accounts, which included a security interest in a payment-in-kind contract ("PIK contract") with the U.S. Department of Agriculture ("USDA"). Under this PIK contract, the debtor farm and the USDA agreed that in exchange for the debtor's agreement *not to grow* a crop of corn (apparently as part of a price-support program), the USDA would compensate the debtor farm by transferring corn in-kind from the federal government's stockpiles. After the debtor entered into the PIK contract, it filed a Chapter 11 petition and then "performed" the contract by honoring its agreement not to plant a crop of corn and planting a "cover" crop instead. Subsequently, the debtor assigned its payment rights under the PIK contract to a third party that received the actual payment-in-kind—a supply of corn from federal stockpiles. The secured lender claimed that it was entitled to the post-petition proceeds of the PIK contract, *i.e.* the value of the payment in kind made by the USDA.

33. Judge Posner agreed with the lender and held that the payment in kind—the corn allocated to the debtor-farmer's assignee as compensation for the debtor's post-petition performance—was proceeds of the pre-petition right to payment under the PIK contract. The Court held that the savings clause of § 552(b)(1) with respect to "proceeds" mandated this result, even though performance under the contract occurred post-petition. According to Judge Posner, a different rule (one holding that pre-petition security interests in rights to payment under executory contracts do not extend to post-petition proceeds of such contracts) would be contrary

to bankruptcy law. Otherwise, "[t]he debtor could divest himself of all the assets constituting the creditor's collateral by making executory contracts, and the creditor would have no recourse." *Id.* at 1247.

34. Like the decision of the First Circuit in *Schlichtman*, the Seventh Circuit's *Catten Farms*, the Eight Circuit's *Sunberg*, and the Fourth Circuit's *Slab Fork* all enunciate important and generally acknowledged principles governing § 552(b)(1) of the Bankruptcy Code, the outcome of this contested matter, and the conclusion that the entirety of the Net Funds constitutes Wheeling collateral: a valid and perfected, pre-petition security interest in "accounts" (and payment intangibles and rights to payment in general) carries over to and attaches to proceeds of the account or other right to payment, including proceeds that are earned by the debtor after the filing of a bankruptcy petition. These circuit level cases are not unique. There are many other cases from other jurisdictions that are in accord with these authorities. *E.g.*, *Johnson v. Cottonport Bank*, 259 B.R. 125, 130 (W.D. La. 2000) ("The sums Johnson received from the Tribe are the proceeds of the right to receive them, a right obviously transferred to Cottonport. The security interest applied to future payments and continues to apply to those made after Johnson's bankruptcy."); *In re Porch & Patio Systems, Inc.*, 194 B.R. at 573 (pre-petition construction contract created an account in favor of the debtor notwithstanding that performance and payment were post-petition; "[t]he fact that Debtor may not have begun performance on the contracts until after filing for bankruptcy is immaterial in determining the extent of Creditor's security interest. The only fact that is significant is that the contracts were entered into prepetition."); *James Cable Partners, L.P. v. Citibank, N.A. (Matter of James Cable Partners, L.P.)*, 141 B.R. 772, 777 (Bankr. M.D. Ga. 1992) (post-petition payments to a cable provider on account of pre-petition subscriptions were proceeds of pre-petition accounts subject

to a pre-petition security interest"); *Carlson v. W.J. Menefee Constr. Co. (In re Grassridge Indus., Inc.)*, 78 B.R. 978 (Bankr. W.D. Mo. 1987) (*citing In re Sunberg*, 729 F.2d 561 (8th Cir. 1984); *J. Catton Farms. V. First Nat'l Bank of Chicago*, 779 F.2d 1242 (7th Cir. 1985); *In re Slab Fork Coal Co.*, 784 F.2d 1188 (4th Cir. 1986)).

35. In sum, the dispute presently before this Court falls squarely within the principles set forth in the foregoing cases, and its outcome is controlled by them, especially the First Circuit's decision in *Schlictmann* and the Seventh Circuit's decision in *Catten Farms*. The Net Funds, which are the subject of this dispute, are indisputably proceeds of the Debtor's pre-petition contract right to payments from KMSI. The Net Funds are collateral for Wheeling, and this is true even though these proceeds were generated or arose post-petition.

II. There are No Equitable Or Other Grounds For The Bankruptcy Court To Divest Wheeling Of Its Security Interest In Proceeds Of The TMA.

36. Wheeling expects the Trustee to argue that notwithstanding the rules set forth in § 552(b)(1) of the Bankruptcy Code and the *Schlichtman* case, the "equitable" exception to § 552(b)(1) protects a portion of the Net Funds—the post-petition portion ($238,852.35)—and prevents Wheeling's security interest from extending thereto. Under § 552(b)(1), a pre-petition security interest extends to assets acquired post-petition if such assets are "proceeds" of pre-petition collateral, but this rule is subject to the Bankruptcy Court's power to reach a contrary conclusion "based on the equities of the case[.]"

37. The equity exception, however, is "seldom used[,]" *Aspen Dairy v. Bank of Am. (In re Aspen Dairy)*, 2005 Bankr. LEXIS 170 (Bankr. D. Neb. Feb. 14, 2005), and its application to the facts of this case runs counter to the First Circuit's interpretation of the equity exception in *In re Cross Baking Co.*, 818 F.2d 1027 (1st Cir. 1987). While the facts of *Cross Baking* differ from those before the Court, the First Circuit's analysis is instructive:

> We have found the legislative history to be particularly helpful in determining the scope of the equitable powers outlined in section 552(b). The report of the Senate Judiciary Committee states that the proviso in section 552(b) is designed 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, but is limited to the benefit inuring to the secured party thereby.
>
> Senate Report, *supra*, at 91, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5877. . . . We can only conclude from our reading of these reports that the "equities of the case" proviso is a legislative attempt to address those instances where expenditures of the estate enhance the value of proceeds which, if not adjusted, would lead to an unjust improvement of the secured party's position. In such cases Congress intended for courts to limit the secured party's interest in the proceeds according to the equities of the case *so as to avoid prejudicing the unsecured creditors*.

Id. at 1033 (emphasis added).

38. The First Circuit's reasoning in *Cross Baking* mirrors the reasoning of the Seventh Circuit in *J. Catton Farms, Inc.* There, Judge Posner described the paradigmatic circumstances for application of the equity exception as follows:

> The equity exception is meant for the case where the trustee or debtor in possession uses other assets of the bankruptcy estate (assets that would otherwise go to the general creditors) to increase the value of the collateral. See, e.g., *In re Village Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984). Suppose a creditor had a security interest in raw materials worth $1 million, and the debtor invested $100,000 to turn those raw materials into a finished product which he then sold for $1.5 million. The proceeds of this sale (after deducting wages and other administrative expenses) would be added to the secured creditor's collateral unless the court decided that it would be inequitable to do so—as well it might be, since the general creditors were in effect responsible for much or all of the increase in the value of the proceeds over the original collateral.

J. Catton Farms, Inc., 779 F.2d at 1246-47.

39. When the factors described in *Cross Baking* and *Catten Farms* for application of an "equitable" exception to the rule of § 552(b)(1) are considered, it becomes clear that there is

no basis for the Court to exercise equitable discretion to defeat Wheeling's valid security interest in the proceeds of rights to payment under the TMA.

40. First, neither the Debtor nor Trustee expended funds for track maintenance to benefit KMSI or Wheeling. The Debtor was under no obligation from either of these parties, under the TMA or otherwise, to spend anything on track maintenance. Discovery has revealed that whatever the Debtor and the Trustee (post-petition) spent on track maintenance, they spent in the ordinary course of the Debtor's business, for its own business purposes, and to assure the safe and reliable operation of the railroad. It is obvious that the Debtor and the Trustee (post-petition) were required to maintain the Track so the Debtor could safely and timely deliver freight, and so that the Trustee could preserve the value of the Debtor's assets in a sale—not so that it could create "tax credits" for KMSI. It is equally obvious that the TMA imposed no obligation on the Debtor to incur maintenance expenditures, and neither the Debtor nor Trustee had any incentive to do so—since they would only receive 47.5% of the value of such expenditures in the form of payments under the TMA. This is emphatically not a case where estate funds have been used to enhance collateral for the sole benefit of the secured lender; rather, funds were spent to preserve the operations of the Debtor's railroad, and for its own business purposes.

41. Second, to the extent that the Debtor or Trustee made Qualified Expenditures, they did not expend unencumbered funds, *i.e.* funds that would otherwise have been distributed to unsecured creditors. As discussed above, at least through October 18, 2013, the Debtor and Trustee spent its own operating revenues. These were undoubtedly proceeds of its accounts receivable, accounts, payment intangibles and other rights to payment—all Wheeling's collateral and proceeds thereof. Had the Debtor not spent this money on track maintenance, it would have

been available for distribution to Wheeling, not to unsecured creditors. In addition, funds expended after October 18, 2013, came from proceeds of a loan that the Trustee obtained from Camden National Bank, secured by a first lien on the Debtor's domestic real estate. Again, these are not estate funds that would, under any circumstance, be available for distribution to unsecured creditors. Camden did not make a loan, and by doing so place a priming lien on another lender's collateral, so that the Debtor could fund a dividend to unsecured creditors.

42. Third, this is not, in any case, a "rehabilitative" bankruptcy proceeding— a point some courts find significant when applying the equity proviso. *All Points Capital Corp. v. Laurel Hill Paper Co. (In re Laurel Hill Paper Co.)*, 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008). It is beyond any doubt that this is a straight asset liquidation proceeding. No one contemplates any operation of this Debtor after its assets are sold, and proceedings for the sale of substantially all of the Debtor's assets are currently pending before the Court. Plainly, the assets of this Debtor are to be liquidated and then distributed to creditors in the order provided by law. There is no justification for varying that order for the purpose of creating a windfall for unsecured creditors or the estate.

43. In sum, this case does not present circumstances in which unencumbered estate assets have been spent for the benefit of a secured lender, thereby warranting "equitable" consideration under § 552(b)(1). None of the money spent by the Trustee during the course of this Chapter 11 proceeding represented assets that would have been available for distribution to unsecured creditors. The Trustee, for his own purposes, decided it would enhance the estate to continue railroad operations, and he spent funds on track maintenance as a necessary component thereof. These funds were derived from collateral securing one lender or another. Unsecured creditors incurred no cost by the expenditure of maintenance funds; instead, if the Trustee's

judgment was sound, they may have benefited from expenditures which maintained the Debtor as a going concern. The only real question—a question for another day—is whether they were benefited to the same degree by which the interests of secured lenders were impaired. There simply is no room for application of any equitable principals under Section 552(b)(1) to diminish Wheeling's collateral any more than it has already been diminished by the Trustee's operations.

CONCLUSION

The inescapable conclusion that one must reach is that the entirely of Net Funds constitute proceeds of Wheeling's valid, perfected, first priority, pre-petition security interest in "accounts", "payment intangibles' and other rights to payment of the Debtor. This is true not only as to Net Funds earned on account of pre-petition track maintenance expenditures, but also as to Net Funds earned on account of post-petition track maintenance expenditures. And it is true regardless of the source of funding for these expenditures. There is nothing in the Bankruptcy Code or in the Maine UCC which limits Wheeling's security interest in accounts, payment intangibles and other rights to payment only to those situations where the payments are generated by use of other collateral of Wheeling. Rather, all payments due to the debtor under its pre-petition contracts—such as the Net Funds paid under the TMA—constitute Wheeling's collateral regardless of how these contracts were funded. Furthermore, the equities of this case do not require or even suggest a reversal of this rule. No estate funds have been expended at the request of or for the benefit of Wheeling; rather, all relevant expenditures were made solely for the benefit of the Debtor, by and large by use of collateral of secured lenders, and without any detriment to unsecured creditors.

For these and for all of the foregoing reasons, Wheeling respectfully requests that this Court enter its order requiring the Debtor to turn over to Wheeling all of the Net Funds received under the TMA.

Dated: January 21, 2014

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CERTIFICATE OF SERVICE

I, Holly C. Pelkey, hereby certify that I am over eighteen years old and that I caused a true and correct copy of the above document to be served upon the parties and at the addresses set forth on the Service List attached hereto either electronically or via first class mail, postage prepaid, on 21st day of January, 2014.

/s/ Holly C. Pelkey
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