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## Forfeited Earnest Money Deposits—Subject to a Mortgagee’s Security Interest?

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Consider the following scenario. A debtor-in-possession (DIP) or trustee elects to sell certain real property. A potential buyer contracts, pursuant to a sale agreement and bankruptcy court order, to purchase the property and in connection with the sale posts an earnest money deposit. The property soon declines in value, however, and the potential buyer opts to default rather than purchase it. In accordance with the sale agreement and applicable nonbankruptcy law, the potential buyer, by defaulting, forfeits the deposit to the bankruptcy estate. The question arises: Is the deposit subject to the security interest of the debtor’s mortgagee? Both the mortgagee and the debtor/trustee could assert, depending on the facts of the case and applicable nonbankruptcy law, persuasive arguments on the issue. This article briefly examines these arguments.

### Mortgagee’s Arguments

The mortgagee could cite several factors for the proposition that the deposit is subject to its security interest. First, the mortgage document itself might expressly grant a security interest in such a deposit. Alternatively, and more likely, the mortgage document might generally grant a security interest in property such as “all awards, payments or judgments, including interest thereon, which may heretofore or hereafter be made with respect to the property,” or “all rents, issues and profits arising from the

property,” or “any and all other, further and additional right, title or interest in or to the property.” An earnest money deposit arguably qualifies as a payment made with respect to or on account of the property, a profit arising from the property or an additional right or interest in the property.<sup>1</sup>

Second, most courts addressing the issue of a mortgagee’s interest in an earnest money deposit have turned to the Uniform Commercial Code for guidance. Under former Article 9 of the UCC, the term “proceeds” includes “whatever is received upon the sale, exchange, collection or other disposition of collateral.” UCC §9-306(1) (2000). A majority of courts have held that an earnest money deposit qualifies under this definition as proceeds to which a creditor’s security interest attaches. According to the reasoning of these courts, a potential buyer, in depositing earnest money, “in essence, obtain[s] the right to purchase the land.” *Church v. Colling (In re Aldersgate Found. Inc.)*, 878 F.2d 1326, 1328 (11th Cir. 1989). Further, the payment of the deposit presumably prevents another party from purchasing the property. *Id.* Thus, these courts conclude, “[a] valuable right to the property [is] conveyed. Selling that right to purchase the property at a given price was a disposition of the collateral, and the forfeited deposits thus fall within the statutory



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definition of proceeds.” *Id.*<sup>2</sup>

Third, courts addressing the issue have invoked other analogous state law as persuasive authority. For instance, in *Old Stone*, the Fourth Circuit found that, under Virginia law, a deposit in a foreclosure sale, if forfeited, is subject to the security interest of the debtor’s secured creditor. *Old Stone*, 946 F.2d at 275-76 (citing Va. Code Ann. §55-59.4(2)). Likewise, in *Aldersgate*, the Eleventh Circuit noted that, under Florida law, the funds deposited for the purchase of property at a judicial sale constitute, upon the buyer’s default, property of the judgment creditor. *Aldersgate*, 878 F.2d at 1328 (citing Fla. Stat. Ann. §45.031(2)). Also, depending on the applicable nonbankruptcy law, equitable title to real property, including an earnest money deposit, may vest in the buyer upon execution of the sale agreement. *Old Stone*, 946 F.2d at 274-75 (citing Virginia common law); *Clancy*, 214 B.R. at 392 (adopting *Old Stone* court’s analysis).

Fourth, parties utilize an earnest money deposit, ostensibly, in order to compensate for a decline in the value of real property during the pendency of the sale agreement. *Old Stone*, 946 F.2d at 275. Thus, insofar as the value of the property declines below the amount of a mortgagee’s lien, the deposit should compensate the mortgagee, and not the debtor, for any such lost value. *Id. See, also, Clancy*, 214 B.R. at 392 (adopting *Old Stone* court’s analysis).

Finally, the sale agreement likely provides that in the event of a completed sale, the deposit will apply toward the purchase price. In such a circumstance, the deposit would constitute part of the proceeds subject to the mortgagee’s security interest. The mortgagee should conceivably have no less right to the deposit simply because of the potential buyer’s failure to consummate the sale. *Old Stone*, 946 F.2d at 274.

### Debtor’s/Trustee’s Arguments

Meanwhile, a DIP or a trustee could assert several arguments in opposition to the mortgagee’s position. First, it could maintain that the sale agreement, and not the underlying mortgage document, governs the issue of entitlement to the deposit. After all, it is the agreement that provides for the deposit

<sup>1</sup> *Summit Nat’l. Bank v. Spicer*, No. 4:00-CV-1837-Y, 2002 WL 737145, at \*3 (N.D. Tex. April 23, 2002) (holding that earnest money deposit constituted either “issues, profits, revenues, income” or “other benefit derived” under plain meaning of such terms in Rents and Profits clause in Deed of Trust). *Cf. Bank of Silvis v. Bouldinghouse Auction Co.*, 389 N.E.2d 267, 269 (Ill. App. Ct. 1979) (holding that, where contract entitled auctioneer to 3 percent of proceeds from the sale of real estate, the down payment forfeited by defaulting potential buyer constituted “proceeds” subject to auctioneer’s interest, on the basis that “proceeds” means “something received in hand,” and as defined in *Webster’s Dictionary*, “what is produced by or derived from something” (quoting *Webster’s Third New Int’l. Dictionary Unabridged* (1961))). At the very least, the existence of a mortgage provision granting a general security interest in such property evidences an intent to grant an interest in every possible facet of the property, including a deposit. *Old Stone Bank v. Tycon I Limited P’ship*, 946 F.2d 271, 275 (4th Cir. 1991) (“Our conclusion that earnest money associated with the contract for sale of the property may constitute proceeds [of the property in which the bank had an interest] is buttressed by...the impact of the deed of trust when read in its entirety...”).

and, usually in a “liquidated damages” clause, the forfeiture of the deposit in the event of default. Further, the mortgagee likely received notice of the sale and the accompanying order. Therefore, unless it objected to the terms of the order and expressly preserved or asserted its interest in the deposit, the mortgagee can be said to have consented to the terms of the liquidated damages clause awarding the deposit to the bankruptcy estate in the event of default.<sup>3</sup>

Second, in *Wolinsky v. Vermont Fed. Bank FSB (In re Vermont Knitting Co.)*, 111 B.R. 464 (Bankr. D. Vt. 1990), the court held, on the basis of an extensive analysis of Bankruptcy Code §552 and the former UCC, that a creditor’s pre-petition security interest did not extend to a forfeited deposit held by a chapter 7 trustee. Section 552(b) provides that a pre-petition security interest continues in proceeds of property acquired pre-petition. 11 U.S.C. §552(b). In reaching its determination, the court noted first that the legislative history of §552 expresses a requirement that the subject property be “converted” before it can qualify as proceeds. *Vermont Knitting*, 111 B.R. at 467 (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 376-3877 (1977)). Further, the court observed that “[t]he *American Heritage Dictionary* defines ‘convert’ in part as: ‘To change into another form, substance, state or product; transform: convert water into ice.’” *Id.* (quoting *American Heritage Dictionary* (2d ed. 1982)). The court concluded that the §552 legislative history requires that the creditor’s collateral “change” into another form before it can qualify as proceeds. *Id.*

The court next noted that the former UCC defines the term “sale” as follows: “A ‘sale’ consists in the passing of title from the seller to the buyer for a price (§2-401).” *Id.* (citing 9A Vt. Stat. Ann. §9-306; 9A Vt. Stat. Ann. §9-105(3) (1989)). The court noted that former §2-401, in turn, provides in relevant part that “[u]nless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance.” *Id.* at 467-68 (quoting 9A Vt. Stat. Ann. §2-401 (1989)). The court concluded that, by virtue of the bidder’s failure to tender the balance due, a sale under the former UCC had never occurred. *Id.* at 469.

<sup>2</sup> See, also, *Old Stone*, 946 F.2d at 273 (adopting *Aldersgate* court’s analysis); *In re Clancy & Co. Constr. Inc.*, 214 B.R. 387, 391-92 (D. Colo. 1997) (adopting *Aldersgate* court’s reasoning); *Hoagland v. Illinois Guar. Savs. & Loan (In re Vandevender)*, 87 B.R. 59, 60-61 (Bankr. S.D. Ill. 1988) (adopting analysis of lower court in *Aldersgate*).

<sup>3</sup> *Old Stone*, 946 F.2d at 277 (Widener, J., dissenting) (“The provision in the agreement identifying the deposit as liquidated damages specifically contemplated the very event that came to pass—namely, the failure of the purchaser to close the sale. It seems to me disingenuous for [the secured creditor] to insist that it intended for the deposit to be treated as proceeds when it consented to a contract that plainly stated otherwise.”). But see *Old Stone*, 946 F.2d at 274 (holding that a mere label attached to the deposit, such as “liquidated damages,” should not control the determination of entitlement to the deposit).

The court finally determined that the expression “other disposition” in former §9-306 similarly did not encompass the transaction at issue. *Id.* After observing that the doctrine of *ejusdem generis*, as applied to the section, requires a transfer or substitution of collateral for other property, the court found that the creditor’s collateral had not been “converted” within the meaning of the legislative history of §552; rather, the court found, it had remained intact. *Id.*

Accordingly, the court concluded that, upon the potential buyer’s failure to consummate the terms of the bid, no estate property had been transferred, and thus no disposition or substitution of the creditor’s collateral had occurred. Accordingly, the deposit belonged to the bankruptcy estate. *Id.* Other courts have reached a similar conclusion as to proceeds of other types of property.<sup>4</sup>

Thus, a debtor or trustee asserting an interest in an earnest money deposit could argue, on the basis of *Vermont Knitting* and related cases, that reference to the U.C.C. supports its position. A relatively recent development likely nullifies this argument, however. The revised UCC, adopted in 2001, defines the term “proceeds” in a more expansive fashion. Now, the term refers not only to “whatever is acquired upon the sale, lease, license, exchange or other disposition of collateral,” but also “whatever is collected on, or distributed on account of, collateral” and “rights arising out of collateral.” UCC §9-102(64) (2005). An earnest money deposit likely qualifies as something that is collected on account of collateral or a right arising out of collateral.

At any rate, §552(b) does not apply “to the 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).

<sup>4</sup> See, e.g., *Fed. Deposit Ins. Corp. v. Hastie (In re Hastie)*, 2 F.3d 1042, 1045-46 (10th Cir. 1993) (holding that perfected security interest in chapter 11 debtor’s stock did not continue in cash dividends paid post-petition on stock on basis that “the cash dividend...does not alter the ownership interest represented by the stock” and “therefore, is not a disposition of the stock”); *Perris Valley Rentals Inc. v. Rebel Rents Inc. (In re Rebel Rents Inc.)*, 307 B.R. 171, 189-90 (Bankr. C.D. Cal. 2004) (holding that equipment seller holding security interest in debtor’s equipment and proceeds thereof did not hold interest in rents because term “proceeds” referred to only whatever was received upon a permanent or final conversion of collateral through sale, exchange, collection or other disposition); *Covey v. Ipava State Bank (In re Ladd)*, 106 B.R. 174, 176-77 (Bankr. C.D. Ill. 1989) (holding that payments did not constitute proceeds where payments did not result from sale or disposition); *In re S & J Holding Corp.*, 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984) (holding that coins obtained through video machines were not proceeds of collateral); *Gen. Elec. Credit Corp. v. Cleary Bros. Constr. Co. (In re Cleary Bros. Constr. Co.)*, 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980) (holding that mere rental of collateral does not produce proceeds).

<sup>5</sup> See, e.g., *In re Cafeteria Operators LP.*, 299 B.R. 400, 410 (Bankr. N.D. Tex. 2003) (holding that, even assuming that revenues generated from post-petition operation of business could be regarded as proceeds, creditor’s security interest should not extend to post-petition revenues to extent that such revenues had been enhanced due to post-petition toil and effort of debtors’ employees); *Wood v. La Bank (In re Wood)*, 190 B.R. 788, 795 (Bankr. M.D. Pa. 1996) (holding that increase in value of property during bankruptcy case would not be reflected in mortgagee’s secured claim where such increase was solely result of debtor’s efforts).

Courts have utilized this exception in cases in which the proceeds result from the labor and fruit of the estate.<sup>5</sup> A debtor or trustee could conceivably argue that the deposit resulted from its efforts to sell the property, and hence, that the mortgagee’s security interest should not extend to the deposit.

Finally, not all analogous state law may favor the mortgagee. For instance, in *Old Stone*, the dissenting justice noted that, under Virginia law, a judgment lien attaches to land but not the proceeds of sale thereof. *Old Stone*, 946 F.2d at 276 n.1. Also, he noted that under Virginia law, a DIP is entitled to receive and utilize the income and profits of real property, even though a mortgage covers such property. *Id.* at 277. Thus, he concluded, the “rents, issues and profits” language in the applicable mortgage should not confer upon the mortgagee a right in a deposit. *Id.*

## Conclusion

Two factors will likely determine the issue of entitlement to a forfeited earnest money deposit: (1) the terms of the security agreement, sale agreement and order approving sale; and (2) the interpretation of the UCC. As to the first factor, the mortgagee can affirmatively safeguard its interest through two acts. First, it can draft the mortgage document to expressly reflect that its security interest extends to forfeited earnest money deposits. Second, the mortgagee can ensure that the sale agreement and/or the order approving sale expressly reflect its interest in the deposit. As to the second factor, the recent change in the definition of proceeds under the U.C.C. would appear to have resolved, in favor of the secured creditor, the dispute over whether an earnest money deposit constitutes proceeds to which a security interest attaches. ■

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