# Payment is not always certain for post-petition sales to a Bankruptcy Debtor

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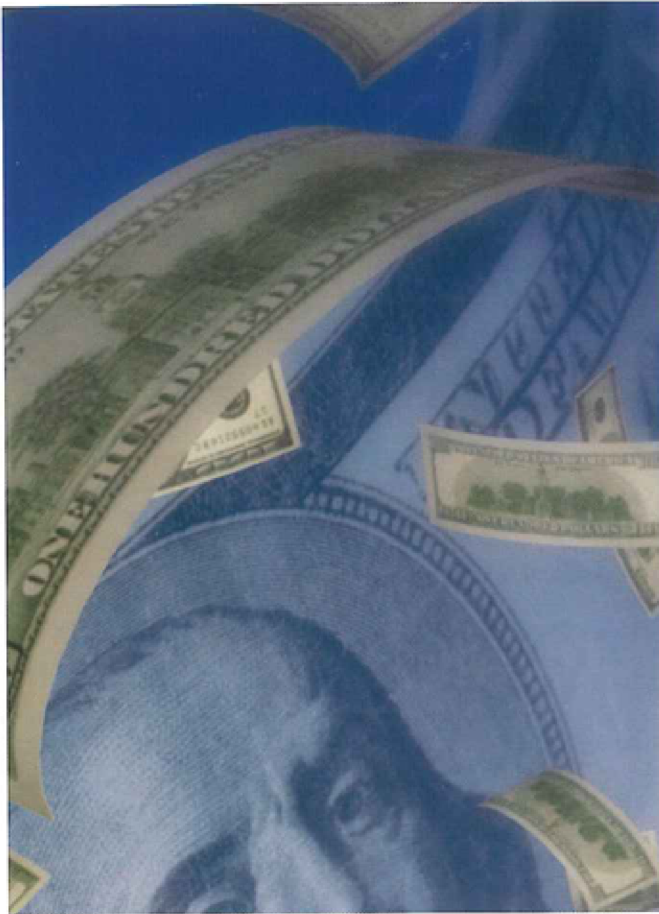
In the current economic and political environment in the US and globally, many lenders are facing difficult decisions regarding their debt holdings. Regulated financial institutions must classify loans as either performing or non-performing. Financial institutions must reserve for non-performing loans, which adversely impacts its capital requirements. In some cases, this dynamic causes lenders to modify loan terms rather than "call the loan". However, facing the reality that a large percentage of modified loans ultimately fail, lenders often "call the loan" sooner to resolve the asset. In Chapter 11 cases, this has resulted in more cases where the pre-petition lender is not willing to provide debtor in possession ("DIP") financing, leaving Chapter 11 debtors without working capital. This focuses increased attention on the provisions of the US Bankruptcy Code on the debtor's use of lenders' "cash collateral" where the lender does not consent.

In March of this year, the Eleventh Circuit Court of Appeals issued a decision that highlights the rights of parties to "cash collateral". In *Marathon Petroleum Co. v. Cohen* (In *re Delco Oil*), the court held that a Florida bankruptcy trustee could recover more than $1.9 million paid to a vendor for goods provided to the debtor in the ordinary course of business after the bankruptcy filing, because the payments were unauthorised. The basis for this ruling is that the debtor is not permitted to use the lender's cash collateral unless the lender has consented, or the court authorises the use despite the lender's objection. The case was initially filed as a chapter 11 with the debtor continuing its operations in the ordinary course as the debtor in possession, and during this time the goods were delivered and invoices were paid. Subsequently, the case converted to chapter 7, and the trustee was appointed.

Sections 364 and 1108 of the US Bankruptcy Code allow a chapter 11 debtor to operate its business, incur debts in the ordinary course of business, and pay those debts as administrative expenses. Moreover, Section 549 of the Bankruptcy Code allows a trustee to recover unauthorised post-petition payments or other transfers. What made the payments in this case unauthorised?

Section 363 of the Bankruptcy Code prohibits the use of "cash collateral" by a debtor unless either the secured party consents to such use or the court has authorised such use after finding that the secured party is adequately protected. "Cash collateral" includes cash and deposit accounts (bank accounts) in which another party has a security interest. In this case, a lender had a perfected security interest in the debtor's inventory and accounts receivable. Pursuant to the Uniform Commercial Code, this security interest continued in identifiable cash proceeds of the inventory and accounts receivable,



so the cash in the debtor's bank account was the lender's cash collateral.

On the same day as the filing of the chapter 11 case, the debtor filed an emergency motion for the use of the lender's cash collateral in order to continue the debtor's operations and pay for postpetition shipments of inventory. In the absence of consent by the creditor, the debtor may not use cash collateral during the period between the bankruptcy filing and entry of an order allowing at least interim use of cash collateral. In nearly all chapter 11 cases, the court holds a hearing on such emergency use of cash collateral on the next business day after the filing, and the motion is usually granted on an interim basis for at least a week or two, with a final hearing on the use of cash collateral scheduled before the end of this interim period. In this case, however, the court scheduled the hearing for nearly two weeks after the motion was filed, and then continued the hearing for an additional week. The lender did not consent to the use of its cash collateral. Despite this, the debtor continued to use cash generated by accounts receivable collections as working capital.

At the hearing on the use of cash collateral, the debtor's presentation of evidence was not compelling. The debtor was operating at a huge loss and was unable to show adequate protection for the use of the lender's cash collateral, and the court denied the motion. However, during the 20 days prior to the hearing, the vendor shipped the products and was paid over $1.9 million, all on a "cash before delivery" basis. Shortly after the hearing, the case was converted to chapter 7, which results in a cessation of business operations, and the trustee sought to recover the payments to the vendor. The bankruptcy court held, and the Eleventh Circuit affirmed, that the payments were unauthorised due to the denial of the use of cash collateral and thus were recoverable as unauthorised payments.

Outside of a bankruptcy case, cash payments of a lender's collateral to a third party, in the absence of collusion by that third party, are free of the lender's security interest. Here, there was no collusion regarding the payments, and the shipments and payments were in the ordinary course of business. However, the fact that the court did not allow the use of cash collateral meant that the payments were unauthorised and were recoverable. The vendor's lack of knowledge that the payments were unauthorised was irrelevant.

The vendor would have a chapter 11 administrative expense claim for the $1.9 million, but those claims are subordinate to the chapter 7 administrative expense claims. The denial of the use of cash collateral indicates that chapter 11 administrative expenses might not be paid in full. Further, the lender would be entitled to a superpriority chapter 11 administrative expense claim for the diminution in the value of its collateral while the debtor was operating, so the lender would be paid after the trustee's chapter 7 administrative expenses and before the vendor's claim and any other chapter 11 expenses.

An important fact to note is that the lender and the trustee had a court approved agreement where the lender agreed to fund the trustee's legal costs to pursue recovery from the vendor, and to share the proceeds of the recovery between the trustee and the lender.

Although the vendor shipped the products, it was ordered to give back the $1.9 million in payments, and likely will receive only a fraction of its $1.9 million administrative expense. The takeaway of the Delco case is that absent the entry of a cash collateral order or a debtor-in-possession financing order (and the continued vitality of that order), the debtor may not use the lender's cash collateral, and any payments made in the "ordinary course of business" are subject to disgorgement.

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