Caveat Vendor: Eleventh Circuit Rules That Unauthorized Payments by DIP Using Cash Collateral Must Be Disgorged

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When a company files for chapter 11 protection, it typically obtains either debtor-in-possession ("DIP") financing or permission to use cash collateral, or a combination of both, to keep the business operational. In today's restricted credit market, DIP financing has been difficult to obtain. As a consequence, chapter 11 debtors are increasingly relying on the use of cash collateral to finance the journey through the bankruptcy process. A ruling recently handed down by the U.S. Court of Appeals for the Eleventh Circuit highlights the principle that a debtor's use of cash collateral is subject to later court review. In *In re Delco Oil, Inc.*, a three-judge panel of the court of appeals put vendors who trade with a debtor postpetition on notice that unauthorized payments by a DIP using cash collateral can be avoided and recovered by the estate.

Cash Collateral

Section 363(a) of the Bankruptcy Code defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." Cash collateral also includes "the proceeds, products, offspring, rents, or profits of property . . . subject to a security interest." The Bankruptcy Code defines "security interest" as a "lien created by an agreement."

Generally, cash collateral is thought of as an asset that can dissipate or be consumed quickly, easily, and undetectably. And once gone, cash collateral is difficult to trace and recover. Because of this transient characteristic, Congress has codified special provisions in the Bankruptcy Code to account for cash collateral and restrict the use of it, to protect the rights of the creditor that holds a security interest in the cash collateral.

Under section 363(c)(4) of the Bankruptcy Code, a DIP is required to segregate and account for any cash collateral in its possession, custody, or control. This requirement applies to both cash collateral the debtor has on hand before the commencement of the bankruptcy case and any cash collateral the DIP acquires thereafter. Because the DIP has a duty to protect and maintain the collateral for the benefit of the one or more secured creditors who have an interest in the collateral, it is especially important to identify each secured creditor that has an interest in it.

Under section 363(c)(2) of the Bankruptcy Code, a DIP may not use, sell, or lease cash collateral without either (i) the consent of each secured creditor with an interest in the collateral or (ii) the court's authorization. Often, a secured creditor will allow the DIP to use cash collateral for specific purposes to keep the business operational, under certain terms and conditions. This type of agreement benefits the secured creditor because it maintains the DIP as a going concern, thereby preserving the value of the secured creditor's interest in the collateral.

If the secured creditor and the DIP cannot agree on a proposed use of cash collateral, the court may grant such permission, provided that the secured creditor's interest in the collateral is adequately protected. The DIP bears the burden of proving that it can adequately protect the secured creditor's interest in the cash collateral. Even though section 363(c)(2) requires notice and a hearing before the court can grant permission to use cash collateral, the court may, and often does, hear motions to use cash collateral on an expedited basis—particularly at the inception of a bankruptcy case. The court may conduct a preliminary hearing on the first day of the bankruptcy case to authorize the use of cash collateral for certain urgent and vital uses on an interim basis to prevent immediate and irreparable harm to the debtor's estate. The court typically convenes a later final hearing on the use of cash collateral.

Avoiding Unauthorized Postpetition Transfers

Section 549(a) of the Bankruptcy Code gives a bankruptcy trustee or DIP the power to avoid unauthorized postpetition transfers of estate property. It provides that, with certain exceptions, "the trustee may avoid a transfer of property of the estate—(1) that occurs after the commencement of the case; and (2)(A) that is authorized only under section 303(f) or 542(c) of this title; or (B) that is not authorized under this title or by the court." The exceptions involve transfers occurring during the involuntary bankruptcy petition "gap period" and certain transfers by or to parties who act in good faith without knowledge of the debtor's bankruptcy filing.

In *Delco Oil*, the Eleventh Circuit addressed whether a chapter 7 trustee may use section 549(a) to remedy a debtor's impermissible use of cash collateral.

Delco Oil

Delco Oil, Inc. ("Delco"), was a distributor of gasoline. Before its bankruptcy filing, Delco entered into a purchase agreement with Marathon Petroleum Company, LLC ("Marathon"), for petroleum products and a financing agreement with CapitalSource Finance ("CapitalSource"), whereby CapitalSource provided financing to Delco in exchange for a security interest in all of Delco's personal property, including collections, cash payments, and inventory.

Delco filed for chapter 11 protection in October 2006 in Florida. On the petition date, it filed an emergency motion for court permission to use CapitalSource's cash collateral, a request opposed by CapitalSource. The court denied Delco's motion three weeks later. During the gap period between the filing of the motion and the court's ruling—although it did not have court approval or CapitalSource's consent to use cash collateral—Delco paid Marathon more than $1.9 million in cash for petroleum products delivered postpetition.

The bankruptcy case was converted to a chapter 7 liquidation in December 2006. The chapter 7 trustee filed an adversary proceeding to avoid and recover the transfers to Marathon. On summary judgment, the bankruptcy court ruled in favor of the chapter 7 trustee, holding that Delco lacked authority to use CapitalSource's cash collateral to pay Marathon. The district court affirmed the bankruptcy court's ruling, and Marathon appealed to the Eleventh Circuit.

The Eleventh Circuit's Decision

Marathon argued before the Eleventh Circuit that the lower courts erred in granting summary judgment because there was a material issue of fact regarding whether the funds it received from Delco were CapitalSource's cash collateral. According to Marathon, under Florida's version of the Uniform Commercial Code, when Marathon received the funds from Delco's deposit account, Marathon took the funds free and clear of any security interest attached to them.

The Eleventh Circuit did not dispute Marathon’s interpretation of the Florida statute but instead found that the statute was inapposite. Under federal bankruptcy law, the court of appeals explained, the appropriate time to determine whether the funds were cash collateral was when they were in Delco’s possession prior to the transfers. At that time, CapitalSource held a perfected security interest in all of Delco’s personal property, and the funds Delco transferred to Marathon were cash proceeds of the personal property. Thus, the Eleventh Circuit ruled, the funds were cash collateral as defined under section 363(a) of the Bankruptcy Code, and Delco was prohibited from transferring the funds to Marathon without CapitalSource’s permission or a court order.

No “Harmless” Exception to Section 549

Marathon also argued that, even if the funds were cash collateral, the chapter 7 trustee could not avoid the transfers because CapitalSource was not harmed by the transfers; the petroleum products Marathon sold to Delco postpetition in exchange for the payments of cash collateral constituted inventory subject to CapitalSource’s lien in an amount allegedly equal to the amount of the cash transfers. Thus, the value of the assets covered by CapitalSource’s lien arguably was not reduced by the unauthorized postpetition transfers of funds. The Eleventh Circuit dismissed this argument, holding that section 549(a) of the Bankruptcy Code does not have an exception for “harmless” transfers. Section 549(a), the court explained, broadly grants power to the chapter 7 trustee to avoid any unauthorized postpetition transfers of property of the estate.

No Ordinary-Course Transfer or “Innocent Vendor” Defense

Finally, Marathon asserted that based on public policy, section 549 provides implicit defenses for ordinary-course transfers and for innocent vendors who trade with the debtor. The Eleventh

Circuit rejected this argument as well. It reasoned that Congress, by specifically carving out the use of cash collateral from section 363(c)(1)—which permits the debtor to enter into ordinary-course-of-business transfers without notice or a hearing—intended that cash collateral not be used even in the ordinary course of business without secured creditor or court permission. Similarly, the Eleventh Circuit noted that there is no indication from the text of sections 549(a) and 550(a) that Congress intended to create an “innocent vendor” defense based upon the transferee’s status and culpability. Consequently, the court ruled, no such implied defense exists under section 549(a) of the Bankruptcy Code.

Outlook

The Eleventh Circuit’s decision in *Delco Oil* is consistent with courts’ strict enforcement of section 363(c)(2) of the Bankruptcy Code and the protection of secured creditors’ interests in cash collateral. Under the Eleventh Circuit’s ruling, section 363(c)(2)’s reach is broad, extending to payments to vendors who trade postpetition with the debtor, even in the ordinary course of business.

By ordering disgorgement of payments to Marathon, the Eleventh Circuit has written a cautionary tale for postpetition vendors. Any vendor that receives postpetition payments from a DIP is well advised to ensure that the DIP has the requisite creditor consent or court authority to make the payments. Furthermore, under this decision, postpetition vendors apparently will not qualify for the good-faith transferee “safe harbor” in section 550(b). Absent such an assurance, vendors may refuse to deal with a DIP whose assets are substantially encumbered. Alternatively, such vendors may be forced to rely on an administrative-priority claim for the value of any goods or services provided to a DIP, which claim may be of little practical value in a chapter 11 case on the brink of administrative insolvency and/or conversion to chapter 7.

In re Delco Oil, Inc., 599 F.3d 1255 (11th Cir. 2010).