

IN RE DELCO OIL, INC.: POST-PETITION TRANSFERS OF CASH COLLATERAL

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When dealing with a debtor in Chapter 11, vendors typically seek to protect against loss by insisting upon payment in advance or on very short terms. However, the monies paid to a vendor following the filing of bankruptcy often constitute the cash collateral of a secured creditor. It is critical that a vendor determine whether the debtor has authorization to use cash collateral.

In *Marathon Petroleum Co. v. Cohen (In re Delco Oil)*, the Court of Appeals for the Eleventh Circuit recently held that there is no protection for a vendor who was unaware that the debtor was not authorized to use cash collateral to pay for the delivered good. Therefore, should a case be converted to Chapter 7, a trustee could avoid a debtor's post-petition transfers of funds that were cash collateral, notwithstanding that the payments had been made in good faith and in the ordinary course of business.

The Eleventh Circuit held that the transfers were avoidable under section 549(a) of the Bankruptcy Code because they were made without a court order or the consent of the secured party, a violation of section 363(c)(2) of the Bankruptcy Code.

Below is a brief summary of *In re Delco*, followed by analysis of the Eleventh Circuit's decision and key steps for vendors when dealing with a Chapter 11 debtor and the transfer of cash collateral for goods and services in the normal course of business.

In re Delco

On Oct. 17, 2006, Delco Oil, Inc. filed for Chapter 11 bankruptcy protection. The company filed a routine first-day motion and concurrently filed a motion with the Bankruptcy Court seeking authorization to use cash collateral. A secured creditor of the oil company objected to the cash collateral motion on the grounds that its security interest was not adequately protected. The court allowed Delco to continue its business as a debtor-in-possession (DIP), but reserved judgment on the cash collateral motion until after a hearing. Before the hearing date on the cash-collateral motion, Delco, pursuant to a sales agreement and without the court's permission, paid approximately \$1.9 million to purchase products from its petroleum vendor. The cash-collateral motion was subsequently denied, and in December of 2006 the *Delco* case was voluntarily converted to Chapter 7. The Chapter 7 trustee filed suit

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against Delco's petroleum vendor to recover the \$1.9 million payment as an unauthorized post-petition transfer.

Eleventh Circuit's Decision

Relying on the plain language of the Bankruptcy Code, the court held that there is no "innocent vendor" defense to a trustee's 549(a) powers. Likewise, the cash collateral provisions of section 363(c)(2) do not contain a provision that excludes ordinary course of business transactions from its reach.

The vendor argued that payment to Delco (which constituted cash collateral) of the cash collateral did not harm the secured creditor or the estate, and thus should not be subject to avoidance. The vendor reasoned that it provided reasonably equivalent value to the estate in the form of inventory. Relying again on the plain language of the code, the court rejected the "harmless exception" defense to a trustee's section 549(a) avoiding powers. The court concluded that the code does not require an analysis of the adequacy of consideration; it only requires that the court determine whether the transfer was authorized.

Finally, the Eleventh Circuit rejected the vendor's argument that it should prevail as a matter of policy based on an implicit defense existing under section 549 for innocent vendors who do business with a debtor and receive payments in good faith and in the ordinary course of business. The court dismissed this argument on the basis that sections 549(a) and 550(a) contain no reference to a transferee's status or state of mind, and this exception should not be read into the Bankruptcy Code.

Possible Solutions for Vendors

The *Delco* decision highlights the potential pitfalls of doing business with a Chapter 11 debtor. Broadly applied, the ruling casts doubts on how or whether a vendor can be paid for providing goods and services to a debtor in the early days of a Chapter 11 filing. It is worth noting that *Delco* is a case with unusual facts; Bankruptcy Courts typically address cash collateral issues at the first-day hearing. Ordinarily, Bankruptcy Courts do not authorize debtors to continue their business operations as a debtor in possession and then allow weeks to pass before ruling on the debtor's ability to use cash collateral.

Vendors engaging in post-petition transactions with debtors should note the results of this case—it may no longer be enough to demand payment in advance or on delivery. If there is a secured creditor involved, a cautious vendor should place the burden on the debtor to explicitly demonstrate that the debtor is authorized to continue making payments, and confirm the court's entry of an order authorizing the use of cash collateral. In addition to requesting a copy of the cash collateral order approved by the Bankruptcy Court, a vendor may want to demand from the debtor a line item on the cash collateral budget that specifically references the vendor and the proper amount of payments.

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