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"Caveat Venditor -- Ensure Debtor Has Authority To Pay"

By Jonathan Guy and James Burke

Imagine that you are the head of a major petroleum company that has a sales agreement with a distributor of motor fuel. Under the terms of the agreement, if the distributor wants your products, you are contractually obligated to deliver them. And the sales volume is significant, say $1 million per week. Assume further that the distributor, as is often the case, has pledged all of its personal property, including cash and inventory, to obtain financing.

Now imagine that the distributor files for chapter 11 protection and on the following day the bankruptcy court authorizes it to continue its operations. You cannot breach the sales agreement. If you do, the debtor could argue that you violated the automatic stay. And, the debtor promises to pay you contemporaneously with your deliveries, just as it has always done. So you go ahead and deliver $1.9 million of product in the first three weeks of the bankruptcy case. You are duly paid by the debtor for those deliveries.

Unbeknownst to you, however, the debtor's secured lender never consented to the debtor's use of its cash collateral. And on the third week of the bankruptcy, after you have made your deliveries and received payments totaling $1.9 million, the bankruptcy court denies the debtor's request to authorize such use.

Shortly thereafter, the debtor voluntarily converts the bankruptcy case to a chapter 7 proceeding and a trustee is appointed.

Then comes the really bad news: the trustee files an adversary complaint against you, asking that you pay back the $1.9 million you received on the grounds that the debtor's use of cash collateral was unauthorized.

What happens next?

The answer in the Eleventh Circuit is that you have to give the money back. Indeed, these are the facts of Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.), Case No. 09-11759, 2010 WL 918058 (11th Cir. Mar. 16, 2010), in which Delco Oil was the debtor, Marathon the petroleum company, Mr. Cohen the trustee, and CapitalSource Finance the secured lender.

In Delco, the United States Court of Appeals for the Eleventh Circuit affirmed the district court's decision affirming the bankruptcy court's entry of summary judgment in Mr. Cohen's favor.

The Eleventh Circuit relied upon sections 363(c)(2) and 549(a) of the Bankruptcy Code. Section 363(c)(2) provides that a debtor may not use cash collateral (e.g., cash, inventory, and receivables) unless each entity that has an interest in the collateral consents or the bankruptcy court authorizes such use. To obtain court authorization over a secured lender's objection, the debtor must show that the secured lender is adequately protected because, for example, the overall cash collateral position will not be diminished if the cash will be used to buy new inventory. Section 549(a), in turn, provides that a trustee may recover unauthorized post-petition transfers of estate property.

In simple logic that must have made unhappy reading for Marathon, the Eleventh Circuit ruled that all Mr. Cohen had to show to avoid the $1.9 million of payments Marathon received after the bankruptcy filing was that (1) an unauthorized transfer occurred; (2) the property transferred was property of the estate; and (3) the transfer occurred post-petition.

In that those elements were satisfied, Marathon argued that Mr. Cohen could not avoid the payments because the secured lender, CapitalSource, and the debtors' estate were not harmed. While it was true that the debtor paid out $1.9 million post-petition, it also received inventory of equal value in exchange, and CapitalSource had a perfected security interest in both. Thus, CapitalSource's interests were not diminished; rather, one form of collateral (cash) was substituted for another (inventory). Likewise, the estate's overall assets remained the same. Marathon also argued that it was simply continuing to sell its products to the debtor in the ordinary course, innocent of the debtor's troubles with its secured lender. Thus, Marathon surely could not be required to pay back funds to the estate for deliveries that the debtor got to keep, giving the debtor a windfall.

The Eleventh Circuit, however, gave short shrift to such arguments. Relying on the plain language of the Bankruptcy Code, the Eleventh Circuit held that there is no "harmless" exception to section 549(a)'s avoiding powers. A transferee, therefore, cannot circumvent section 363(c)(2)'s requirements by showing, after the fact, that the secured creditor's interests were adequately protected. Further, the Eleventh Circuit held that Marathon's status as an "innocent vendor" was irrelevant: section 549 contains no reference to a transferee's status as a vendor or its state of mind. And, under section 363(c)(2), all transactions that use cash collateral, ordinary or not, require permission of the secured creditor or the court.

Although the Eleventh Circuit did not acknowledge the harshness of this result, it is undoubtedly so. Marathon, in compliance with the terms of its contract with the debtor, delivered and was paid for product post-petition, all arguably in the ordinary course. To be sure, the payments were "unauthorized" under section 363(c)(2), but Marathon did not know that and the failure to obtain authorization lay squarely in the debtor's lap. Further, no one was ultimately harmed, neither the estate nor the secured lender. And the result of the decision is that Marathon is out both $1.9 million and $1.9 million of inventory.

Still, it is hard to argue with the Eleventh Circuit's logic. Section 549 is clear; it provides no

exceptions for harmless transactions or innocent vendors. And it is not the place of the courts to create such exceptions in Congress's absence.

So what is the takeaway from Delco?

First, the facts described above are unusual. The bankruptcy court authorized Delco to continue its business as a debtor-in-possession one day after the bankruptcy filing (October 18) but did not deny Delco's request to use cash collateral until approximately three weeks later (November 6). Ordinarily, cash collateral issues are addressed on the first day of a bankruptcy case. And it is rare for a debtor to willfully use cash collateral without authority.

Nevertheless, the events of the Delco case show that the unusual can happen. The Eleventh Circuit's decision thus underscores the need for creditors engaging in post-petition transactions to put the burden on the debtor to show that it is authorized to continue operating its business; the contemplated transactions are within the ordinary course of the debtor's business or appropriate approval has been obtained; and the debtor has permission, either from the court or the secured creditors, to use cash collateral to make any payments that come due.

It is not enough for a vendor to protect itself by ensuring it will be paid for post-petition deliveries by, for example, demanding payment in advance. Rather, it must make sure that the payments themselves are fully authorized. In sum, the Russian proverb, which President Reagan was fond of quoting, applies: "Trust, but verify." Or perhaps more simply: Caveat venditor.

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