

## Eleventh Circuit Affirms Decision Allowing Chapter 7 Trustee to Avoid \$1.9 Million of Post-petition Payments Made to Vendor for Products Delivered Post-petition Pursuant to Pre-petition Sales Agreement

On March 16, 2010, the United States Court of Appeals for the Eleventh Circuit issued a decision in the bankruptcy case for Delco Oil, Inc. (“Delco”) affirming the district court’s opinion affirming the bankruptcy court’s judgment avoiding over \$1.9 million of payments Delco made to a vendor without first obtaining a court order authorizing the use of cash collateral. This decision may have implications for creditors engaging in transactions with debtors after their bankruptcy filings.

### I. Case Background

Prior to the commencement of its bankruptcy case, Delco entered into a financing agreement with its principal lender and pledged substantially all of its assets, including its cash and cash collections, as security. Delco eventually defaulted under the financing agreement and filed a petition for chapter 11 relief. On the same day as the bankruptcy filing, Delco filed a motion requesting authority to (1) continue operating its business as a debtor-in-possession and (2) use its cash collateral to pay essential bills. Delco’s secured lender did not consent to the request.

The bankruptcy court entered an order on the following day authorizing Delco to continue its operations, including the payment of debts incurred in the ordinary course of business. But the court declined to rule on Delco’s motion to use cash collateral until the completion of an evidentiary hearing almost two weeks later. In the meantime, Delco continued to receive deliveries from one of its vendors, Marathon Petroleum Co., LLC (“Marathon”), under a pre-petition sales agreement. By the time that the evidentiary hearing concluded, Delco had paid Marathon more than \$1.9 million on account of the post-petition deliveries.

Ultimately, the bankruptcy court denied Delco’s motion to use cash collateral on the grounds that Delco’s secured lender was not adequately protected against the risk that its collateral would diminish in value. Soon afterwards, Delco voluntarily converted its case to a chapter 7 proceeding and the court appointed a trustee (the “Trustee”).

### II. The Avoidance Litigation

The Trustee filed an adversary proceeding against Marathon seeking to avoid the post-petition payments that Marathon received from Delco. The Trustee’s complaint was based on sections 363(c)(2) and 549(a) of the Bankruptcy Code. Section 363(c)(2) requires a debtor who is authorized to continue operating its business to obtain either the secured lender’s permission or the bankruptcy court’s authorization, upon a showing that the secured lender’s interests are adequately protected, before using cash collateral in the ordinary course of its business. Section 549(a), in turn, allows a trustee to recover any unauthorized post-petition transfer of estate property. Applying these provisions to the facts of the case, the bankruptcy court granted summary judgment in favor of the Trustee, concluding that Delco used cash collateral without authorization when it made the post-petition payments to Marathon. Upon review, the district court affirmed.

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On appeal before the Eleventh Circuit, Marathon argued that the payments it received from Delco did not constitute cash collateral because, under state law, the lender's security interest in the funds terminated when Delco transferred the funds to Marathon. The Eleventh Circuit concluded that this argument was "beside the point." For purposes of section 363(c)(2), the relevant inquiry was whether the transferred funds constituted cash collateral "while they were in the Debtor's hands before the disputed transfer, not at the moment the bankruptcy petition was filed and certainly not at the moment after the funds left [the] Debtor's control." Otherwise, debtors would be able to distribute cash collateral without restraint and section 363(c)(2) would be rendered meaningless.

Marathon also argued that the Trustee should not be able to avoid the payments from Delco because (1) the secured lender's lien attached to the products Marathon delivered to Delco and, thus, the lender was not harmed, (2) the transactions between Delco and Marathon took place in the ordinary course of business, and (3) Marathon acted innocently in dealing with Delco. As to all three arguments, the Eleventh Circuit's response was the same – section 549 does not provide any such exceptions. Once the Trustee proved that an unauthorized transfer had occurred, the property transferred was property of the estate, and the transfer occurred post-petition, Marathon's liability was established. Accordingly, the Eleventh Circuit affirmed.

### III. Potential Implications

The avoidance action against Marathon in the Delco bankruptcy case arose out of uncommon circumstances. Typically, bankruptcy debtors either procure their secured lender's consent to the use of cash collateral prior to filing their bankruptcy petition, or successfully obtain an interim order from the bankruptcy court shortly after their filing. In most cases, therefore, payments made by a debtor for post-petition deliveries are not subject to avoidance under section 549.

Nevertheless, the events of the Delco case underscore the need for creditors engaging in post-petition transactions with bankruptcy debtors to consider, among other things, (1) whether the debtors are authorized to continue operating their businesses, (2) whether the contemplated transactions are within the ordinary course of the debtors' businesses, and (3) whether the debtors have permission to use cash collateral to make any payments that come due. For evaluation of your transactions or further information, please contact Jonathan Guy, Richard Wyron, or James Burke.