

Vendors Beware: The Risk of a Debtor's Unauthorized Post-petition Payments For Post-petition Goods or Services

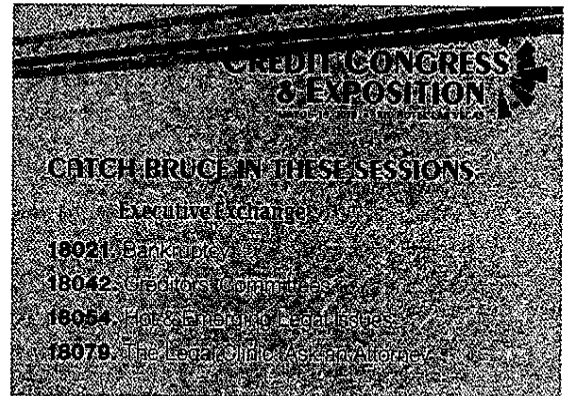
SELECTED TOPIC

You like horror stories? Well here is a doozy! Close your eyes and just imagine that your company had sold goods on cash-in-advance terms to a Chapter 11 debtor. The debtor paid approximately \$1.9 million to your company in exchange for your sale and delivery of goods of an equivalent amount. Unfortunately, the cash paid by the debtor was proceeds of its secured lender's collateral and the debtor had not obtained either its secured lender's or bankruptcy court approval of the payments as required under the Bankruptcy Code. And wouldn't you know it: that poor debtor just could not make a go of its business, its Chapter 11 case was converted to Chapter 7, and a Chapter 7 trustee was appointed. You would think this is the end of the story, but not so fast! It is now time to add the horror piece.

A few months later, the Chapter 7 trustee filed suit against your company, seeking recovery of the debtor's post-petition payments of \$1.9 million to your company during the short-lived Chapter 11 case. The trustee sought recovery from your company under Section 549 of the Bankruptcy Code, which permits the trustee to recover a debtor's unauthorized post-petition payments. The trustee claimed the payments were from the cash proceeds of the debtor's secured lender's collateral, which the debtor was barred from using without having first obtained the lender's or bankruptcy court's permission. The court ruled against your company, which now has to pay the \$1.9 million to the trustee.

The trustee claimed the payments were from the cash proceeds of the debtor's secured lender's collateral.

Well ladies and gentlemen, this horror story played out for real in *In re Delco Oil, Inc.* The U.S. 11th Circuit Court of Appeals, which covers the states of Alabama, Georgia and Florida, recently upheld a Chapter 7 trustee's judgment in the amount of approximately \$1.9 million against a vendor that sold goods to a Chapter 11 debtor post-petition in exchange for the debtor's post-petition payments totaling approximately \$1.9 million to the vendor. The court ruled these payments were avoidable under Section 549 of the Bankruptcy Code, as unauthorized transfers of property of the debtor's estate and recoverable from the vendor. The payments were from the cash proceeds of the secured lender's collateral



that the debtor was not permitted to use under Section 363(c)(2) of the Bankruptcy Code because neither the secured lender nor the bankruptcy court had authorized such use. It did not matter that the transactions between the debtor and vendor were in the ordinary course of business; the vendor had provided product of equivalent value to the debtor post-petition in exchange for the cash payments, and the vendor had no knowledge of the debtor's unauthorized use of the lender's cash collateral.

So what does all of this mean for trade creditors that do business with Chapter 11 debtors? While the facts of the *Delco Oil* case are somewhat unusual, the 11th Circuit's *Delco Oil* decision serves as a warning to vendors to make sure that their Chapter 11 debtor customer has obtained the consent of its secured lender, or bankruptcy court approval of Chapter 11 financing or the use of the secured lender's cash collateral, that allows the debtor to pay vendors for post-petition goods or services. Otherwise, the vendor may be compelled to repay all of the debtor's post-petition payments for post-petition goods sold or services provided by the vendor to the debtor.

The Facts of the Delco Oil Case

Delco Oil, Inc. ("Delco Oil") was a motor fuel distributor and owner of gas stations with headquarters in DeLand, FL. On April 23, 2003, Delco Oil entered into a written supply agreement with Marathon Petroleum Co., LLC ("Marathon"). Marathon was Delco Oil's primary supplier of petroleum products under the supply agreement, having sold gasoline, low sulfur fuel oil and high-sulfur fuel oil to Delco Oil.

On April 26, 2006, Delco Oil entered into a lending agreement with CapitalSource Finance LLC ("Capital-

Source"). CapitalSource agreed to provide up to \$18 million in revolving credit to Delco Oil. Delco Oil granted CapitalSource a perfected security interest in all of Delco Oil's personal property, including inventory, collections and cash payments, as collateral security for the payment of Delco Oil's obligations to CapitalSource.

On October 17, 2006, Delco Oil filed a Chapter 11 petition with the United States Bankruptcy Court for the Middle District of Florida. That same day, Delco Oil filed an emergency motion under Bankruptcy Code Section 363(c)(2) requesting court approval to use the cash proceeds of CapitalSource's collateral (the "CapitalSource Cash Collateral") to continue Delco Oil's business operations. On October 20, 2006, CapitalSource filed an objection to Delco Oil's motion to use the CapitalSource Cash Collateral. For nearly a month, the bankruptcy court did not rule on the motion, which meant Delco Oil was not allowed to use the CapitalSource Cash Collateral to pay any business expense not otherwise approved by CapitalSource, including the purchase price of the petroleum products that Marathon had sold and delivered to Delco Oil post-petition.

However, to confuse matters further, on October 18, 2006, the bankruptcy court granted Delco Oil permission to "operate its business and manage its property" as a debtor-in-possession. Specifically, the court directed that:

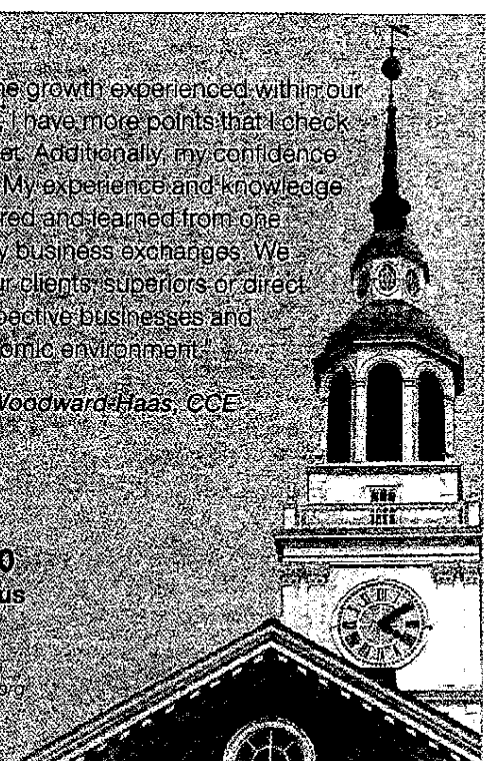
"Subject to the provisions of Section 363 and Section 365 of the Bankruptcy Code..., the debtor-in-possession may use, sell or lease property of the estate

The debtor-in-possession is authorized to pay all necessary and current expenses of operating its business... to the extent that such payments are necessary to preserve the assets or operate the business; however unless ordered by the court or authorized herein, such payments may only be made for post-petition obligations."

So, there was a court order authorizing Delco Oil to conduct business and pay all necessary business expenses. That should have included Delco Oil's post-petition payments to Marathon for Delco Oil's post-petition purchases of petroleum products from Marathon under their supply agreement. However, according to Bankruptcy Code Section 363(c)(2), to which the order was subject, Delco Oil was barred from using the CapitalSource Cash Collateral, and was, therefore, barred from paying Marathon for goods purchased post-petition, without CapitalSource's consent or a court order authorizing Delco Oil's use of CapitalSource's cash collateral.

From October 17 through November 4, 2006, Delco Oil purchased petroleum products from Marathon according to the terms of their supply agreement. Delco Oil paid the aggregate sum of \$1,960,088.91 (the "post-petition payments") for Marathon's goods from Delco Oil's checking account at Mainstreet Bank, which Delco Oil had secretly opened prior to its Chapter 11 filing.

In the meantime, on October 31, 2006, CapitalSource had filed an emergency motion with the bankruptcy court for an order prohibiting Delco Oil's further use of the CapitalSource Cash Collateral. It was not until November 9, 2006, nearly one month after Delco Oil had filed its original emergency motion to use the CapitalSource Cash Collateral, that the bankruptcy



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court had denied the motion. Thereafter, Marathon stopped selling petroleum products to Delco Oil.

In December 2006, Delco Oil voluntarily converted its Chapter 11 case to Chapter 7, and a Chapter 7 trustee was appointed. On June 26, 2007, the trustee filed a complaint to avoid and recover the post-petition payments that Marathon had received. The trustee argued that the post-petition payments were avoidable and recoverable from Marathon under Sections 549(a) and 550(a) of the Bankruptcy Code because they were improper unauthorized post-petition payments of the CapitalSource Cash Collateral made in violation of Bankruptcy Code Section 363(c)(2) because neither CapitalSource nor the bankruptcy court had ever authorized them.

Marathon argued that it had acted in good faith in selling petroleum product to Delco Oil under their supply agreement in exchange for the post-petition payments of equivalent value.

The bankruptcy court granted judgment against Marathon avoiding the post-petition payments and directing their repayment by Marathon. The district court upheld the judgment and Marathon appealed to the U.S. 11th Circuit Court of Appeals.

The Operative Bankruptcy Code Provisions

Section 549(a) of the Bankruptcy Code authorizes a trustee to avoid a debtor's post-petition transfer of property of the estate that is not authorized by the Bankruptcy Code or the bankruptcy court. Section 550(a) of the Bankruptcy Code then allows the trustee to recover the improperly transferred property from among other persons, the initial recipient of the transfer.

The other operative Bankruptcy Code provisions are Section 363(c)(1) and (2). Section 363(c)(1) allows a Chapter 11 debtor to use, sell or lease property of the estate in the ordinary course of business without notice and a hearing. However, Section 363(c)(2) limits a debtor's activities under Section 363(c)(1) by forbidding the debtor from using the cash proceeds of a secured lender's collateral, unless the debtor has obtained the secured creditor's consent or bankruptcy court approval for such use.

Marathon's Opposition to the Trustee's Section 549 Unauthorized Post-petition Transfer Claim

Marathon argued it was not subject to exposure under Section 549 because (a) the post-petition payments were not from the CapitalSource Cash Collateral and were, therefore, authorized ordinary course payments allowable under Bankruptcy Code Section 363(c)(1); (b) the post-petition payments to Marathon had caused no harm to either CapitalSource or Delco Oil's bankruptcy estate; and (c) Marathon was an innocent vendor that received the post-petition pay-

ments in the ordinary course of business in exchange for goods of equivalent value.

The Post-petition Payments Were Not From CapitalSource's Cash Collateral

Marathon, relying on Section 9-332 of Florida's Uniform Commercial Code, asserted that the post-petition payments were not from the CapitalSource Cash Collateral. UCC Section 9-332 allowed Delco Oil to transfer the CapitalSource Cash Collateral to Marathon, free and clear of CapitalSource's security interest, absent a showing of collusion between Marathon and Delco Oil to improperly divert CapitalSource's collateral. Marathon argued that it had acted in good faith in selling petroleum product to Delco Oil under their supply agreement in exchange for the post-petition payments of equivalent value, in the ordinary course of their business. Marathon also denied any knowledge that Delco Oil's payments to Marathon were improper payments of the CapitalSource Cash Collateral.

The Post-petition Payments Did Not Harm Either CapitalSource or Delco Oil's Bankruptcy Estate

Marathon also asserted a full defense to the trustee's Section 549 avoidance claim because Delco Oil's unauthorized payment of the CapitalSource Cash Collateral to Marathon did not harm either CapitalSource or Delco Oil's bankruptcy estate. No harm could be proved where Delco Oil had received petroleum product of equivalent value and these goods were subject to CapitalSource's perfected security interest. In the absence of such a showing, Delco Oil's violation of Section 363(c)(2) should be excused as harmless and purely technical that should not subject Marathon to exposure under Section 549.

Marathon Was an Innocent Vendor

Marathon also raised an innocent vendor defense to Section 549 actions as a matter of policy and consistent with the objectives of Chapter 11. Marathon had supplied new value—essential petroleum product—to Delco Oil in exchange for the post-petition payments in the ordinary course of their business. Without Marathon's new product, Delco Oil could not have survived. Marathon had no knowledge that the payments were from the CapitalSource Cash Collateral.¹ It was also not practical or realistic to expect a vendor, such as Marathon, to determine whether its customer in Chapter 11 has secured creditors and was improperly using their cash collateral.

The 11th Circuit's Delco Oil Decision

The U.S. 11th Circuit Court of Appeals sided with the trustee and ruled that Delco Oil's post-petition payments to Marathon were unauthorized transfers of CapitalSource's Cash Collateral and property of Delco Oil's bankruptcy estate that were avoidable and recoverable under Sections 549 and 550 of the Bankruptcy Code. The court first rejected Marathon's argument that the post-petition payments were not from the CapitalSource Cash Collateral by virtue of UCC Section 9-332. What mattered was that CapitalSource had a perfected security interest in these funds, as cash proceeds of CapitalSource's collateral, prior to their payment to Marathon.

As a result, Delco Oil was prohibited from paying them to Marathon under Section 363(c)(2) without CapitalSource's or the bankruptcy court's permission. It did not matter that the post-petition payments were free of CapitalSource's security interest when received by Marathon by virtue of UCC Section 9-332.

The 11th Circuit also rejected Marathon's "harmless exception" defense to the trustee's Section 549 action based on a lack of harm to either CapitalSource or Delco Oil's bankruptcy estate from Delco Oil's unauthorized payments to Marathon. Section 549 does not contain a "harmless exception" defense to a trustee's avoidance powers. It did not matter that the vendor had sold and delivered petroleum products of equivalent value to the debtor that did not diminish or otherwise "harm" either the debtor's secured lender or the debtor's bankruptcy estate. Once the trustee proves that the debtor had made unauthorized post-petition transfers of property of the estate, the trustee is entitled to avoid the transfers under Section 549, and then recover them from the recipient under Section 550.

Here, there was no question the post-petition payments were unauthorized because they were made from CapitalSource's Cash Collateral, without either CapitalSource's or the bankruptcy court's approval, as required by Section 363(c)(2). As a result, the court upheld avoidance of the post-petition payments under Section 549 and their recovery from Marathon.

Finally, the 11th Circuit rejected Marathon's "innocent vendor/ordinary course defense" to Section 549 claims. Bankruptcy Code Section 363(c)(1) allows a Chapter 11 debtor to use, sell or lease property of the estate in the ordinary course of the debtor's business, without notice or a hearing. However, Section 363(c)(2) forbids the debtor from using a secured lender's cash collateral, even in the ordinary course of business, unless either the secured creditor or the bankruptcy court approves such use.

The 11th Circuit was simply unwilling to create an innocent vendor/ordinary course payment defense to Section 549 actions that does not otherwise exist in Section 549 or any other provision of the Bankruptcy Code. The court noted that neither Bankruptcy Code Section 549 nor any other provision of the Bankruptcy Code permits the recipient of an unauthorized post-petition transfer of estate property to raise its status as an innocent vendor or purchaser as a defense to a Section 549 avoidance action. It did not matter that Marathon had provided equivalent value in exchange for its post-petition payments, lacked knowledge of the voidability of the payments, or otherwise acted in good faith.

The Moral of the Delco Oil Story

While the facts of the *Delco Oil* case are somewhat unusual, the ruling of the U.S. 11th Circuit Court of Appeals serves as a warning that trade creditors might be at risk if they sell goods or provide services to a Chapter 11 debtor, even on a cash-in-advance basis, where the cash is subject to the security

interest of the debtor's lender prior to payment. A vendor considering post-petition sales to a Chapter 11 debtor, that has a secured lender with a valid and perfected security interest in the debtor's cash, should first confirm that either a cash collateral order or Chapter 11 financing order has been entered authorizing the debtor's cash payments to the vendor, or the secured lender has approved the debtor's payments to the vendor. Otherwise, according to *Delco Oil's* holding, the debtor's post-petition payments to the vendor may be considered "unauthorized" for purposes of Section 549, subjecting

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the vendor to the risk of avoidance and repayment. The vendor's protestations of its lack of knowledge of the voidability of the payments, and that its post-petition sales to the debtor and the debtor's post-petition payments to the vendor were in the ordinary course of business and the secured lender and debtor's estate were not harmed by the payments won't be sufficient to avoid this horrific result! ●

1. The lower court decisions stated that Marathon had sufficient notice of CapitalSource's objection to Delco Oil's use of cash collateral when Marathon had sold post-petition goods to and received payments from Delco Oil. This did not have an impact on the 11th Circuit's decision.

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