2019 BANKRUPTCY AT THE BEACH
32nd Annual Seminar
Alabama State Bar
Bankruptcy & Commercial Law Section

June 7-8, 2019

Cash Collateral: Components, Concepts, and Consequences

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Introduction

Often cash collateral matters come and go in bankruptcy proceedings without issue. Indeed, when addressed promptly and proactively, cash collateral issues may even be routine. But in the absence of prompt and proactive handling, the unauthorized use of cash collateral may occur and ultimately prove consequential. Consequences that may result from practitioners having the mistaken impression that Chapter 11 and Chapter 13 cases are essentially one in the same.[1] These materials intend to address those consequences as well as provide an overview of cash collateral components and concepts under the Bankruptcy Code.

Cash Collateral Components

Cash collateral has two components: the "first component identifies the type of property" that constitutes cash collateral and the "second component of cash collateral is that it must be

[1] "[N]otwithstanding the similarity of many Chapter 11 and Chapter 13 provisions, there is no basis to conclude, as a general matter, that Chapter 11 and Chapter 13 are otherwise parallel. The structure of each Chapter is substantially different in many ways." *Matter of Kennedy*, 158 B.R. 589, 596 (Bankr. D.N.J. 1993). *See e.g. Toibb v. Radloff*, 501 U.S. 157, 164 (U.S. 1991) ("Moreover, differences in the requirements and protections of each chapter reflect Congress' appreciation that various approaches are necessary to address effectively the disparate situations of debtors seeking protection under the Code."); *Bass v. Fillion, (In re Fillion)*, 181 F.3d 859, 862 (7th Cir. 1999) ("Confirmation of a Chapter 13 plan requires a substantially different inquiry than needed for a Chapter 11 plan."); *Meier v. Katz (In re Meier)*, 550 B.R. 384, 390 (N.D. Ill. 2016) ("[A]s the trustee points out, there are numerous procedural and substantive differences between Chapter 11 and Chapter 13 proceedings . . . The differences between Chapter 13 and Chapter 11 are replete with policy considerations, and Congress is better equipped at making these policy choices than the courts."); *In re Ginko Associates, L.P.*, No. 05-19436bf, 2009 WL 2916917, *1, *3 (Bankr. E.D. Pa. 2009) (observing that "[t]he structure of chapter 13 and chapter 11 are significantly different. . . .").

property 'in which the estate and an entity other than the estate have an interest.'"[2] Section 363(a) begins by providing that: "'cash collateral' means cash, negotiable instruments, documents of title, deposit accounts, or other cash equivalents whenever acquired."[3] Cash collateral also "includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provide in section 552(b) of this title whether existing before or after the commencement of a case under this title."[4] Section 552(b) is an exception to the general rule of section 552(a), which provides that property acquired post-petition by the debtor or estate is not subject to any lien resulting from a pre-petition agreement.[5] Section 552(b) states that:

> [I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law . . . .

11 U.S.C. § 552(b). "This exception allows lenders to follow their legitimate interests in transmuted forms of their collateral; a security interest in a receivable generated prepetition is not

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[2] *In re Las Vegas Monorail Co.*, 429 B.R. 317, 328-29 (Bankr. D. Nev. 2010).

[3] 11 U.S.C. § 363(a).

[4] *Id.*

[5]Precisely, 11 U.S.C. § 552(a) provides that ". . . property acquired by the estate or by the debtor after commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before commencement of the case.").

lost in bankruptcy simply because it was paid in cash after filing."[6] By way of example, "the debtor will be able to sell inventory or collect accounts receivable as noncash collateral, but the cash proceeds will be cash collateral, even though they are acquired by the debtor after the commencement of the case."[7]

The second component of cash collateral concerns the requirement that it must be property "in which the estate and an entity other than the estate have an interest."[8] As one court explained:

> This typically means that the party seeking protection with respect to cash collateral has some ownership or property interest in the disputed cash collateral. This component is satisfied if the "interest" is a security interest or lien recognized under nonbankruptcy law. This recognition can take the form of a lien granted by statute, such as a mechanic's lien on a car brought in for repairs, or a consensual security interest such as that governed by Article 9 of the Uniform Commercial Code ("UCC").

Thus, "by its terms, the definition of cash collateral is expansive and includes cash and all types of cash equivalents whether existing before or after case commencement."[9]

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[6] *In re Las Vegas Monorail*, 429 B.R. at 328.

[7] Committee on the Administration of the Bankruptcy System of the Judicial Conference of the United States, *Cash Management Manual for United States Bankruptcy Judges*, 628 (2d ed. 2012).

[8] *See In re Las Vegas Monorail*, 429 B.R. at 328 (citing 11 U.S.C. § 363(a)).

[9] Michael J. Holleran, Donna Larsen Holleran & John B. Corr, *Bankruptcy Code Manual* § 363:2 (May 2018 Update); *see also Matter of Wheaton Oaks Office Partners Ltd. Partnership*, 27 F.3d 1234, 1240 (7th Cir. 1994) (noting that 363(a) is "intentionally broad.").

Cash Collateral Concepts under the Code

"Cash collateral motions[10] are generally 'first day' motions[11] filed promptly after a chapter 11 case is initiated."[12] But when the general course does not prevail and, for whatever reason, prompt action is lacking, inattention to cash collateral issues can quickly prove consequential. This is especially true when a debtor, postpetition, uses cash collateral without authority -- even if the cash used is expended in the ordinary course of business.[13] Section 363(c)(2) imposes the requirement of consent or authorization to use cash collateral and, in the absence of either, the use of cash collateral postpetition is categorically unauthorized. Indeed, the "Bankruptcy Code prohibits the post-petition use of cash collateral by a trustee or a debtor-in-possession, unless the secured party or the bankruptcy court after notice and a hearing authorizes the use of cash collateral

[10] A motion for the authorization to use cash collateral is handled as a contested matter and should comply with Bankruptcy Rule 4001(b)(1)(B). As with any motion, local rules should likewise be consulted.

[11] "In the typical Chapter 11 case, the debtor in possession or trustee will have an immediate need to use cash collateral, and a fourteen-day delay at the outset of the case could be fatal to the reorganization effort." *Cash Management Manual for United States Bankruptcy Judges, supra,* 630. Therefore, interim relief may be requested. If interim relief is requested, however, the "court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing." Fed. Rule. Bankr. P. 4001(b)(2).

[12] *In re Bowers Investment Company, LLC.*, 553 B.R.762, 773 (Bankr. D. Alaska 2016).

[13] William L. Norton, 2 *Norton Bankruptcy Law and Practice* § 44.5 (3d ed. 2008, April 2019 Update) (citing *In re Three Partners, Inc.*, 199 B.R. 230 (Bankr. D. Mass. 1995) for the proposition that a "trustee can recover payments made with cash collateral where made without consent or court order, even if made in ordinary course of business, as Code § 363(c)(2) trumps Code § 363(c)(1)."); *see also In re Premier Golf Properties, LP*, 564 B.R. 710, 725–26 (Bankr. S.D. Cal., 2016) ("Debtor incorrectly attempts to read § 363(c)(1)'s 'ordinary course of business' language into § 363(c)(2). Whether or not Debtor sold estate assets in the ordinary course of business, it needed authority to use cash collateral.").

upon a finding that the secured party's interest in the cash is adequately protected."[14] While adequate protection is not defined in the Bankruptcy Code, "section 361 provides three non-exclusive examples of adequate protection" which include: (1) periodic payments; (2) additional or replacement liens; or (3) other relief "as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."[15]

The Eleventh Circuit has ascertained the purpose of § 363(c)(2) as balancing "competing interests in a Chapter 11 reorganization." It described this balance in the *In re Delco* decision:[16]

> [A] debtor reorganizing his business has a compelling need to use cash collateral in order to meet its daily operating expenses and rehabilitate its business. *In re George Ruggiere Chrysler–Plymouth, Inc.*, 727 F.2d 1017, 1019 (11th Cir.1984). At the same time, however, unhindered use of cash collateral, i.e., "secured 'property' may result in the dissipation of the estate." *Id.* Section 363(c)(2) resolves this tension between a debtor and a secured creditor by only allowing the debtor to use cash collateral after it has procured either the secured creditor's or the bankruptcy court's permission upon a showing that the secured creditor's interest is adequately protected. *Id.* [17]

In practice, balancing these competing interests means that:

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[14] *Marathon Petroleum Co., LLC. v. Coehn* (*In re Delco Oil, Inc*.), 599 F.3d 1255, 1258 (11th Cir. 2010) (citing 11 U.S.C. § 1107 (providing a debtor-in-possession the rights, powers, functions and duties of a bankruptcy trustee); 11 U.S.C. § 363(c)(2) ("The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—(A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section."); 11 U.S.C. § 363(e) ("[O]n request of an entity that has an interest in property ... proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.")).

[15] *See In re Topgallant Group, Inc*. No. 89-41997, 1992 WL 12004198, *1, *7 (S.D. Ga. Dec. 23, 1992); *see also* 11 U.S.C. § 361.

[16] 599 F.3d 1255, 1258 (11th Cir. 2010). The *In re Delco* decision is discussed at length *infra* pp. 15-19.

[17] *In re Delco*, 599 F.3d at 1258.

> [A] bankruptcy court should apply the following standard when determining whether a debtor should be permitted to use cash collateral: (1) The court must establish the value of the secured creditor's interest; (2) The court must identify risk to the secured creditor's value resulting from the debtor's request for use of cash collateral; and (3) The court must determine whether the debtor's adequate protection proposal protects as nearly as possible against risks to that value consistent with the concept of indubitable equivalence.[18]

Therefore, "while § 363(c)(2) authorizes the trustee [or debtor-in-possession as extended under 11 U.S.C. §1107] to use, sell, or lease *property of the estate* in the ordinary course of business without notice and hearing, § 363(c)(2) restricts that authority if the property is cash collateral."[19]

The cash collateral rules are "intended to recognize the unique nature of cash collateral, and the risk to the entity with an interest in such collateral, arising from the dissipation or consumption of the collateral in a rehabilitative effort in bankruptcy."[20] Thus, the "special treatment afforded cash collateral recognizes its unique status as the highest and best form of collateral but also establishes that upon an appropriate showing it can be used if the rights of the secured creditor can be adequately protected."[21] The uniqueness of cash collateral distinctly informs the statutory authority that governs it, which also requires segregation of cash collateral under § 363(c)(4). Section 363(c)(4) "requires a trustee [or debtor-in-possession as extended under 11 U.S.C. §1107] to segregate and account for any cash collateral in the trustee's possession,

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[18] *LightStyles, Ltd. v. Susequehanna Bank (In re LightStyles, Ltd.)* No. 1:12-bk-03711 MDF, 2012 WL 3115902, *1, *3 (Bankr. M.D. Pa. July 27, 2012) (citing *Martin v. United States (In re Martin)*, 761 F.2d 472, 476-77 (8th Cir. 1985).

[19] *In re Three Partners*, 199 B.R. 230, 236 (Bankr. D. Mass 1995).

[20] 3 Alan N. Resnick & Henry J. Sommer, *Collier on Bankruptcy* ¶ 363.03[4][c] (16th ed. 2014).

[21] *Id.* at ¶ 363.05[3].

custody or control."[22] And in the "absence of authorization to use cash collateral, the trustee is responsible for maintaining the collateral for the protection of the creditor with an interest in the collateral."[23] In the event that there is unauthorized use of cash collateral, the failure to segregate cash collateral can further negatively reflect upon debtor and their ability, or lack thereof, to "deal effectively with the cash collateral issues."[24]

Section § 363(c) makes clear that the Bankruptcy Code imposes certain requirements and restrictions for the use of cash collateral. Compliance with section 363 is often made easier, however, by consent from the secured party. As one commentator notes: The "requirements of notice and a hearing and of court authorization, before cash collateral may be used, sold or leased, may at first blush appear to be particularly onerous to a debtor in possession faced with a genuine emergency. However, often a secured party will consent to limited use of the cash collateral to preserve the value of its interest in other collateral."[25] Consent is "typically in the form or a stipulation or agreed order which authorizes the debtor's use of cash collateral, under certain terms and conditions."[26] And, typically, a chapter 11 debtor files an emergency motion for use of cash collateral when the petition is filed. But in the atypical case, consent can become a thorny issue.

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[22] *Id.* at ¶ 363.03[4][b].

[23] *Id.*

[24] *See In re Bowers*, 553 B.R. at 773 (holding that the debtor's "continuing refusal to segregate" cash collateral contributed to a finding of cause to support dismissal or conversion pursuant to 11 U.S.C. § 1112(b)(4)(D)).

[25] Resnick & Sommer, *supra*, ¶ 363.03[4].

[26] Norton, *supra*, § 44.5.

Under the Bankruptcy Code, there is no requirement for written consent to use cash collateral. Consequently, in cases where there is no written consent that is dispositive of the issue, whether a creditor consented to the debtor's use of cash collateral may be disputed. Such a dispute gives rise to the question of whether express or implied consent is required under the Code. To date, the Eleventh Circuit has not addressed this precise issue and the topic is not prevalent in the case law. And while the case law is scant, the consensus nonetheless favors express consent. [27] In a 1987 decision from the Ninth Circuit, the Court held that express consent is required:

> [W]e find that the purposes underlying § 363(c)(2) & (4) require that a debtor seek affirmative *express* consent from all parties involved before using cash collateral. *See 2 Collier on Bankruptcy,* 363.02 (15th ed. 1986) (the protection offered by § 363(c)(2) is "in recognition of the unique nature of cash collateral and the risk to the entity with an interest therein arising from the consumption of the collateral in a rehabilitative effort in bankruptcy."); 2 *Collier on Bankruptcy,* 363.04 ("It was recognized that due to the unique nature of cash collateral, specific protections should apply to prevent its dissipation, leaving the court and the entity with an interest therein with a *fait accompli.*"). Without deciding whether Freightliner, by its actions, gave debtor its implied consent to use the cash collateral or is estopped from denying such consent, we find implied consent to be insufficient to satisfy the requirements of § 363(c)(2).[28]

Similarly, it has been held that the failure of a secured creditor to object to the unauthorized use of cash collateral is not "tantamount to that creditor's consent to the use of cash collateral."[29]

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[27] *See e.g. In re Madawaska Hardscape Products, Inc*., 476 B.R. 200, 214 (Bankr. D.S.C. 2012) ("A debtor's offer of adequate protection for the use of cash collateral without the express consent of the creditor is not sufficient to meet the requirements of § 363(c)(2)"); *In re Cha Hawaii, LLC.*, 426 B.R. 828 (Bankr. D. Haw. 2010) (the creditor's consent to the use of cash collateral must be express, not implied."); *In re Three Partners*, 199 B.R. 230, 236 (Bankr. D. Mass 1995) ("The Debtor's failure to obtain the express consent of the IRS for the use of cash collateral violated § 363(c)(2)(A).").

[28] *Freightliner Market Development Corp. v. Silver Wheel Freightlines, Inc*., 823 F.2d 362, 368–69 (9th Cir. 1987).

[29] *In re Three Partners*, 199 B.R. at 237.

And at least one court has rejected a debtor's argument that consent was given in a prepetition agreement, holding instead that "regardless of the prepetition conduct of the parties . . . [t]he consent to the use of cash collateral contemplated under Code [§] 363(c)(2)(A) must, of necessity, be regarded as a post-petition consent."[30] Even though there is some authority for the proposition that a "secured creditor on notice may not choose to ignore unauthorized use of cash collateral until a chapter 11 case is converted and then seek to recover damages for all of the funds so misused,"[31] express consent, preferably in writing, is undeniably the better course.

Cash Collateral Consequences

As alluded to above, "[t]he use of cash collateral without court authorization or the creditor's consent can have harsh consequences." Indeed, the unauthorized use of cash collateral has prompted strong commentary by more than one court.[32] For example, in *In re Cha*, the court admonished: "[T]he unauthorized use of cash collateral is a significant offense that I will not overlook or condone. This is true even though there is no evidence that the debtors knowingly or intentionally violated [the creditor's] rights in the cash collateral, and even though [the creditor]

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[30] *Hartigan v. Pine Lake Village Apartment Co. (In re Pine Lake Village Apartment Co.)*, 16 B.R. 750 (Bankr. S.D.N.Y. 1982).

[31] *Ossen v. Bernatovich (Matter of National Safe Northeast, Inc*.), 76 B.R. 896, 906 (Bankr. D.Conn. 1987).

[32] *See e.g. In re Visicon Shareholders Trust*, 478 B.R. 292, 314 (Bankr. S.D. Ohio 2012) (holding: "[t]he Debtor''s unauthorized use of cash collateral to pay the numerous personal expenses of the insiders, to pay prepetition claims, to make unauthorized payments to professionals . . . and the payment of expenses for which no explanation was given unequivocally rises to a level of being 'considerable in importance, value, degree, amount, or extent.' [Hence], "[n]on-priority unsecured creditors were paid in *complete derogation of the bankruptcy priority scheme*. No evidence was presented to establish the appropriateness or legal justification for these payments." (emphasis added)).

has never contended that the debtors used the cash for any purpose other than paying normal and reasonable business and administrative expenses."[33]

A bankruptcy court has "discretion in how it remedies the unauthorized use of cash collateral."[34] And in exercising this discretion, courts have fashioned remedies for the unauthorized use of cash collateral that "include dismissal of the case or granting relief from the automatic stay."[35] Moreover, pursuant to 11 U.S.C. § 1112(b)(1), a bankruptcy court "upon request of a party in interest, shall dismiss or convert a Chapter 11 case for cause, whichever is in the best interest of the creditors and the estate, unless the court determines that the appointment of a trustee or examiner is in the best interests of the creditors and the estate."[36] "Cause to dismiss a chapter 11 case exists where (1) a debtor uses cash collateral without consent of the secured creditor or court approval of the use of cash collateral, and (2) the creditor suffers substantial harm as a result of the unauthorized use."[37] As such, the unauthorized use of cash collateral is an explicit ground for dismissal.[38]

In the *In re Visicon Shareholders Trust* case, the court considered what constitutes substantial harm in the context of unauthorized use of cash collateral.[39] Substantial, the court

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[33]*In re Cha*, 426 B.R. at 837.

[34]*In re Visicon*, 478 B.R. at 317.

[35] *In re Bowers*, 553 B.R. at 771.

[36] *In re Visicon*, 478 B.R. at 309 (citing 11 U.S.C. . § 1112(b)(1)).

[37]*In re Dorn*, No. 10-00951-DD, 2010 WL 5437238, *1, *3 (Bankr. D.S.C. 2010) (citing 11 U.S.C. § 1112(b)(4)(D)).

[38] 11 U.S.C. § 1112(b)(4)(D).

[39] *In re Visicon*, 478 B.R. at 314.

noted, is "defined as 'considerable in importance, value, degree, amount, or extent."[40] And the court found that the debtor's use of unauthorized cash collateral to "pay insiders' personal expenses and certain non-priority unsecured creditors" with no evidence to prove the expense "benefited the estate or was otherwise justified" met that definition.[41] In *Pena v. Manfredo*, the debtor did not file his cash collateral motion until the date of his meeting of creditors, which was six weeks after he filed his bankruptcy petition.[42] In the meantime, the debtors used $16,000 in cash collateral.[43] Pursuant to 11 U.S.C. § 1112(b)(4)(D), the bankruptcy court converted the case because at least one creditor was substantially harmed by the unauthorized use of cash collateral.[44] In affirming on appeal, the district court noted that some of the $16,000 was used for business overhead and secured debt payment, but nonetheless found conversion warranted.[45] More recently, a bankruptcy court found that even though "strict use" cash collateral to pay the operating expenses of the estate "might preclude a finding of substantial harm," it would not so preclude that finding in a case where the "debtor's reluctance to deal effectively with the cash collateral issues . . . its failure to completely and accurately account for the use of cash collateral, and its continuing refusal

[40] *Id.*

[41] *In re Bowers*, 553 B.R. at 772 (citing *In re Visicon Shareholders Trust*, 478 B.R. 292 (Bankr. S.D. Ohio 2012)).

[42] *Pena v. Manfredo*, No. 12-01233-AWI, 2013 WL 4814581, *1 (E.D. Cal. 2013).

[43] *Id.* at *2.

[44] *Id.* at *6.

[45] *Id.*

to segregate the monthly expenses" associated with the secured creditor's collateral also constituted substantial harm.[46]

Beyond conversion or dismissal, as provided for in 11 U.S.C. § 1112(b)(4)(D), "courts have employed a number of devices to achieve restitution for the affected creditor, as well as to create an effective incentive for a debtor-in-possession, as well as for debtors-in-possession in future cases, to take affirmative action to insure compliance with the cash collateral restrictions imposed by the Code."[47] Those devices include "the imposition of a replacement lien upon other unencumbered property of the estate; the repayment of the converted funds by the debtor or the debtor's principals; the grant of a superpriority administrative expense; the entry of a judgment declaring the debt arising from the defalcation to be non-dischargeable; the entry of a conversion judgment for money damages; the granting of stay relief; the appointment of an examiner; the appointment of a Chapter 11 trustee; or [as previously mentioned] the conversion of the case to Chapter 7."[48] In implementing one of these devices, namely, a replacement lien, the court in *In re Aerosmith Denton Corporation* explained:

> It is true that there are no apparent provisions of the Code which specifically provide sanctions for the failure of the debtor to comply with "cash collateral" requirements. However § 105(a) of the Code gives to the Bankruptcy Court the power to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. Regardless of debtor's argument that § 105 was not intended to confer the power to create lien rights the Court does have an obligation to carry out the intent of Congress in its enactment of the Bankruptcy Code. As mentioned above the continuation of lending transactions between the business community on the one hand and lending institutions on the other require

[46] *In re Bowers*, 553 B.R. at 773.

[47] *In re Four Seasons Marine & Cycle, Inc.*, 263 B.R. 764, 769 (Bankr. E.D. Texas 2001).

[48] *In re Four Seasons*, 263 B.R. at 769 (citing Harley J. Goldstein & Craig A. Sloane *Spending Other People's Money: Creditor's Remedies for Misuse of Cash Collateral in Bankruptcy*. 7 U. Miami Bus. L. Rev. 243, 249 (1999).

> that liens negotiated in good faith and for which full consideration has been given must be protected. Adoption of the theory advanced by the debtor that there are no applicable sanctions, so that a valid lien of a creditor is recognized by the Court but both the Court and the creditor are powerless to preserve and protect that lien after bankruptcy has been initiated, will result in anarchy. That cannot be the result intended by Congress. Therefore I have interpreted § 105(a) of the Code as giving to the Court the power and the duty to do those things which are reasonably required to protect the Court's jurisdiction and to carry out the intent of Title 11.[49]

But consequences for the unauthorized use of cash collateral are not confined to the offending debtor. In fact, courts have not only contemplated but also imposed sanctions against corporate officers. In the case of *In re A-1 Specialty Gasolines, Inc.,* the court held the debtor's officer/sole shareholder and billing clerk in contempt of court and assessed compensatory sanctions for violating the Bankruptcy Code's cash collateral provisions.[50] In doing so, the court held:

> [P]rotections afforded by Section 363(c) are sufficiently important to warrant a finding of contempt when the provision is violated. To hold otherwise would be to allow debtors-in-possession to violate Section 363(c) unless and until the court enters an order effectuating the Code provision. The Court is not aware of any authority indicating that Code provisions are not self-effectuating unless the provision states otherwise. Such a construction would reduce Section 363(c) to a provision granting bankruptcy courts discretion to enter an order prohibiting use of cash collateral, when requested by a creditor or party in interest, but otherwise allowing debtors-in-possession to do with impunity exactly what the Code provision says they cannot do.[51]

Likewise, in the case of *In re Four Seasons Marine & Cycle,* the court observed the propriety of assessing sanctions against corporate officers. While the *Four Seasons* court ultimately decided

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[49] *Mercantile National Bank at Dallas v. Aerosmith Denton Corp. (In re Aerosmith Denton Corp.),* 36 B.R. 116, 119 (Bankr. Tex. 1983).

[50] *In re A-1 Specialty Gasolines, Inc*., 246 B.R. 445, 450 (Bankr. S.D. Fla. 2000).

[51] *In re A-1 Specialty Gasolines*, 246 at 450.

against sanctions (because an "adequate alternative remedy" was available to the secured creditor), it nonetheless recognized sanctioning corporate officers as a viable option for rebuking the unauthorized use of cash collateral:

> [U]nder appropriate circumstances, but particularly in a liquidation context such as this, a secured creditor damaged by the misuse of its cash collateral by a debtor corporation, acting in a debtor-in-possession capacity, may properly look to the officers of the defunct debtor corporation for satisfaction of that claim, and that the authority granted to a bankruptcy court under § 105(a) of the Code to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title" authorizes this court to enforce the cash collateral restrictions of the Code by issuing a monetary assessment against those former corporate officers.[52]

Significantly, counsel may also face sanctions in connection with the unauthorized use of cash collateral. In *Midwest Properties No. Two v. Big Hill Investment, Co., Inc*, the district court held that there was "ample evidence to support [the bankruptcy court's] finding that cash collateral was improperly used without affirmative consent of the creditors or an order of the bankruptcy court" and therefore the bankruptcy court did not abuse its discretion is awarding monetary sanctions against the debtor company's president and its attorney for unauthorized use of cash collateral.[53] It is worth noting that the evidence upon which the bankruptcy court relied upon assessing sanctions was undisputed: there was no consent nor court approval for the use of cash collateral, yet the debtor spent over $550,000 in cash collateral between April and May, 1987.[54] And while the court refrained from imposing sanctions against an attorney in the *In re Aerosmith Denton Corporation* case, it nonetheless stated: "the law should now be settled in this court—

[52] *In re Four Seasons*, 263 B.R. at 771.

[53] *Midwest Properties No. Two v. Big Hill Inv. Co., Inc.*, 93 B.R. 357, 363–64 (N.D. Tex. 1988).

[54] *Midwest Properties No. Two*, 93 B.R. at 362.

proper sanctions can be imposed against those responsible for use of cash collateral after a Title 11 case has been filed when there has been no compliance with § 363(c)(2)."[55]

The Eleventh Circuit's *In re Delco Oil*[56] decision is perhaps the best example, however, of how far-reaching the consequences of the unauthorized use of cash collateral can be. Up to this point in the caselaw mentioned, the consequences of the unauthorized use of cash collateral have been, somewhat predictably, borne by the offending debtor with possible risk to corporate officers or counsel as well. But *In re Delco Oil* broadened the landscape and widened the horizon, in terms of bringing so-called "innocent vendors" into the fold of those affected by the unauthorized use of cash collateral. In that case, the debtor, Delco Oil, "a distributor of motor fuel and associated products," filed bankruptcy six months after granting a bank (CaptialSource) a security interest in all of the debtor's "personal property, including collections, cash payments, and inventory."[57] Upon filing for bankruptcy, the debtor also filed an emergency motion requesting authorization to use cash collateral to continue its operations.[58] The bank objected to the motion.[59] The bankruptcy court denied the cash collateral motion three weeks later.[60] Thus, in between the time the motion was filed (October 18, 2006) and the denial of the same (November 6, 2006), the debtor, operating

[55] *In re Aerosmith Denton Corp*., 36 B.R. 116, 119–20 (Bankr. N.D. Tex. 1983).

[56] 599 F.3d 1255 (11th Cir. 2010).

[57] *Id.* at 1257.

[58] *Id.*

[59] *Id.*

[60] *Id.*

as a debtor-in-possession, used its cash collateral to "distribute over 1.9 million in cash to [vendor] Marathon in exchange for petroleum products pursuant to its sales agreement."[61]

The debtor voluntarily converted its bankruptcy to a chapter 7 proceeding in December 2006. Thereafter, a trustee was appointed, and an adversary proceeding was filed against the vendor to avoid the 1.9 million in cash transfers.[62] The bankruptcy court granted summary judgment in favor of the trustee, which was affirmed on appeal.[63] On appeal, the Eleventh Circuit framed the issue before it as "whether a bankruptcy trustee may avoid post-petition payments by a debtor under 11 U.S.C. § 549(a) and § 363(c)(2) as unauthorized transfers of cash collateral."[64]

In affirming summary judgment for the trustee, the Eleventh Circuit cited extensively from § 363 of the Bankruptcy Code and, as mentioned above, recognized § 363(c)(2) as balancing "competing interests in Chapter 11 reorganization."[65] But it rejected the vendor's argument that the subject funds did not constitute cash collateral. [66] The vendor argued that pursuant to Florida's replica of U.C.C. § 9-332(b), which provides"[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party," the proceeds lost their status as cash

[61] *In re Delco Oil*, 559 F.3d at 1257.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.* at 1259.

collateral upon transfer.[67] The Court conceded the fact that after the debtor transferred the funds to the vendor the funds were no longer subject to the bank's security interest, but it held that "[s]uch a result, however, has no bearing on the following dispositive facts: (1) The bankruptcy code prohibited the transfer to [vendor] Marathon altogether, because [the bank] CaptialSource had a perfected security interest in the Debtor's cash proceeds while they were in Debtor's hands, and (2) the bankruptcy code allows the trustee to avoid and take back unauthorized transfers."[68] Examining the status of the "funds while they were in 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 Debtor's control" was necessary, the Court held, because:

> Otherwise, a debtor could circumvent Section 363(c)(2)'s prohibition on the use of cash collateral without the secured creditor's or bankruptcy court's permission by distributing cash proceeds it knows are subject to a security interest as it likes, knowing that once distributed the proceeds would not be defined as cash collateral under Section 363(a) and, therefore, the transfer would not violate Section 363(c). Such an outcome would render Section 363(c) virtually meaningless, leaving a debtor generally free to transfer cash or its equivalent that is subject to a security interest.[69]

The Eleventh Circuit also held that a "harmless exception" to a trustee's avoiding powers does not exist and there was no doubt that the transfers to the vendor were unauthorized "because the Debtor completed them without the permission of CapitalSource [the bank] or the bankruptcy court in express violation of Section 363(c)(2)."[70] Further, the Court rejected an "innocent vendor"

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[67] *Id.*

[68] *Id.*

[69] *Id.* at 1260-61.

[70] *Id.* at 1262.

defense.[71] The Court stated: "Congress knew how to create exceptions based on transferee's status and culpability. But it chose not to do so when it came to initial transferees of post-petition transfers of cash collateral. We will not create such exceptions in Congress's absence."[72]

In the wake of the *In re Delco Oil* decision, several commentators have written articles concerning its impact and even criticizing its result.[73] But, to date, no cases have directly taken on the decision. Instead, a few cases have declined to extend the holding or distinguished the decision on its facts.[74] At least one court reached a different result on grounds that the Eleventh Circuit did not address standing in *In re Delco Oil,* namely, the issue of an injury to the estate as a jurisdictional question.[75] Nonetheless, the *In re Delco Oil* decision stands and it is a worthy reminder of just how consequential the use of unauthorized cash collateral can be.

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[71] *Id.* at 1263.

[72] *Id*.

[73] *See e.g.* Juan Mendoza, *Avoiding the Inequities Created by In re Delco Oil, Inc. – The Need for an Innocent Vendor Exception,* 30 EMORY BANKR. DEV. J. 257 (2013); Shane G. Ramsey, *Avoiding the Pitfalls of In re Delco Oil*, AM. BANKR. INST. J., April 2011 at 62, 63, 100; Jonathon Friedland & Bill Schwartz, *Punishing the Innocent: Lessons from Delco Oil,* AM. BANKR. INST. J., May 2010 at 87-89.

[74] *See e.g. Abbott v. Arch Wood Protection, Inc.* (*In re Wood Treaters*), 479 B.R. 122 (Bankr. M.D. Fla. 2012); *In re Indian Capitol Distributing, Inc.,* 2011 WL 4711895 (Bankr. D.N.M. 2011).

[75] *In re Wood Treaters*, 479 B.R. 122, 128 ("In this case, therefore, as in *Indian Capitol,* the Court may consider the question of injury to the estate as a jurisdictional matter under Article III of the Constitution. The Eleventh Circuit's decision in *Delco* does not preclude the analysis of exchanged value, since the facts in *Delco* were materially different from the situation in this case, and since the issue of injury to the estate was not evaluated by the Eleventh Circuit as a jurisdictional question."); *see also Dill v. Hall (In re Indian Capitol Distributing, Inc.*), No. 10-1180-S, 2011 WL 4711895, *1 (Bankr. D. N.Mex. Oct. 5. 2011).

Conclusion

The unauthorized use of cash collateral is strictly proscribed. In no uncertain terms, the Bankruptcy Code provides: "The trustee [and, by extension, the debtor-in-possession under 11 U.S.C. §1107] may not use, sell, or lease cash collateral under paragraph (1) or (2) of this subsection unless— (A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section."[76] Therefore, counsel should be mindful to address cash collateral issues promptly and proactively. The failure to do so may have far-reaching and case-ending consequences.

[76] 11 U.S.C. § 363(c)(2).