





In Re Delco Oil, Inc.— A Cautionary Tale for Vendors Doing Business with Chapter 11 Debtors

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Sellers of goods and services to companies in bankruptcy have to manage credit and other risks. A recent decision of the Eleventh Circuit has created a hidden risk that vendors may not be able to control. In *In re Delco Oil, Inc.*,¹ the Eleventh Circuit required an innocent vendor to return almost \$2.0 million in payments for goods delivered to the bankruptcy estate. Although the payments were in the ordinary course of business and for value, the Eleventh Circuit avoided the payments because the chapter 11 debtor did not have authority to use cash collateral.

Preliminary Considerations

The Chapter 11 Debtor in Possession

In most cases, a debtor in chapter 11 remains in possession and control of the bankruptcy estate and exercises the powers and duties of a trustee under title 11 of the United States Code (the “Bankruptcy Code”).² Moreover, under Section 1108 of the Bankruptcy Code, a debtor-in-possession (the “DIP”) automatically is authorized to operate its business.³

To minimize disruption of normal operations, Section 363(c)(1) of the Bankruptcy Code authorizes the DIP to enter into transactions in the ordinary course of business without notice and a hearing.⁴ However, Section 363(c)(2) of

the Bankruptcy Code provides that the DIP may not use, sell or lease “cash collateral” without either (i) the consent of each creditor that has an interest in the cash or (ii) court authorization, granted after notice and a hearing.⁵ Most commonly, cash collateral consists of cash, deposit accounts and other cash equivalents, such as proceeds of accounts receivable and inventory, that are subject to a lender’s security interest.⁶ A creditor’s interest in cash collateral is protected further by Section 363(e), which provides that, upon request of the creditor, the bankruptcy court must prohibit or condition the DIP’s use, sale or lease of property “as is necessary to provide adequate protection of such interest.”⁷

These restrictions on using cash collateral are designed to strike a balance between the competing interests in the collateral. On one hand, the DIP has a compelling need to use cash to rehabilitate its business and meet daily operating expenses such as rent, payroll and utilities.⁸ On the other hand, the DIP’s unrestricted use of cash collateral jeopardizes the creditor’s interest in the collateral,⁹ as cash is dissipated by use.¹⁰

Avoidance Powers under the Bankruptcy Code

To maximize the value of the bankruptcy estate and ensure common treatment of similarly situated creditors, the Bankruptcy Code provides a trustee (and by extension, a DIP) with the power to

avoid and recover certain transfers of the debtor’s property. Common examples of the trustee’s “avoidance powers” include preferences under Section 547 of the Bankruptcy Code and fraudulent transfers under Section 548 of the Bankruptcy Code. Sections 547 and 548, by definition, apply to pre-bankruptcy transfers. Section 549 of the Bankruptcy Code allows the trustee to set aside unauthorized transfers made by a debtor after filing bankruptcy. Section 549 most often applies when debtors, without court approval, pay claims that arose prior to the bankruptcy case. With the *Delco Oil* decision, the Eleventh Circuit has expanded the scope of Section 549 to include payments to post-petition vendors in the ordinary course of business.

The Delco Oil Decision

Prior to filing for bankruptcy protection under chapter 11 of the Bankruptcy Code, Delco Oil, Inc. (“Delco”) operated as a distributor of motor fuel and associated products. CapitalSource Finance, LLC (“CapitalSource”) provided financing to Delco pre-bankruptcy and obtained a pledge of essentially all of Delco’s personal property, including accounts receivable and inventory and the proceeds thereof. Marathon Petroleum Company, LLC (“Marathon”) sold petroleum products to Delco pre-bankruptcy pursuant to a sale agreement and continued to sell to Delco after the bankruptcy filing.

On the first day of its chapter 11 case, Delco filed a motion for authority to use cash collateral. The bankruptcy court later denied the motion. In the interim, Delco paid Marathon over \$1.9 million for petroleum products supplied to Delco after the bankruptcy petition. When the bankruptcy court denied Delco's request to use cash collateral, Delco voluntarily converted its bankruptcy case to a case under chapter 7 of the Bankruptcy Code. The chapter 7 trustee sued Marathon under sections 549 and 363 of the Bankruptcy Code to recover the payments Marathon received from Delco while the case was pending under chapter 11. The bankruptcy court entered summary judgment in favor of the trustee, and Marathon appealed.


Section 549 of the Bankruptcy Code authorizes a bankruptcy trustee to avoid a transfer of property of the bankruptcy estate that is made after the case is filed and that is not authorized by the Bankruptcy Code or the bankruptcy court.¹¹ In *Delco Oil* the trustee took the

position that the funds paid to Marathon were cash collateral subject to CapitalSource's security interest. Because CapitalSource did not consent to the use of its cash collateral and the bankruptcy court did not authorize Delco to use cash collateral, the trustee argued the payments were unauthorized under Section 363(c)(2) of the Bankruptcy Code and, therefore, avoidable under Section 549.

Marathon asserted multiple defenses to the trustee's claims. First, Marathon argued that it took the cash from Delco free of CapitalSource's security interests under applicable state law. Second, Marathon alleged that a genuine issue of material fact existed as to whether the monies paid to Marathon constituted cash collateral, challenging the trustee's claim that all funds in Delco's deposit account were identifiable proceeds of CapitalSource's pre-bankruptcy collateral. Third, Marathon requested that the bankruptcy court find implied, equitable exceptions to Section 549. Because the bankruptcy estate received equivalent

value in the form of goods delivered, neither the bankruptcy estate nor CapitalSource were harmed by the subject transfers. Moreover, the transfers were made in the ordinary course of business, and Marathon acted in good faith and without knowledge of CapitalSource's alleged security interest in the funds. Depriving Marathon of payment for goods delivered to the DIP post-petition would unduly harm Marathon and create a windfall to the estate.

As to Marathon's first defense, the Eleventh Circuit conceded that Marathon took the monies paid by Delco free of CapitalSource's security interest pursuant to Florida's version of the Uniform Commercial Code ("UCC").¹² Section 9-322(b) of the UCC provides that "[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."¹³ The Eleventh Circuit nevertheless concluded that Section 9-322(b) was irrelevant for



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purposes of determining whether each transfer was an unauthorized transfer of cash collateral under Section 363(c) of the Bankruptcy Code. The Court stated that the funds constituted cash collateral at the times of the transfers, and, absent lender consent or specific court approval, the transfers were not authorized by the Bankruptcy Code.¹⁴ The Eleventh Circuit explained:

Lest any confusion exist, [the trustee] may avoid and recover from Marathon the funds [Delco] transferred to it not because CapitalSource continued to have a security interest in the funds once they were in the hands of Marathon, but because [Delco] was not authorized to transfer the funds to anyone post-[filing] without the permission of CapitalSource or the bankruptcy court.¹⁵

The Eleventh Circuit also rejected Marathon's second defense, holding that

no material issue of fact existed as to whether the monies transferred to Marathon were CapitalSource's cash collateral.¹⁶ Marathon argued that the trustee had not proven Capital Source's control of Delco's deposit account or established that the monies paid to Marathon were identifiable cash proceeds of CapitalSource's collateral. While acknowledging that CapitalSource might not have a perfected security interest in Delco's *deposit account*, the Court concluded that CapitalSource held valid, perfected, security interests in all *monies in* the deposit account through "proceeds perfection."¹⁷ In reaching this conclusion, the Court cited an affidavit of an officer of Delco, which stated that CapitalSource held a perfected security interest in all cash and all bank deposits in Delco's possession as of the date of the bankruptcy filing. The Eleventh Circuit opined that the monies transferred to Marathon after the bankruptcy filing could have come from no other source than the proceeds of CapitalSource's pre-bankruptcy collateral.¹⁸

Finally, rejecting Marathon's defenses as to the value given, lack of harm, ordinary course nature of the transactions and its status as an innocent purchaser, the Eleventh Circuit strictly construed Section 549, stating that no such exceptions were codified in the code section and that Congress would have included such express exceptions if it had intended to do so.¹⁹

Criticism of Delco Oil

Delco Oil creates terrible problems for the trial courts, lawyers and vendors who must apply the Court's ruling.²⁰ For instance, the Eleventh Circuit failed to consider the effect of Section 552 of the Bankruptcy Code. Section 552 provides, with limited exceptions, that after-acquired property clauses in pre-petition security agreements do not apply to assets that the debtor acquires post-petition.²¹ Some of the funds transferred to Marathon could have come from revenues generated during the bankruptcy case. Pursuant to Section 552 of the Bankruptcy Code, cash

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generated by Delco during the bankruptcy case might not have been subject to CapitalSource's lien. Tracing and separating pre-petition revenues from post-petition revenues is a material factual issue in many bankruptcy cases. Because the Eleventh Circuit did not discuss this issue, the trustee may not have met his burden of proving that the subject funds were cash collateral. Problems with the trustee's proof are compounded by the Court's failure to require the trustee to definitively prove that the funds transferred constituted identifiable cash proceeds under applicable state law.

While the gaps in the Delco trustee's evidence on proceeds perfection could be remedied in subsequent cases, there are broader conceptual problems with the Eleventh Circuit's analysis in *Delco Oil*. Most notably, the Court did not address whether the estate or the lender was entitled to the funds recovered by the trustee. Trustees and secured creditors often dispute who gets the benefit of transfers

avoided and recovered on behalf of the estate.²² If the transferee takes the subject property free and clear of the secured party's interest under applicable state law, as in the *Delco Oil* case,²³ the secured party may not have an effective argument that its lien should attach to the recovered funds.²⁴ Conversely, Delco's bankruptcy estate received value for the payments and was not harmed by the debtor's unauthorized use of CapitalSource's cash collateral. No matter how the courts subsequently decide the issue of whether the bankruptcy estate or the secured party is entitled to the recovered funds, the Eleventh Circuit did not address critical legal and equitable issues.

Courts trying to sort out the critical question the Eleventh Circuit failed to address will face problems with either answer. On one hand, if the bankruptcy estate is entitled to receive the funds recovered by a trustee upon avoidance of an unauthorized transfer of cash collateral,

the estate receives a windfall. The estate receives value from the vendor's goods and is not harmed by the damage, if any, to the lender's interest in the cash. Allowing the estate to keep the goods and the recovered cash is an anomalous result, especially considering the basis for the right to recover the funds from the vendor is the debtor's unauthorized use of the secured party's collateral.

On the other hand, returning the recovered cash to the lender presents other problems. Section 550 of the Bankruptcy Code states that the trustee may recover transfers avoided under Section 549 *for the benefit of the estate*.²⁵ Courts have concluded that this precludes a chapter 7 trustee from pursuing an avoidance action that will not benefit the unsecured creditors of the estate.²⁶ Allowing the lenders to recover unauthorized transfers of cash collateral under Section 549 could violate Section 550. Moreover, if the goods received by virtue of the unauthorized transfers of cash collateral were subject to



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the secured creditor's lien on inventory or proceeds, the secured party also could get a windfall if it receives the trustee's recovery. The problems with permitting a trustee to pursue avoidance actions for the benefit of a secured creditor under *Delco Oil* are compounded by the Eleventh Circuit's conclusion that the transferee took the funds free and clear of the secured party's liens under state law.²⁶ The trustee's recovery for the benefit of the secured party under *Delco Oil* would have the effect of trumping UCC priority rules by requiring an innocent transferee to return to the secured creditor funds that it took free and clear of the creditor's liens.

A review of the docket in the underlying bankruptcy case suggests the bankruptcy court approved a compromise between CapitalSource and the trustee prior to the commencement of the suit against Marathon, pursuant to which CapitalSource agreed to fund the litigation in exchange for 60 percent of the amounts recovered.²⁸ As a result, CapitalSource arguably used the trustee's powers under Section 549 to overcome the state law priority rules, and the bankruptcy estate received a windfall. Because a DIP is vested with the powers of a bankruptcy trustee, *Delco Oil* appears to allow a debtor to pursue an action to recover its own unauthorized transfers. The provisions of the Bankruptcy Code governing the use of cash collateral are intended to limit the debtor's ability to prejudice the interests of secured lenders. These provisions should not affect the debtor's relationship with vendors. The effect of *Delco Oil* may be to allow debtors to profit from their own failure to abide by the rules. The only party who got hurt in *Delco Oil* was the innocent vendor.

In addition to failing to address which party was entitled to the recovered payments, the Eleventh Circuit failed to discuss whether, upon return of the payments received, the transferee was entitled to an administrative expense claim. Section 503 of the Bankruptcy Code states that a party that confers a benefit on the bankruptcy estate, such as by providing goods or services, is entitled to an administrative expense claim for the value provided.²⁹ Administrative expense claims are entitled to priority of payment

over pre-petition unsecured claims.³⁰ An unpaid vendor generally will be entitled to an administrative expense claim for the value of the goods delivered.³¹ However, Section 502(h) of the Bankruptcy Code provides that claims arising from a trustee's recovery of property in accordance with the trustee's avoiding powers are to be treated as pre-petition claims.³² Section 502(h) might have the effect of turning what would otherwise have been an administrative expense claim, had no payment been received by the transferee, into an unsecured claim. Accordingly, the *Delco Oil* decision creates an unnecessary conflict between sections 503 and 502(h) of the Bankruptcy Code.

After entry of the *Delco Oil* decision, Marathon filed a request for an administrative expense claim in the bankruptcy case for the amounts recovered by the trustee. CapitalSource objected to the claim. The parties filed a motion to approve a compromise, under which Marathon agreed to significantly reduce its administrative expense claims in the bankruptcy case.³³ At the end of the day, therefore, the vendor who delivered the goods and was paid in due course, according to its rights, ended up in a worse position than if it had never been paid at all.

The Implications of Delco Oil

The *Delco Oil* decision is contrary to the purpose of chapter 11, which is to rehabilitate debtors and maximize enterprise value. A key policy of chapter 11 is to encourage vendors to do business with the debtor. The Eleventh Circuit's ruling increases the risk to vendors of continuing to do business with companies in chapter 11 and places an untenable burden on vendors to conduct due diligence on a debtor's cash collateral authorization before shipping goods or providing services to the debtor. A likely consequence of the *Delco Oil* decision, and the litigation that will necessarily follow, is that vendors will be less likely to continue to do business with a company that files for protection under chapter 11, which could have a significant detrimental impact on companies seeking to reorganize in bankruptcy and their creditors. ▲▼▲

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Endnotes

1. *Marathon Petroleum Co., LLC v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255 (11th Cir. 2010).
2. See 11 U.S.C. §§ 1101 and 1107. The bankruptcy court may appoint a chapter 11 trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement..." 11 U.S.C. § 1104(a)(1).
3. 11 U.S.C. § 1108; *In re WWG Industries, Inc.*, 772 F.2d 810, 811-12 (11th Cir. 1985).
4. 11 U.S.C. § 363(c)(1).
5. 11 U.S.C. § 363(c)(2).
6. Cash collateral is more broadly defined in the Bankruptcy Code as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and 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 provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title." 11 U.S.C. § 363(a).
7. 11 U.S.C. § 363(e). Section 363(e) applies to other types of collateral as well as cash collateral. See *id.*
8. *Chrysler Credit Corporation v. Ruggiere (In re George Ruggiere Chrysler-Plymouth, Inc.)*, 727 F.2d 1017, 1019 (11th Cir. 1984).
9. See *id.*
10. *In re Somero*, 122 B.R. 634, 640 n. 5 (Bankr. D. Me. 1991).
11. 11 U.S.C. § 549(a). This avoiding power is subject to certain limited exceptions not applicable in the *Delco Oil* case. See 11 U.S.C. 549(b) (describing an exception for certain transfers made during the gap period in involuntary bankruptcy cases between the date of the bankruptcy filing and the entry of the order for relief); see also 11 U.S.C. § 549(c) (describing an exception for certain real property transfers to good-faith purchasers).
12. See *In re Delco Oil, Inc.*, 599 F.3d 1255, 1260 (11th Cir. 2010); see also FLAT. STAT. § 679.332(2).
13. FLAT. STAT. § 679.332(2); see also U.C.C. § 9-322(b).
14. *Delco Oil*, 599 F.3d at 1259-60.
15. *Id.* at 1260.
16. *Id.* at 1262.
17. *Id.* at 1261-62.
18. *Id.* at 1262.
19. *Id.* at 1262-63.
20. See, generally, Christopher W. Frost, *Seller Beware: The Unauthorized Use of Cash Collateral, Innocent Vendors, and Proceeds Post Bankruptcy*, 30 No. 7 BANKR. L. LETTER 1 (July 2010); Jonathon Friedland and Bill Schwartz, *Punishing the Innocent: Lessons from Delco Oil*, 29 AM. BANKR. INST. J. 1, 88 (May 2010).
21. Section 552 provides that property acquired by a debtor after filing for bankruptcy is not subject to any lien resulting from a pre-petition security agreement except in certain limited circumstances, such as proceeds of property acquired before the commencement of the case that the estate acquires after the commencement of the case. See 11 U.S.C. § 552(a) and (b).
22. See, generally, Nancy L. Sanborn, *Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?*, 90 COLUM. L. REV. 1376 (1990).
23. See *In re Delco Oil, Inc.*, 599 F.3d 1255, 1260 (11th Cir. 2010).
24. See Nancy L. Sanborn, *Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?*, 90 COLUM. L. REV. 1376, 1396-98 (1990).

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25. See 11 U.S.C. § 550(a).
26. See, e.g., *Congress Credit Corp. v. AJC Intern.*, 186 B.R. 555, 558-59 (D. Puerto Rico 1995).
27. See *In re Delco Oil, Inc.*, 599 F.3d 1255, 1260 (11th Cir. 2010).
28. *In re Delco Oil, Inc.*, No. 06-03241 (Bankr. M.D. Fla. Apr. 23, 2007) (order granting motion to approve compromise of controversy between the estate and CapitalSource Finance, LLC).
29. See 11 U.S.C. § 503(b)(1)(A).
30. See 11 U.S.C. § 507.
31. See, generally, *In re The New Power Co.*, 313 B.R. 496, 504 (Bankr. N.D. Ga. 2004) (citing a New York bankruptcy case for the proposition that “expenses will generally be entitled to priority treatment if ‘the right to payment arose from a post-petition transaction with the debtor estate rather than from a prepetition transaction with the debtor, and the conduct giving rise to the payment was beneficial to the estate of the debtor’”) (internal citation omitted).
32. See 11 U.S.C. § 502(h).
33. *In re Delco Oil, Inc.*, No. 06-03241 (Bankr. M.D. Fla. filed Oct. 17, 2006).



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