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David G. Epstein

University of Richmond, depstein@richmond.edu

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POSTPETITION LENDING UNDER SECTION 364: ISSUES REGARDING THE GAP PERIOD AND FINANCING FOR PREPACKAGED PLANS

*Paul M. Baisier**
*David G. Epstein***

INTRODUCTION

A company in bankruptcy is not generally viewed as the ideal borrower. Most lenders are understandably reluctant to extend credit to such a business. This reluctance compounds the difficulties of a Chapter 11 business debtor. Without new financing, the cash needs of a company in bankruptcy will often cause a Chapter 11 business to be closed or liquidated, thereby foreclosing any hope of reorganization and defeating the rehabilitative purposes of the Bankruptcy Code (the Code).¹

To counter the understandable reluctance of financial institutions to lend to Chapter 11 debtors,² section 364 of the Code provides incentives³ to lenders to provide financing to borrowers who are the subject of bankruptcy cases. Section 364 enables a debtor in a bankruptcy case to obtain credit⁴ by granting a prospective lender a variety of different incentives,

* King & Spalding, Atlanta, Georgia; J.D., Harvard Law School, 1990; B.S., University of Illinois, 1987.

** King & Spalding, Atlanta, Georgia; LL.B., University of Texas 1966; B.A. University of Texas, 1964. Although the authors regularly practice in the area of insolvency and commercial disputes, they are not currently advocating the positions espoused herein on behalf of any of their clients.

1. 11 U.S.C. §§ 101-1330 (1988), *as amended by* 11 U.S.C.A. §§ 100-1330 (West Supp. 1991); all sections referred to herein are of the Bankruptcy Code unless otherwise indicated.

2. The Bankruptcy Code contemplates that a Chapter 11 debtor will continue to operate its business and manage its own affairs. *See* 11 U.S.C. §§ 1107, 1108 (1988). This is true in both voluntary and involuntary Chapter 11 cases. A Chapter 11 debtor in such a situation is called a "debtor-in-possession." 11 U.S.C. § 1101(1) (1988). Although the Code permits the appointment of an independent trustee in a Chapter 11 case to run the business where fraud, dishonesty, or gross mismanagement is alleged, 11 U.S.C. §§ 1104, 1108 (1988), it is generally difficult to satisfy the standards for trustee appointment. By contrast, a trustee is automatically appointed in a voluntary Chapter 7 case. 11 U.S.C. §§ 701, 702 (1988). In an involuntary Chapter 7, the trustee is not appointed until an order for relief is entered. 11 U.S.C. § 701 (1988). A Chapter 7 trustee is authorized to operate the business during the liquidation. 11 U.S.C. § 721 (1988).

3. It can, of course, be argued that there should not be incentives to lend to companies in bankruptcy. Laurence Kallen, a Chicago bankruptcy attorney, has described Chapter 11 as a "monster" because "the bankruptcy system diverts scarce assets such as capital to inefficient producers, thereby allowing them to remain in existence at an added expense to society." LAURENCE KALLEN, *CORPORATE WELFARE* 465, 467 (1991).

4. Although § 364 is entitled "Obtaining Credit," it is not the only statutory basis that can be used by a Chapter 11 business debtor to obtain credit. Chapter 11 business debtors

some of which are not available on a nonconsensual basis outside of the bankruptcy context.⁵ Section 364 is set out below:

(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1304, 1203, or 1204 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not

generally look first to § 363(c), which governs the use of cash collateral. By complying with § 363(c)(2), a debtor can use the cash it receives from the postpetition sale of inventory or the postpetition collection of accounts even though the inventory or accounts are the collateral of some prepetition lender. Section 363(c)(2)(B) provides a method for making a prepetition lender into an involuntary postpetition lender. *See generally* Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562 (1991); Stephen C. Mount, Note, *Standards and Sanctions for the Use of Cash Collateral Under the Bankruptcy Code*, 63 TEX. L. REV. 341 (1984). The use of the cash collateral alone, however, is rarely sufficient to meet the cash needs of a debtor over the course of a Chapter 11 case.

5. *See* 11 U.S.C. §§ 364(c)(1), 364(d) (1988). Even greater incentives can be provided to a lender that already has funds at risk with the debtor. Extending postpetition financing often provides a petition lender with an opportunity to enhance the security of its at-risk prepetition funds. Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109, 42-44 (1986).

such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

(f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933 (15 U.S.C. 77e), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), and any State or local law requiring registration for other or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.⁶

The starting point for analyzing postpetition financing is section 364(a). It provides that a debtor may obtain unsecured credit in the ordinary course of business without approval of the bankruptcy court. This treatment is consistent with the Chapter 11 concept of the "debtor-in-possession," which allows the debtor to continue to operate its business in the ordinary course of business.⁷ To qualify under section 364(a), the credit must fund an expense that is otherwise eligible for treatment as an administrative expense under section 503(b). To be so eligible, the credit must be extended to fund an expense that is an "actual, necessary cost[] [or] expense[] of preserving the estate"⁸

A consequence of the requirement that the credit be extended in the "ordinary course of business" is that the financing provided under section 364(a) is usually limited to trade credit. Other lenders do not generally rely on this section, as whether extensions of credit are made "in the ordinary course of business" is a fact-based question that is not always easily answerable. Moreover, section 364(b) provides a safer method for creditors who desire to extend postpetition unsecured credit. Section 364(b) effectively eliminates the need to make the difficult determination of whether a particular credit is made in the "ordinary course of business." Section 364(b) allows the postpetition debtor to obtain unsecured credit outside of the ordinary course of business. However, Section 364(b) requires the approval of the bankruptcy court after notice and a hearing.⁹ Often, a Chapter 11 business debtor cannot obtain sufficient credit to maintain business operations on an unsecured basis. Consequently, sections 364(c) and (d) allow the debtor to offer lenders positions with priority over administrative expenses (called secured or supersecured positions) to obtain credit. More specifically, section 364(c) empowers the debtor to grant a postpetition lender (1) a priority over all administrative expenses of the case,¹⁰ (2) a security interest in unencumbered property

6. 11 U.S.C. § 364 (1988).

7. See 11 U.S.C. §§ 1107, 1108; cf. 11 U.S.C. § 363(c)(1).

8. 11 U.S.C. § 503(b)(1)(A).

9. For those extending credit other than clearly extended in the ordinary course of business, this is the prudent manner in which to proceed.

10. 11 U.S.C. § 364(c)(1) (1988). For the relevance of such a priority over administrative expenses, see Appendix A.

of the debtor,¹¹ or (3) a junior lien on already encumbered property.¹² Lending under section 364(c) often involves the grant of more than one of these incentives (i.e., a junior lien *and* priority over administrative expenses for any deficiency in the security). Section 364(c), like section 364(b), requires court approval after notice and hearing. Further, to be granted the priorities provided for in section 364(c), a debtor must prove to the court that it cannot obtain the needed credit on an unsecured basis.¹³

If the priorities provided by section 364(c) are insufficient to entice potential lenders to provide sufficient financing to a Chapter 11 debtor, the debtor may, with the court's approval, obtain credit by granting the lender a lien on property of the debtor that is senior to existing liens on such property (a "priming lien"). The granting of such a priming lien, however, is subject to several statutory conditions. First, as with section 364(c), the debtor must prove that it cannot obtain credit on any less intrusive basis (i.e., through the use of section 364(a), (b), or (c)).¹⁴ Second, the debtor must prove that the interest of any lender whose interest is to be primed is "adequately protected."¹⁵ Although adequate protection can be provided in any number of ways,¹⁶ debtors attempting to utilize section 364(a) usually claim that the prime lender's interest is adequately protected by a substantial "equity cushion"¹⁷ in the property.

11. 11 U.S.C. § 364(c)(2) (1988).

12. 11 U.S.C. § 364(c)(3) (1988).

13. For a discussion of § 364(c), see *In re Ames Dep't Stores Inc.*, 115 B.R. 34, 37-40 (Bankr. S.D.N.Y. 1990); *In re St. Mary Hosp.*, 86 B.R. 393, 401-02 (Bankr. E.D. Pa. 1988).

14. 11 U.S.C. § 364(d)(1) (1988).

15. 11 U.S.C. § 364(d)(2) (1988).

16. 11 U.S.C. § 361 sets out examples of adequate protection. It provides:

When adequate protection is required under section 362, 363 or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

11 U.S.C. § 361 (1988).

17. *Id.* An equity cushion exists as to any secured creditor if the value of a secured creditor's collateral exceeds the amount of its debt plus any debt with priority over its debt. There have been relatively few reported cases under § 364(d). Most of the reported cases granting § 364(d) financing have held that the prepetition lender is adequately protected by an equity cushion. For a discussion of the protection offered by the equity cushion, see *In re Snowshoe Co.*, 789 F.2d 1085, 1188-90 (4th Cir. 1986); *In re Dunes Casino Hotel*, 69 B.R. 784, 795-96 (Bankr. D.N.J. 1986). However, it is far more common for a Chapter 11 debtor

Finally, lenders who have advanced funds based on court orders granted under section 364 are protected on appeal by section 364(e).¹⁸ Chapter 11 debtors generally have an immediate need for postpetition financing. Creditors would be reluctant to advance funds if a section 364(b) or (c) priority or a section 364(c) or (d) lien could be removed by the reversal on appeal of the order granting the priority or lien. Consequently, section 364 lenders are protected from reversal on appeal by section 364(e), provided that the order granting the priority or lien was sought in good faith¹⁹ and provided that a stay pending the appeal was not obtained by a party opposing the grant of the priority or lien.²⁰

I. ISSUES RELATED TO POSTPETITION FINANCING

There are numerous books and articles that provide a more comprehensive overview of debtor-in-possession financing and the issues raised by such financing.²¹ Rather than attempt to duplicate those facts here, this article will instead answer two specific questions regarding postpetition financing that have been raised by recent cases: (1) may the debtor, in the context of a "prepackaged" bankruptcy, establish an arrangement, prior to its filing, for postpetition financing that will be binding on the lender postpetition; and (2) may an involuntary debtor utilize section 364 to obtain financing during the "gap period" between the filing of an involuntary petition and the entry of an order for relief?

II. SECURING FINANCING IN A PREPACKAGED BANKRUPTCY FILING

Perhaps the most significant bankruptcy development of the early 1990's has been the use of prepackaged bankruptcy plans.²² A prepack-

to use the threat of § 364(d) to persuade prepetition lenders to extend postpetition credit than it is for a Chapter 11 debtor to use § 364(d) to persuade a bankruptcy judge to grant a priming lien to a new postpetition lender. Can a debtor make a realistic § 364(d) threat to a lender who does not have an equity cushion? Is an equity cushion essential to satisfy the "adequate protection" requirement of § 364(d)? Consider the following example. D owes S \$1,000,000. S's collateral has a value of \$800,000. No equity cushion. D needs \$300,000 in postpetition financing. D's appraiser is prepared to testify that the infusion of this additional \$300,000 will increase the value of S's collateral from \$800,000 to \$1,250,000. If a court accepts this appraisal, is not S adequately protected, notwithstanding the absence of an equity cushion? Is it not arguable that a debtor can establish adequate protection by establishing that each dollar of the priming loan will enhance the value of the prepetition lender's collateral by at least a dollar. Judge Scholl explains the argument more eloquently in *In re Aqua Associates*, 123 B.R. 192, (Bankr. E.D. Pa. 1991).

18. 11 U.S.C. § 364(e) (1988).

19. *Id.*

20. *Id.*

21. See generally 2 ROBERT E. GINSBERG, *BANKRUPTCY* § 13.06(c) (2d ed. 1989); Mark L. Prager, *Financing the Chapter 11 Debtor: The Lenders Perspective*, 45 BUS. LAW 2127 (1990).

22. For a discussion of prepackaged bankruptcy plans, see generally Case & Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Declaratory Judgment Act for Instant Reorganizations*, 1991 Annual Survey of American Law ____; Richard L. Epling, *Exchanges Offers, Defaults, and Insolvency: A Short Primer*, 8

aged bankruptcy plan is a plan that is negotiated with and accepted²³ by creditors prior to the filing of any bankruptcy petition. The Code recognizes creditor acceptances of a Chapter 11 plan obtained prior to the filing of the Chapter 11 case if the solicitation of the acceptances meets the requirements of section 1126.²⁴ These provisions for prepetition solicitation have been a part of the Code since its enactment in 1979. Even prior to 1979, prepetition solicitation was possible under Chapter XI of the old Bankruptcy Act.²⁵

Although the prepackaged Chapter 11 plan is not a product created in the 1990's, it has proved to be a product created for the 1990's. Leveraged buyouts in the 1980's resulted in numerous businesses with too much debt. A prepackaged Chapter 11 is often the most efficient way to restructure that debt. The primary advantages of a prepackaged Chapter 11 over an ordinary Chapter 11 are reductions in time in bankruptcy as well as business and legal risks from bankruptcy. An ordinary Chapter 11 can take months if not years to complete, and a debtor in Chapter 11 faces not only the business risks of loss of customers and suppliers but also the legal risk of loss of assets and even loss of control to creditors during the course of the Chapter 11. By contrast, prepackaged Chapter 11 cases have been completed in less than two months.²⁶ Through the use of a prepackaged Chapter 11 plan, a business can at least reduce the business and legal risks of Chapter 11.

The primary advantage of a prepackaged Chapter 11, less time in bankruptcy, is also its greatest disadvantage. Because a debtor is using a

BANKR. DEV. J. 15 (1991); Marc S. Kirschner et al., *Prepackaged Plans: The Deleveraging Tool of the '90's in the Wake of OID and Tax Concerns*, 21 SETON HALL L. REV. 643 (1991).

23. It is necessary to distinguish "prepackaged" plans from "prenegotiated" plans. Prepackaged plans are plans in which solicitation of creditor and shareholder acceptance of the plan occurs prior to the bankruptcy filing. Prenegotiated plans are plans in which the structure and perhaps even the language of the plan and disclosure statement are negotiated prior to a bankruptcy filing but the actual solicitation of acceptances is delayed until after the bankruptcy filing. By "prenegotiating" but not "presoliciting," the plan proponent avoids SEC review of its disclosure documents. For a discussion of the avoidance of SEC review, see 11 U.S.C. § 1125(e) and 15 U.S.C. § 77a (1988). For a general discussion of the SEC rules governing exchange offers, see Epling, *supra* note 22, at 18-30.

24. Section 1126(b) provides:

For the purpose of subsections (c) and (d) of this section [1126], a holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if—

- (1) the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or
- (2) if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information, as defined in section 1125(a)(1) of this title.

11 U.S.C. § 1126(b) (1988).

25. See *Campbell v. Alleghany Corp.*, 75 F.2d 947, 950 (4th Cir. 1935) *cert. denied*, 296 U.S. 581 (1935).

26. *In re JPS Textile Group*, Case No. 91-B-10546 (S.D.N.Y. 1991) (42 days).

prepackaged Chapter 11 to spend less time in bankruptcy, a disgruntled creditor may attempt to gain concessions by threatening to take action that will delay the confirmation of the Chapter 11 plan. One type of creditor that arguably has the power to impede the progress of a prepackaged Chapter 11 in this way is a party that has agreed prepetition to provide the debtor with postpetition financing.

In answering the question of whether a creditor can delay the prepackaged Chapter 11, it is necessary to consider two provisions of the Code—sections 364 and 365. Section 364 has already been summarized.²⁷ Section 365 deals with leases and executory contracts.²⁸ It generally empowers a debtor to assume executory contracts subject to court approval. The Code does not expressly deal with the consequences of assumption of an executory contract.²⁹ However, it is clear from the cases that assumption gives (1) the debtor the right to enforce the contract against the other party, and (2) the other party the right to collect amounts due and owing under the contract, both prepetition and postpetition, as an administrative expense priority claim.³⁰

A debtor can assume a contract even though the other party to the contract objects, and even though the contract expressly provides for termination on a bankruptcy filing.³¹ Accordingly, if a Chapter 11 debtor can invoke section 365 and assume a prepetition contract to extend credit postpetition, the answer to the question is “No” because a debtor can

27. For a discussion of § 364, see *supra* notes 6-20 and accompanying text.

28. There is no statutory definition of an executory contract. In what is undoubtedly the most widely cited law review article on a bankruptcy topic, Professor Countryman reviewed the case law under the 1898 Act on executory contracts and synthesized the cases into the following definition: “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance by the other.” Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). Most reported cases under § 365 use the Countryman definition. See, e.g., *Gloria Mfg. Corp. v. International Ladies Garment Workers Union*, 734 F.2d 1020, 1021-22 (4th Cir. 1984).

29. Section 365(b)(1) is perhaps the most helpful provision. It sets out the requirements for assumption of a contract if there has been a default.

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

- (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
- (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
- (C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. 365(b)(1) (1988). Note that § 365(b)(1) does not apply if the debtor is not in default.

30. See Don Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341, 376 (1980). For the relevancy of such a priority, see Appendix A.

31. 11 U.S.C. §§ 365(a), 365(e) (1988).

require the chosen postpetition lender to extend credit postpetition on terms agreed to prepetition.

However, section 365(c) identifies categories of executory contracts that cannot be assumed. Section 365(c)(2) thus arguably prevents the debtor from assuming a prepetition contract for postpetition financing. It provides:

the trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if . . . (2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.³²

An agreement to provide postpetition financing is clearly a contract "to make a loan, or extend other debt financing or financial accommodations to or for the benefit of the debtor," and thus such contracts would seem to be nonassumable under section 365(c)(2).³³

Additionally, section 364 is perhaps relevant. Congress purported it would govern "all obtaining of credit and incurring of debt by the estate."³⁴ If this precludes the application of section 365 to prepetition contracts for postpetition credit, then a debtor cannot hold the lender to the contract by assumption. These two legal provisions, sections 365(c)(2) and 364, allow the postpetition lender to argue that its prepetition agreement to provide financing to the debtor is unenforceable by the debtor postpetition.³⁵ This article will evaluate this argument in light of the structure of the Code and recent case law.

A contract to extend postpetition financing is an executory contract, regardless of the definition of the term that is employed.³⁶ A Chapter 11 debtor generally has until the confirmation of its plan of reorganization to assume, reject, or assume and assign an executory contract,³⁷ subject to the nondebtor party's ability to request that the court shorten that time.³⁸ The decision to assume or reject is reviewable by the bankruptcy

32. 11 U.S.C. § 365(c)(2) (1988).

33. Section 365(e)(2) would also allow the lender to terminate such a contract on the basis of an *ipso facto* clause contained in the contract; however, in the context of a prepackaged bankruptcy, a putative debtor seeking postpetition financing would not likely allow the insertion of a clause that would permit the termination of the contract in a situation that is explicitly contemplated to occur.

34. H.R. REP. No. 595, 95th Cong., 1st Sess. 345-47 (1977), reprinted in 1978 U.S.C.A.N. 5963; S.R. REP. No. 989, 95th Cong., 2d. Sess. 57-58 (1978).

35. Thus, they may provide that lender with the ability to extract additional profits from the debtor, who is anxious to expedite its prepackaged bankruptcy. As the postpetition lender is often a prepetition lender of the debtor, this extortion may be in the form of additional interest on the postpetition borrowing or, instead, in the form of some special treatment of its prepetition claim. As to the propriety of the latter, see generally Tabb, *supra* note 5.

36. For the Countryman definition of an executory contract, see *supra* note 28.

37. 11 U.S.C. § 365(d)(2) (1988).

38. *Id.*

court under a "business judgment" standard.³⁹

As noted previously, the Chapter 11 debtor has no power to assume or reject a prepetition contract if the contract is one "to make a loan, or extend other debt financing or financial accommodation to or for the benefit of the debtor,"⁴⁰ as section 365(c)(2) precludes assumption of such contracts. The purpose of the subsection is to "prevent the trustee from requiring new advances of money or other property."⁴¹ Section 365(c)(2) appears to have been designed to protect lenders from having to continue to fund the debtor postpetition under a prepetition financing agreement. Assume, for example, that C Bank agreed to extend a \$1,000,000 line of credit to D Inc. on January 15. On July 15, D Inc. filed for bankruptcy. D Inc. then attempted to draw on the line of credit. Under section 365(c)(2), D Inc. could not use the assumption of the executory contract to compel C Bank to extend postpetition financing pursuant to the terms of the prepetition contract.⁴²

A question *not* answered by section 365(c)(2) is whether D Inc. should be able to draw on the line of credit if C Bank agrees? Another issue is whether D Inc. should be able to draw on the line of credit if C Bank and D Inc. entered into this "financial accommodation" contract in anticipation of D Inc.'s bankruptcy filing? The language of section 365(c)(2) provides no explicit exception for the assumption of contracts to extend financial accommodations either with the consent of the lender or in situations in which the contract was entered into explicitly for the purpose of providing postpetition financing. The absence of exceptions for these two situations bolsters the position of the chosen postpetition lender in attempting to avoid its contracts and generally puts at issue the assumability of prepetition contracts to provide postpetition financing in the context of a prepackaged bankruptcy. Two recent cases, *In re Sun Runner Marine, Inc.*⁴³ and *In re T.S. Industries Inc.*,⁴⁴ consider these issues.

In *Sun Runner*, the debtor moved to assume a prepetition financing agreement with Transamerica.⁴⁵ Under the contract, Transamerica advanced funds to retailers who sold boats manufactured by the debtor, and the debtor, in turn, agreed to buy the boats back from Transamerica for

39. See 11 U.S.C. § 365(a) (1988); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984); *but cf. In re Food City, Inc.*, 94 B.R. 91, 92 (Bankr. W.D. Texas 1988).

40. 11 U.S.C. § 365(c)(2) (1988).

41. H.R. REP. No. 595 at 348.

42. *In re Sun Runner Marine, Inc.*, 945 F.2d 1089 (9th Cir. 1991). See also *In re Taylor Freezers of Alabama, Inc.*, 115 B.R. 333, 335 (Bankr. N.D. Ala. 1990) (holding that if contract had provided for credit sales, it would be a contract for financial accommodations that could not be assumed); *In re Placid Oil Co.*, 72 B.R. 135, 139 (Bankr. N.D. Texas 1987) (holding that a § 365(c)(2) contract cannot be assumed); *In re Swift Aire Lines*, 30 B.R. 490, 496-97 (9th Cir. 1983).

43. 116 B.R. 712 (Bankr. 9th Cir. 1990), *aff'd in part, vacated in part*, 945 F.2d 1089 (9th Cir. 1991).

44. 117 B.R. 682 (Bankr. D. Utah 1990).

45. *Sun Runner*, 116 B.R. at 714.

the outstanding balance of the loan in the event a dealer defaulted.⁴⁶ Citicorp, a major secured and unsecured creditor in the case, objected to the assumption of the contract, as assumption would have elevated over \$124,000 in prepetition claims of Transamerica to administrative expense status.⁴⁷ The bankruptcy court allowed the assumption.⁴⁸ The Bankruptcy Appeals Panel for the Ninth Circuit (BAP) reversed on two grounds. First, the BAP held that the agreement was not an executory contract.⁴⁹ Second, the BAP found that the contract was one for financial accommodation and was thus nonassumable, even with the consent of the lender.⁵⁰ On appeal, the Ninth Circuit vacated the BAP opinion on the executory contract issue and relied exclusively on the second ground. In affirming the BAP, the Ninth Circuit adopted the BAP opinion on the section 365(c)(2) issue in its entirety.⁵¹

The BAP analysis of section 365(c)(2) involved two other sections of the Bankruptcy Code: section 364 and section 365(c)(1). As to section 364, Judge Volinn concluded that a prepetition contract for postpetition financing is "governed solely by section 364."⁵² In so concluding, he compared the effect on unsecured creditors of the application of sections 364 and 365:

Section 364 does not, however, authorize the debtor to pay the lender's pre-petition unsecured claim as a condition precedent to the post-petition financing. Permitting the assumption of a financial accommodation contract would allow a post-petition lender, such as Transamerica in this case, to receive full payment on its pre-petition unsecured claim under § 365(b)(1). This benefit to the lender would be at the expense of the other unsecured creditors, such as Citibank in this case, because it would diminish the estate assets available to satisfy their claims. Thus the § 365(c)(2) prohibition against the assumption of financial accommodation contracts protects all unsecured creditors, not just the lender, and the lender's consent alone is not sufficient to abrogate it.⁵³

Although section 364 does not expressly provide for the payment of prepetition debts, there is case law under section 364 sustaining the grant of liens on postpetition assets to secure prepetition debts as a part of a postpetition financing package.⁵⁴ Judge Volinn acknowledged this line of cases on "cross-collateralization" and the argument that the cross-collateralization cases, by analogy, supported the payment of prepetition claims that would result from assumption under section 365.⁵⁵ He then concluded that such an argument was not before the BAP as it had not

46. *Id.*

47. *Id.*

48. *Id.* at 715.

49. *Id.* at 716.

50. *Id.* at 717.

51. *Sun Runner*, 945 F.2d 1089.

52. *Sun Runner*, 116 B.R. at 717-18.

53. *Id.* (footnotes omitted).

54. *See, e.g., In re Texlon Corp.*, 596 F.2d 1092, 1097-98 (2d Cir. 1979).

55. *Sun Runner*, 116 B.R. at 719.

been made to or considered by the bankruptcy court.⁵⁶

The BAP opinion in *Sun Runner* also dealt with section 365(c)(1). The section provides:

The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.⁵⁷

Notice that the prohibition of section 365(c)(1) is limited by consent. Judge Volinn noticed that limitation and commented on it briefly.⁵⁸ The explicit consent exception in section 365(c)(1) is probably the strongest argument against implying a consent exception in section 365(c)(2). Under accepted principles of statutory construction:

1. A Code should be construed as a whole⁵⁹—what section 365(c)(1) does say is relevant in interpreting what section 365(c)(2) does not say;

2. The inclusion of a consent exception in section 365(c)(1) indicates that Congress could and would expressly provide for consent where it so intended.⁶⁰

This argument is bolstered by the legislative history of section 365(c)(2). In the original House version of the section, contracts currently covered by section 365(c)(2) were covered by what is now section 365(c)(1) and thus were subject to an express consent exception.⁶¹ From that it can be argued that the division was made to bar assumption of contracts to make a loan, or extend other debt financing or financial accommodations, even if the other party to the contract consents.

It also has been argued that lender assent should be irrelevant to assumption under section 365(c)(2) because section 365(c)(2) protects unsecured creditors as well as the contracting party.⁶² Although the argument has been made in cases and commentary, it does not appear anywhere in the legislative history of section 365(c)(2).

There are, however, cases which hold that a prepetition contract that extends credit postpetition can be assumed if the creditor consents. For example, in *In re Prime*,⁶³ the bankruptcy court held that consent of the

56. *Id.* at 719-20.

57. 11 U.S.C. § 365(c)(1).

58. *Sun Runner*, 116 B.R. at 717.

59. 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION, § 46.05 (4th ed. 1984).

60. *Id.*

61. See H.R. 8200, 95th Cong., 1st Sess. § 365 (1978).

62. *Sun Runner*, 116 B.R. at 718; *In re Placid Oil Co.*, 72 B.R. 135, 136 (Bankr. N.D. Texas 1987); Thomas R. Slome, *Assuming Pre-Petition Workout Agreements under Section 365: The "Workout Decade" Begins with Innovation*, 3 Bankr. L. Rptr. (BNA) No. 4, at 104, 105 (Jan. 24, 1991).

63. 15 B.R. 216, 219 (Bankr. W.D. Mo. 1981).

lender abrogates the effect of section 365(c)(2). Other courts, in dicta, have agreed with this conclusion.⁶⁴ Similarly, in *In re Easebe*,⁶⁵ the Ninth Circuit recognized that lenders could waive their rights under section 365(c)(2). More particularly, the court found that "because there is no provision in the bankruptcy code precluding it, [section 365(c)(2)] can be waived 'by those for whose benefit it has been enacted.'"⁶⁶

We find it inappropriate to imply a consent exception in applying section 365(c)(2). Although we believe that the absolute prohibition on assumption of loans, debt financing, and financial accommodation contracts *should* be tempered by a consent of the creditor exception, we do not believe that it is now. We are persuaded by the argument in *Sun Runner* based on the comparison of section 365(c)(1) and section 365(c)(2). The explicit inclusion of a consent exception in section 365(c)(1), coupled with the division of section 365(c) into two subparagraphs, means that a consent exception should not be implied in section 365(c)(2). If section 365(c)(2) applies to a prepetition contract for postpetition financing, then the debtor should not be able to assume that contract even if the lender consents.⁶⁷

Although we do not question *how* section 365(c)(2) should apply, we do question *whether*, in certain circumstances, section 365(c)(2) should apply. At least, we question whether section 365(c)(2) should apply in prepackaged cases or other situations in which the prepetition contract for postpetition financing was negotiated and consummated in explicit contemplation of a bankruptcy filing. Judge Clark dealt with this question in *In re T.S. Industries*.⁶⁸

In *T.S. Industries*, the debtor entered into a restructuring agreement with its major creditors and new investors prior to the filing of its bankruptcy petition.⁶⁹ The agreement included a restructuring of the debtor's credit line with Credit Suisse. After filing its petition, the debtor decided to renege on the agreement and moved to reject it, claiming that it was a contract to provide financial accommodation and was thus nonassumable

64. *In re Charrington Worldwide Enters., Inc.*, 98 B.R. 65, 68 (Bankr. M.D. Fla. 1989), *aff'd* 110 B.R. 973 (M.D. Fla. 1990); *In re Adana Mortgage Bankers, Inc.*, 12 B.R. 977, 988 (Bankr. N.D. Ga. 1980).

65. 900 F.2d 1417, 1420 (9th Cir. 1990).

66. *Id.* (quoting *Cukierman v. Mechanics Bank of Richmond (In re J. F. Hink & Son)*, 815 F.2d 1314, 1318 (9th Cir. 1987)). The language quoted from the *Easebe* court is taken from its analogy to waiver of rights under § 365(f)(3).

67. Even if a consent exception exists for § 365(c)(2), it will be helpful to the potential debtor seeking to lock in postpetition financing for a prepackaged bankruptcy filing only if prepetition consent is sufficient basis. If postpetition consent is required, the lender will still have the right to threaten to slow up the prepackaged process by withholding its consent and thereby extort additional amounts from the debtor. Further, requiring *postpetition* consent would effectively moot the exception, as a debtor and a consenting postpetition lender could simply reexecute their prepetition agreement postpetition and proceed under § 364. There are no cases under § 365(c)(1) regarding the timing of the required consent.

68. 117 B.R. 682 (Bankr. D. Utah 1990).

69. *Id.* at 684.

and had to be rejected.⁷⁰ The debtor was joined in this effort by all of the parties to the agreement.⁷¹ The Unsecured Creditors Committee opposed the motion, as it was proposing a plan of reorganization that included the assumption of the agreement.⁷²

The *T.S. Industries* analysis of the motion to reject began with an overview of the assumption and rejection process under section 365 and the relevance of section 365(c)(2) therein.⁷³ Judge Clark determined from the legislative history of the Code that section 365(c)(2) was passed to protect lenders from being forced to lend to bankrupt debtors.⁷⁴ He also noted a commentator's view that the section was designed to allow lenders to reassess the credit risk of lending to the debtor in light of an actual bankruptcy, as bankruptcy would typically only have been a possibility when the lending originally took place.⁷⁵

Judge Clark concluded that the agreement reached by T.S. Industries and its creditors was not covered by section 365(c)(2) because it was not "the type of agreement that was contemplated as being barred from assumption under [section] 365(c)(2),"⁷⁶ and added "[i]f . . . the . . . [a]greement is a nonassumable executory contract under [section] 365(c)(2), it would render meaningless all future prepetition contracts to extend the debtor post-confirmation financial accommodations."⁷⁷ *T.S. Industries* thus found that the prepetition contract to extend postpetition financing was assumable notwithstanding section 365(c)(2) and denied the debtor's motion to reject premised on its nonassumability.

It is clear that the *T.S. Industries* decision is not consistent with the "plain meaning" rule that has been popular in bankruptcy jurisprudence since the Supreme Court decision in *United States v. Ron Pair Enterprises*.⁷⁸ It is less clear whether the *T.S. Industries* decision is consistent

70. *Id.*

71. *Id.* at 684-85.

72. *Id.* at 685.

73. *Id.*

74. *Id.* at 686.

75. *Id.* at 686-87. On this point, Judge Clark cites an extensive passage from Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 504, 533-34, 536 (1983).

76. *T.S. Industries*, 117 B.R. at 687.

77. *Id.* at 689.

78. 489 U.S. 235 (1989); see generally Falk, *Ron Pair Enterprises: Supreme Court Finds Oversecured Creditors Entitled to Postpetition Interest*, 1 FAULKNER & GRAY'S BANKRUPTCY LAW REV. 9 (Summer 1989). *Ron Pair* has reduced significantly bankruptcy courts' use of legislative history in interpreting the provisions of the Code. The *Ron Pair* Court held that § 506(b) changed pre-Code case law so that a nonconsensual lien creditor is entitled to postpetition interest on its claim. Justice Blackmun based this holding on "the plain meaning" of § 506(b). Justice Blackmun's majority opinion contained a number of statements about construing the Code that are now regularly quoted by bankruptcy courts in rejecting arguments based on legislative history and pre-Code case law.

Initially, it is worth recalling that Congress worked on the formulation of the Code for nearly a decade. It was intended to modernize the bankruptcy laws In such a substantial overhaul of the system, it is not appropriate or realistic to expect Congress to have explained with particularity each step it took.

with the decision in *Sun Runner*. In comparing the *Sun Runner* and *T.S. Industries* decisions, it is important to look at the differences in facts and the differences in the questions presented. In *Sun Runner*, the debtor and other party to the contract were seeking continuation of a contract, entered into before bankruptcy was even contemplated, over the objection of other creditors.⁷⁹ To protect these other creditors, the BAP looked to section 365(c)(2) and reversed the bankruptcy court's approval of assumption.⁸⁰ *T.S. Industries* involved very different facts and presented different questions. In *T.S. Industries*, the other creditors were seeking continuation of a contract entered into in contemplation of bankruptcy over the objection of the debtor and the other parties to the contract.⁸¹ Again acting to protect the other creditors, the court looked to section 365(c)(2) and concluded that it should not apply to contracts entered into in contemplation of the bankruptcy.⁸²

We agree with the rule, if not the holding and reasoning, of *T.S. Industries*. A debtor who files a prepackaged Chapter 11 bankruptcy should be able to enforce contracts it entered into on the eve of its bankruptcy to provide it financing in that bankruptcy. Section 365(c)(2) should not prevent the debtor from enforcing such contracts. As drafted, section 365(c)(2) should not apply to such contracts; thus, the chosen postpetition lender in a prepackaged bankruptcy should not be able to slow down the prepackage process. The lender should not be allowed to escape its prepetition bargain and extort benefits for the prepackaged Chapter 11 debtor by arguing that section 365(c)(2) prevents assumption of their agreement by the debtor. However, such an agreement *should* be subject to approval by the Bankruptcy Court under *both* section 364 and section 365.

Having considered financing for prepackaged bankruptcy filings, we now turn to financing in a wholly different setting, one that typically involves far less planning—the involuntary bankruptcy.

Rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.

The task of resolving the dispute over the meaning of § 506(b) begins where all such inquiries must begin: with the language of the statute itself. In this case it is also where the inquiry should end, for where, as here, the statute's language is plain, "the sole function of the courts is to enforce it according to its terms." The language before us expresses Congress' intent—that postpetition interest be available—with sufficient precision so that reference to legislative history and to pre-Code practice is hardly necessary.

Ron Pair, 489 U.S. at 240-41 (citations omitted) (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)).

79. *Sun Runner*, 116 B.R. at 714-15.

80. *Id.* at 720.

81. *T.S. Industries*, 117 B.R. at 684-85.

82. *Id.* at 689.

III. "GAP PERIOD" FINANCING UNDER SECTION 364

A bankruptcy case is commenced by the filing of a bankruptcy petition.⁸³ This petition can be filed either by a debtor itself or by a number of creditors⁸⁴ of a putative debtor. When the former occurs, the case is called a "voluntary" bankruptcy; the latter is termed an "involuntary" bankruptcy. This is not a distinction without a difference, as there are significant discrepancies in the ability of the debtor to continue operating in voluntary and involuntary cases. For example, a voluntary debtor may only dispose of property without court approval if such is done in the ordinary course of its business⁸⁵ and the debtor may not use "cash collateral"⁸⁶ at all without court approval.⁸⁷ Also, a voluntary debtor generally may not pay its prepetition creditors⁸⁸ and must file regular financial and other reports with the United States Trustee.⁸⁹ Conversely, an involuntary debtor bears none of these burdens; it may instead "continue to operate [its business], and . . . continue to use, acquire or dispose of property as if an involuntary case . . . had not been commenced."⁹⁰

The special status of an involuntary debtor, however, is a temporary one. The involuntary debtor must timely⁹¹ and successfully controvert the petition filed by its creditors. If it does not, the court will enter an order for relief⁹² and the case will proceed, for most purposes, as if it were a voluntary case. The period between the filing of the involuntary petition and the entry of the order for relief is known as the "gap period."

The availability of postpetition financing under section 364 is usually not an issue in involuntary cases. Most involuntary cases are either dismissed or have an order for relief entered fairly quickly, leaving little time for an involuntary debtor to seek and obtain postpetition financing. Moreover, since involuntary filings are not planned by the debtor, the

83. See 11 U.S.C. §§ 301, 303(b) (1988).

84. Generally speaking, if the debtor has twelve or more creditors, such a petition must be filed by at least three creditors whose noncontingent, undisputed unsecured claims total more than \$5,000. 11 U.S.C. § 303(b)(1) (1988). Conversely, if the debtor has fewer than twelve creditors, any single creditor holding noncontingent, undisputed unsecured claim of over \$5,000 may file a petition. 11 U.S.C. § 303(b)(2) (1988).

85. See 11 U.S.C. §§ 363(b)(1), 363(c)(1) (1988).

86. "Cash collateral" generally refers to cash or cash equivalents, whenever acquired, in which an entity other than the debtor's estate has an interest. It includes postpetition proceeds, rents and profits of the debtor's prepetition assets that are subject to a security interest. See 11 U.S.C. § 363(a) (1988).

87. 11 U.S.C. § 363(c)(2) (1988).

88. See 11 U.S.C. § 549 (1988). There is a growing exception to this general rule. Increasingly, courts are approving postpetition payments on prepetition obligations to employees and others on the business, if not legal, theory that such payments are necessary. See generally *In re Eagle-Picher Indus.*, 124 B.R. 1021 (Bankr. S.D. Ohio 1991); *In re Chateaugay Corp.*, 80 B.R. 279 (Bankr. S.D.N.Y. 1987).

89. FED. R. BANKR. P. 2015.

90. 11 U.S.C. § 303(f) (1988).

91. The petition must be controverted within 20 days. FED. R. BANKR. P. 1011(b).

92. 11 U.S.C. § 303(h) (1988); FED. R. BANKR. P. 1013(b). Despite this, the authors are currently involved in a case in which the order for relief was not entered for 155 days.

debtor in an involuntary case has not arranged postpetition financing beforehand, a practice that is quite common in voluntary filings.

In those involuntary cases in which the debtor seeks new credit during the "gap period," the threshold issue of the ability of an involuntary debtor to utilize section 364 is likely to be raised. In those cases, parties that object to the involuntary debtor's use of section 364 may claim that, as the involuntary debtor has not consented to the jurisdiction of the bankruptcy court and acceded to the burdens thereof, it should not be granted the benefits of the Code. Conversely, the debtor may argue that its access to credit has been impaired by the filing of an unwarranted bankruptcy petition against it and, consequently, it should be able to use section 364 to restore its prepetition credit status. Neither of these two viewpoints is likely correct, and a middle ground between them is the most easily supported both by policy and the Code.

There is only one reported case that expressly deals with the question of whether an involuntary debtor can invoke section 364. In that case, *In re Roxy Roller Rink Joint Venture*,⁹³ the bankruptcy court faced an unusual set of facts. The case had begun as an involuntary Chapter 11 case in which the debtor needed \$120,000 to avoid immediate liquidation. An insider had offered to advance the \$120,000 and, as a condition of the proposed financing, had sought priority over administrative expenses and a first priority lien in an unencumbered lease to secure the financing, both pursuant to section 364(c).⁹⁴ The court had granted the debtor's motion to allow the proposed postpetition financing from the bench, and debtor's counsel had offered to present an order for the court's signature later in the week.⁹⁵ The insider made the loan, but the debtor's counsel subsequently failed to deliver the order to the court and failed to have the debtor and the lender execute any loan or security documents. Subsequently, all of the debtor's assets were sold, the case was converted to a Chapter 7 proceeding, and the lender petitioned the bankruptcy court for an order *nunc pro tunc* to authorize the financing.⁹⁶ Faced with the foregoing, the court determined, notwithstanding its previous grant of the financing, not to enter the order authorizing the financing *nunc pro tunc* because an involuntary debtor was not authorized to utilize section 364(c).⁹⁷

In so holding, the court first looked at section 364(a), although the debtor in *Roxy Roller* was moving under section 364(c), and made three findings specific to section 364(a). The court first noted section 364(a) requires that in order to borrow under that section, the debtor⁹⁸ must be

93. 73 B.R. 521 (Bankr. S.D.N.Y. 1987).

94. *Id.* at 522-23.

95. *Id.* at 523.

96. *Id.* at 522.

97. *Id.* at 522-23.

98. The statute literally requires a "trustee" to obtain the financing. 11 U.S.C. § 364(a) (1988). For a discussion of whether an involuntary debtor has the powers of a "trustee," see *infra* notes 107-10 and accompanying text.

operating the business under, *inter alia*, either section 721 or 1108 of the Code.⁹⁹ Second, the court found that the involuntary debtor's authority to operate the business comes from section 303(f) and not from either sections 721 or 1108.¹⁰⁰ Third, the court found that the utilization of section 364(a) by an involuntary debtor to create an administrative expense priority for a gap period creditor would bring section 364(a) into direct conflict with Sections 502(f) and 507(a)(2), which provide priority directly behind administrative expenses for the involuntary debtor's gap period "ordinary course" expenses.¹⁰¹ As a consequence of these three findings, the *Roxy Roller* court held that section 364(a) is not available to an involuntary debtor.¹⁰²

The *Roxy Roller* court next considered the availability of section 364(b) to an involuntary debtor. The leading multivolume bankruptcy treatise, *Collier on Bankruptcy*, states that section 364(b) credit is available to an involuntary debtor.¹⁰³ In disagreeing with *Collier*, the *Roxy Roller* court took issue with the statement that section 502(f) applies only to "ordinary course" transactions, and thus does not present a conflict with section 364(b) that disqualifies an involuntary debtor from obtaining 364(b) financing.¹⁰⁴ The *Roxy Roller* opinion attacked this statement in two ways. First, the court stated that section 502(f) provides "[n]o support" for *Collier's* assertion.¹⁰⁵ Section 502(f) provides ample support for such an assertion, as it deals only with "ordinary course" transactions, in contrast to section 364(b), which deals with transactions outside the "ordinary course." Second, the opinion stated that allowing an involuntary debtor to use section 364(b), but not 364(a), made little sense, as there was not a "sufficient distinction" between the two sections.¹⁰⁶ To the contrary, section 364(b) requires court approval, while section 364(a) does not. The imposition of the requirement of court approval allows the regulation by the court of these credit extensions.

In its discussion of section 364(b), the *Roxy Roller* court also considered a question critical to the section 364(c) superpriority and the lien that the debtor sought: does the involuntary debtor have the status of a

99. *Roxy Roller*, 73 B.R. at 526.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Collier* states:

In an involuntary case credit incurred outside the ordinary course of business before entry of the order for relief must be authorized by the court under section 364(b). Such credit is entitled to priority as an expense of administration under Section 503(b)(1). Section 502(f) applies only to credit obtained in the ordinary course of business during the so-called involuntary gap period, and therefore will not disqualify credits authorized under section 364(b) from priority under Sections 503(b)(1) and 507(a)(1).

WILLIAM M. COLLIER, 2 COLLIER ON BANKRUPTCY, ¶ 364.03 (Lawrence P. King et al. eds, 15th ed. 1991).

104. *Roxy Roller*, 73 B.R. at 526.

105. *Id.*

106. *Id.*

"trustee" during the gap period? Paragraphs (b), (c), and (d) of section 364 use the term "trustee." An involuntary debtor can make use of these paragraphs only if she has the status of a "trustee." On that question, the *Roxy Roller* court held that, although section 1107 equates the powers of a debtor-in-possession with those of a trustee, and an involuntary debtor is a debtor-in-possession,¹⁰⁷ the involuntary debtor could not be a trustee, as its freedom to operate under Section 303(f) was inconsistent with the obligations of a "trustee."¹⁰⁸ Having concluded that an involuntary debtor is not a "trustee," the *Roxy Roller* court held that neither section 364(b) nor section 364(c) was available to an involuntary debtor and, consequently, denied the debtor's motion for an order *nunc pro tunc*.¹⁰⁹

The *Roxy Roller* holding that an involuntary debtor is not a "trustee" for purposes of section 364 seems inconsistent with the language of section 101(12), section 1101, and section 1107. Section 101(12) defines "debtor" as an entity against which a case has been "commenced." It does *not* explicitly limit the definition of debtor to an entity that has commenced a case itself. Section 1101 makes any "debtor" a "debtor-in-possession" unless a trustee has been appointed. Finally, section 1107 allows a "debtor-in-possession" to utilize all the rights of a "trustee." Following this analysis, an involuntary debtor is a "trustee" and can borrow under sections 364(b), (c) and (d).¹¹⁰

Allowing an involuntary debtor to utilize sections 364(b), (c) and (d), is consistent not only with the language of the Code but also with fundamental considerations of fair play and equity. An involuntary debtor has been thrust into bankruptcy against its will. Its credit is likely to be damaged, if not destroyed. Its cash needs will increase, as all of its suppliers are likely to continue transactions only upon a cash on delivery basis. It is not fair to ask the involuntary debtor to shoulder these burdens while not allowing it to obtain any sort of financing other than ordinary course trade credit. This is particularly true when one notes that other than credit granted under section 364(d),¹¹¹ all of the priorities that can be granted to a creditor under section 364 would have been available to the involuntary debtor for granting to creditors outside of bankruptcy.¹¹²

107. See 11 U.S.C. §§ 101(12) (defining "debtor"), 1101(1) (defining "debtor-in-possession") (1988).

108. *Roxy Roller*, 73 B.R. at 527.

109. *Id.*

110. The debtor cannot utilize § 364(a), as outlined *supra*, because its power to operate does not derive from §§ 721 or 1108 of the Code, as required by § 364(a). It is conceded that the debtor's ability to operate comes from § 303(f), not from either §§ 1108 or 721. This concession is made at least in part in recognition of the conflict, noted by the *Roxy Roller* court, between the priority accorded ordinary course unsecured claims pursuant to §§ 364(a) and 507(a)(1) and that accorded "gap period" ordinary course unsecured claims pursuant to §§ 502(f) and 507(a)(2). This conflict is unavoidable, as § 364(a)/507(a)(1) expenses are a subset of § 502(f) expenses. *Roxy Roller*, 73 B.R. at 526.

111. This credit would have been available as well, through the use of a subordination agreement. However, the other types of credit available under § 364 would likely have been available without creditor consent.

112. Section 364(c)(1) credit is also not available on a nonconsensual basis, *i.e.*, with-

Consequently, the denial of the use of section 364(b), (c), and (d)¹¹³ to involuntary debtors would completely cut off all normally available financing at the very time the involuntary bankruptcy filing has dramatically increased the debtor's need for financing.¹¹⁴

The foregoing analysis presents at least one conceptual difficulty: it applies only to Chapter 11 cases. As noted previously, a debtor-in-possession is defined in Section 1101, which applies only to Chapter 11 cases.¹¹⁵ Further, a debtor-in-possession has the powers of a trustee pursuant to Section 1107, which again applies only in Chapter 11 cases.¹¹⁶ Chapter 7 has no parallel provision that grants the Chapter 7 involuntary debtor the powers of a trustee.¹¹⁷ In an actual involuntary Chapter 7 case, a trustee is not appointed until an order for relief is entered.¹¹⁸ Consequently, an involuntary Chapter 7 debtor can never be a trustee, nor would a trustee automatically be appointed during the "gap period" of an involuntary Chapter 7 case, and thus it would seem that an involuntary Chapter 7 debtor could not borrow under any part of section 364, even under our analysis.

Despite the foregoing, a Chapter 7 involuntary debtor can access section 364 by taking one of two possible additional steps. First, an involun-

out a subordination agreement from all other unsecured creditors, outside of bankruptcy. However, such credit is not likely to be utilized to a significant extent by those lending to involuntary debtors for, if such debtors are successful in fending off the bankruptcy, such a priority will be meaningless.

113. Given this potential unfairness, one might wonder why the Code does not allow the involuntary debtor to obtain credit under § 364(a) as well. However, the division of § 364 into the two portions that we suggest has further support in logic and reason, even in light of the above-mentioned unfairness. This is because §§ 364(b), (c), and (d) require court approval; § 364(a) does not. See 11 U.S.C. §§ 364(a)-(d) (1988). This division, coupled with the priority allowed under §§ 502(f) and 507(a)(2), allows the involuntary debtor to obtain financing for its ordinary course debts with a second priority and all other financing under the watchful eye of the bankruptcy court. See 11 U.S.C. § 502(f), 507(a)(2) (1988). This division allows the involuntary debtor significant flexibility to fulfill its cash needs without allowing it complete freedom to obtain financing in the period before an order for relief is entered. Further, according only a second priority for ordinary course expenses during the "gap period" should not have a significant effect on the involuntary debtor's trade credit, provided that the involuntary debtor can convince its creditors that the petition will ultimately be dismissed, and thus Code priorities will be of no significance.

114. The *Roxy Roller* opinion sets out another conceptual difficulty with concluding that an involuntary debtor is a trustee for purposes of § 364. See *Roxy Roller*, 73 B.R. 521. If she is a "trustee" for purposes of § 364, then the involuntary debtor is also a "trustee" for purposes of the avoiding powers such as the preference provision of § 547. Although the filing of an involuntary petition does trigger the Section 547 time periods, we are not comfortable with the idea of an involuntary debtor avoiding a transfer before an order for relief on the petition. We assume that bankruptcy judges will be at least as uncomfortable with the idea and, in the unlikely event that an involuntary debtor filed an avoidance action during the gap period, the judge would act on the involuntary petition before acting on the avoidance action.

115. 11 U.S.C. § 103(f) (1988).

116. 11 U.S.C. § 103(f) (1988).

117. The absence of a parallel Chapter 7 provision is due most likely to the automatic appointment of an interim trustee. 11 U.S.C. § 701 (1988).

118. *Id.*

tary Chapter 7 debtor can move to convert the case to a Chapter 11 case,¹¹⁹ opening up the availability of credit. Although conversion does cause an order for relief to be entered,¹²⁰ the involuntary debtor can always move to dismiss the case for "cause" after the conversion.¹²¹ Alternatively, if the involuntary debtor is unwilling to seek conversion, it can still obtain section 364 financing by first seeking the appointment of an interim trustee under section 303(g). Under this section, a party in interest may request the appointment of an interim trustee to "preserve the property of the estate or to prevent loss to the estate."¹²² To obtain postpetition financing in an involuntary case, it will often be necessary to preserve the property of the estate, so an interim trustee might be available for that reason. An interim trustee would have the powers of a permanent trustee¹²³ and the appointment of such a trustee would not remove the debtor's ability to contest the petition.

CONCLUSION

The ability of prepackaged debtors to lock in financing and the ability of involuntary debtors to take advantage of section 364 both present interesting questions for financial institutions of statutory interpretation and bankruptcy policy in the important area of postpetition financing. We hope that we have shed some light on the answers to those questions.

APPENDIX A

*Priorities**

- I. Primary Liens—section 364(d)
- II. Secured Claims (to value of collateral)—Section 506(a)
- III. Superpriority Claims—Section 364(c)
- IV. Administrative Claims—Section 507(a)(1) and 503(b)
- V. "Gap Period" Claims—Section 507(a)(2) and 502(f)
- VI. Unsecured Claims (including deficiencies in Secured Claims) —Section 506(a)
- VII. Interests

*General overview—some priorities omitted

119. 11 U.S.C. § 706(a) (1988) (providing an absolute right to convert a Chapter 7 case to a Chapter 11 case, provided the case has not already been converted to a Chapter 7 case).

120. 11 U.S.C. § 348(a) (1988).

121. 11 U.S.C. § 1112(b) (1988).

122. 11 U.S.C. § 303(g) (1988).

123. 11 U.S.C. § 701(c) (1988).