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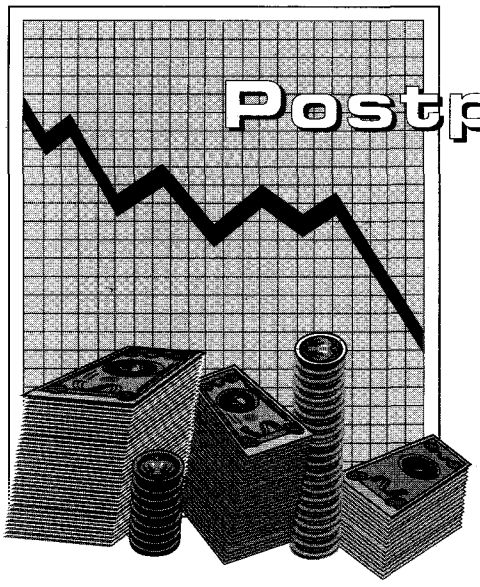
# Postpetition Lending under Section 364: Current Issues - Incentives to Lenders to Provide Financing to Borrowers Who Are the Subject of Bankruptcy Cases

David G. Epstein
*University of Richmond*, depstein@richmond.edu



# Postpetition Lending under

## *Incentives to lenders to provide financing to borrowers who are the subject of bank*

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

A bankruptcy debtor is not viewed by most lenders as a desirable customer. Most lenders are understandably reluctant to extend credit to such a borrower. This reluctance compounds the difficulties of a bankruptcy debtor. Without new financing, the cash needs of a debtor often will cause the debtor's assets to be liquidated, thereby foreclosing any hope of reorganization and defeating the rehabilitative purposes of the Bankruptcy Code.[1]

To counter the understandable reluctance of financial institutions to lend to bankruptcy debtors, section 364 of the Bankruptcy Code provides incentives to lenders to provide financing to borrowers who are the subject of bankruptcy cases. Section 364 enables a debtor to obtain credit by granting a prospective lender a variety of different incentives, some of which are not available on a nonconsensual basis outside of the bankruptcy context.[2]

### Section 364

#### *Section 364 (a)*

The starting point for analyzing the provisions for postpetition financing in the Bankruptcy Code is section 364(a).[3] Section 364(a) 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," that allows the debtor to continue to operate its business in the ordinary course.[4] 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 not allowable under section 502(f) and is an "actual, necessary cost [or] expense of preserving the estate."[5]

#### *Section 364(b)*

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 answered. Moreover, section 364(b) provides a safer method for creditors who desire to extend postpetition unsecured credit to do so. Section 364(b) eliminates the need to make the diffi-

*The phrase "current issues" is relative. The article is "current" as of December 31, 1993; the "issues" are issues that arise primarily in a business bankruptcy practice.

**The authors practice in the bankruptcy and commercial litigation group at King & Spalding in Atlanta, Georgia. Paul M. Baisier received a J.D. from Harvard Law School in 1990 and a B.S. in finance from the University of Illinois in 1987. David G. Epstein received an LL.B. from the University of Texas in 1966 and a B.A. from the University of Texas in 1964. 

# Section 364: Current Issues*

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cult determination whether particular credit is extended 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.[6]

### *Section 364(c)*

A debtor often cannot obtain sufficient credit on an unsecured basis to maintain business operations. Sections 364(c) and 364(d) allow debtors to obtain credit on a priority basis or by the granting of liens on property of the debtor. More specifically, section 364(c) empowers the debtor to grant a postpetition lender either (1) a priority over all administrative expenses of the case, (2) a security interest in unencumbered property of the debtor, or (3) a junior lien on already encumbered property. 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 a hearing. Further, to be able to grant the priorities and liens provided in section 364(c), a debtor must prove to the court that it cannot obtain the needed credit on an unsecured basis.

### *Section 364(d)*

If even the priorities and liens provided by section 364(c) are insufficient to entice potential lenders to provide sufficient financing to a debtor, the debtor, with court approval, may obtain credit by granting the lender a lien on property of the debtor that is senior to existing liens on such property pursuant to section 364(d). The granting of such a lien is, however, subject to several statutory conditions. First, as with section 364(c), the debtor must prove that it cannot obtain credit on an any less intrusive basis (*i.e.*, through the use of sections 364(a), (b), or (c)).[7] Additionally, the debtor must prove that the interest of any lender whose lien is to be primed is "adequately protected."[8]

### *Section 364(e)*

Finally, lenders who have advanced funds based on court orders granted under section 364 are protected on appeal by section 364(e). Debtors generally have an immediate need for postpetition financing. Lenders would be reluctant to advance funds immediately if a section 364(b) or (c) priority or a section 364(c) or (d) lien could be eliminated retroactively by the reversal on appeal of the order granting the priority or lien securing the advance. Consequently, to encourage lending, the priorities and liens granted to lenders pursuant to section 364 are protected from reversal on appeal by section 364(e), so long as the order granting the priority or lien was sought in "good faith" and so long as a stay pending the appeal was not obtained by a party opposing the grant of the priority or lien.

## Cross-Collateralization[9]

For a variety of business and legal reasons, debtor-in-possession financing is often provided by one of the debtor's prepetition lenders. Common reasons for this practice include the familiarity of existing lenders with the debtor and its business and the lack of economic justification for a postpetition loan by a lender lacking a preexisting stake in the debtor.

In agreeing to lend postpetition funds, an undersecured[10] prepetition lender frequently attempts to improve its position on its prepetition claim. For example, in *In re Saybrook Manufacturing Company, Inc.*,[11] the debtor owed Manufacturers Hanover $34 million prepetition. This prepetition obligation was secured by prepetition collateral with a value of less than $10 million. Manufacturers Hanover agreed to lend the debtor $3 million postpetition to facilitate its reorganization, in exchange for a lien on all of the debtor's property, both prepetition and postpetition, given to secure both the debtor's prepetition and postpetition obligations to Manufacturers Hanover.

### *Definition*

Securing prepetition debt with both prepetition and postpetition collateral is generally referred to as "cross-collateralization." The term cross-collateralization appears nowhere in the Bankruptcy Code. The *Saybrook* opinion refers to an earlier Second Circuit decision, *In re Texlon Corp.*,[12] as the first appellate court decision to use the phrase "cross-collateralization."[13] The *Saybrook* Court describes the Manufacturers Hanover loan as "*Texlon*-type cross-collateralization."[14] The phrase "*Texlon*-type cross-collateralization" refers to granting a security interest in postpetition assets to secure prepetition obligations. By contrast, a debtor might also grant a lien on prepetition assets to secure the loans of a postpetition

lender. This "non-Texlon-type of cross-collateralization" is expressly authorized by section 364(c).[15] The phrase "cross-collateralization" as used hereinafter will only include *Texlon*-type cross-collateralization.

### *Texlon*

**1. Facts.** The *Texlon* case was governed by the Bankruptcy Act of 1898. When Texlon filed its Chapter XI petition, Manufacturers Hanover was owed more than $700,000. The collateral securing the loan was valued at less than the amount of this obligation. On the date of the petition, the bankruptcy court entered an *ex parte* order authorizing Texlon to enter into factoring and loan agreements with Manufacturers Hanover. The financing order granted Manufacturers Hanover a security interest in Texlon's prepetition and postpetition assets to secure both the postpetition loan and the prepetition obligation. Within ten weeks, the Texlon Chapter XI case was converted to Chapter VII. In the postpetition interval, Manufacturers Hanover advanced $667,000 to the debtor. After repaying the $667,000 postpetition advance, Texlon had $267,000 in remaining assets.

If the cross-collateralization provision had been upheld, all of that $267,000 would have gone to Manufacturers Hanover in payment of its prepetition unsecured claim. The Chapter VII trustee requested the bankruptcy court to modify its original financing order to delete the cross-collateralization provision. The bankruptcy court agreed with the trustee that the cross-collateralization provision should not have been approved. It stated that the cross-collateralization clause would violate the basic bankruptcy principle of equality of treatment for like situated creditors without statutory authority. The court indicated that it would not enter such orders in the future, but declined to vacate the original order.[16]

**2. Holding.** The Second Circuit reversed the bankruptcy court; however, the holding was limited to the facts of *Texlon*—particularly the fact of an *ex parte* hearing.

> A financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order, where the bankruptcy court relies solely on representations by a debtor-in-possession that credit essential to the maintenance of operations is not otherwise obtainable. The debtor-in-possession is hardly neutral.[17]

*Texlon* is generally recognized only for this narrow holding, although Judge Friendly's *dictum*, questioning the validity of cross-collateralization, is also often cited.

### *Ellingsen and Adams Apple*

After *Texlon*, two other courts of appeal avoided deciding the validity of cross-collateralization clauses. In *In re Ellingsen MacLean Oil Company*,[18] and *In re Adams Apple, Inc.*,[19] the Sixth and Ninth Circuits were confronted with challenges to cross-collateralization clauses. Both the Sixth and Ninth Circuits ruled that section 364(e) mooted the appeals of debtor-in-possession financing orders containing cross-collateralization clauses.

In *Ellingsen*, the postpetition lender received, as part of a section 364(c) financing order, an agreement from the debtor not to challenge the lender's prepetition security interests. The Sixth Circuit determined that this provision was arguably covered by section 364(c), and stated that, even if it were not, that fact would likely not take the provision outside of the protections of section 364(e), as long as that provision was purported to be granted under section 364(c) and was obtained in good faith.[20] Although there does not appear to have been any cross-collateralization involved in the 364(c) order at issue in *Ellingsen*, the court, in *dicta*, stated that "the mere allowance of cross-collateralization in some degree as a financing tool does not deprive an order of section 364(e) protection."[21]

In *Adams Apple*, the Ninth Circuit acknowledged that cross-collateralization was not expressly included in the list of financing devices contained in section 364. The court then stated that cross-collateralization *is covered* by section 364; however, the court cautioned that its conclusion that cross-collateralization clauses were "authorized" under section 364 was limited to the context of section 364(e) mootness and was not intended to prevent a panel of the court from holding in the future that cross-collateralization was illegal per se: "[b]ecause the bankruptcy judge thought that cross-collateralization was legal and entered an order to that effect upon which the creditor relied, we conclude that the creditor should receive the protection of section 364(e) in this case."[22]

### *Vanguard*

Perhaps the strongest decision endorsing cross-collateralization is *In re Vanguard Diversified, Inc.*[23] In *Vanguard*, the court adopted a four-part test proposed by Benjamin Weintraub and Professor Alan Resnick.[24] Under that test, cross-collateralization should be permitted if: (1) the debtor will not survive without the loan; (2) the debtor is unable to get loans from alternative sources on acceptable terms; (3) the lender who proposes to make the loan will not agree to the loan without cross-collateralization; and (4) the loan is in the best interest of creditors.[25] This test is similar to that employed in granting a senior lien under section 364(d), although in this situation the focus is on the protection of all unsecured creditors, rather than on the protection of one or more secured creditors.

### *Saybrook*

In *Saybrook*, the Eleventh Circuit became the first circuit court to rule directly on the propriety of cross-collateralization. The Eleventh Circuit in *Saybrook* concluded that cross-collateralization "is an impermissible means of obtaining postpetition financing"[26] and explained:

> [w]e conclude that cross-collateralization is inconsistent with the bankruptcy law for two reasons. First, cross-collateralization is not

> authorized as a means of postpetition financing under Section 364. Second, cross-collateralization is beyond the scope of the Bankruptcy Court's inherent equitable powers because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code.[27]

### *Goold*

After *Saybrook*, the District Court for the Northern District of Illinois, in *Official Committee of Unsecured Creditors v. Goold Electronics Corp.*,[28] declined to follow the holding in *Saybrook* that cross-collateralization was *per se* impermissible. Instead, it invited the bankruptcy court on remand to establish a test that would "weigh the equities" in approving or declining to approve lending that included cross-collateralization. It suggested the test applied in *Vanguard*, but clearly indicated that that test was not required, and that, on remand, the bankruptcy court was free to establish a test of its own.

### *Contrast with Doctrine of Necessity/Conclusion*

In addition to being inconsistent with the prior holdings in *Ellingsen* and *Adams Apple*, and the subsequent holding in *Goold*, the *Saybrook* holding seems inconsistent with holdings in another developing area of bankruptcy law, the doctrine of "necessity." Courts increasingly are permitting Chapter 11 debtors to make postpetition/preconfirmation payments on prepetition claims to suppliers or employees, finding that such payments are necessary for the debtor to continue its operations.[29] The holding in *Saybrook* regarding cross-collateralization, which prohibits cross-collateralization because its allows the collateralization of prepetition claims, thereby improving their chances of being paid, seems inconsistent with these cases, which authorize the actual *payment* of prepetition claims. If the payment of prepetition claims, in violation of the priorities established in section 507, can be justified by some sort of "necessity," it stands to reason that cross-collateralization may be justifiable on the basis of some similar showing. If that is the case, all that is required is the identification by courts of the factors that might demonstrate a "necessity" for those purposes. For example, the *Vanguard* factors seem to establish a certain "necessity" that might justify cross-collateralization. Similarly, the bankruptcy court in *Goold* may develop such a list of factors. In any event, to the extent that "necessity" is valid justification for the payment of prepetition claims, a factored approach to the approval of cross-collateralization that encompasses the concept of necessity may be the best approach to deciding the propriety of cross-collateralization case-by-case. Such an approach, conducted under the statutory authority of sections 105[30] and 364, also would likely balance the equality of distribution and reorganization objectives of the Bankruptcy Code as well as is possible in the difficult cases in which cross-collateralization is an issue.

## Appeals of Financing Orders

The holding in *Saybrook* that cross-collateralization is *per se* impermissible is significant. Equally significant, however, is the *Saybrook* approach to appellate review of financing orders.[31]

Postpetition financing is generally a matter of some urgency. The debtor often needs immediate court approval of debtor-in-possession financing so that it can obtain the financing quickly and continue in business. If an appellate court could overturn the protections granted to the lender by the bankruptcy judge in her order, most lenders would not be willing to fund the loan until all issues concerning its loan had been fully litigated and appealed. To ensure that lenders are willing to fund postpetition loans quickly, section 364(e) provides that the protections granted to postpetition lenders under a section 364 financing order cannot be later overturned, unless the lenders acted in bad faith or the order is stayed.

Section 364(e) provides

> 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 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 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.

Professor James J. White recently described the purpose of section 364(e) and the corresponding provision in section 363, section 363(m), as follows:

> Necessarily bankruptcy is a contentious setting; almost always some party will believe that a proposed sale under Section 363 or a loan under Section 364 is contrary to its interest and can argue that it is a violation of the provisions of the Code. Since such sales under Section 363 and loans under Section 364 are usually made in the presence of such inchoate threat or challenges, the drafters feared that the buyers would not buy from sellers in bankruptcy and the lenders would not lend to them. By foreclosing appeal - except where there has been something tantamount to bad faith - the Congress has taken extraordinary measures to encourage purchases and loans. The general message of these sections is that one must protest before the bankruptcy judge, and if a person is not successful there, must get a stay pending the appeal, or forsake his case. Even where the bankruptcy judge has misread the law or granted an impermissible right to a lender or buyer, the decision cannot be overturned on appeal if the buyer purchased in good faith or the lender made its loan in good faith.[32]

In general, the reported cases under section 364(e) have been consistent with the above quotation from Professor White. As discussed in Part II, in *Adams Apple*, the Ninth Circuit held that the mootness doctrine applied to an order permitting cross-col-

lateralization despite the fact that some courts had held cross-collateralization orders invalid. Also, in *Ellingsen*, the Sixth Circuit reached the same result with respect to an order barring challenges to the lender's prepetition liens.

### *Saybrook and 364(e)*

In *Saybrook*, the Eleventh Circuit broke with the Sixth and Ninth Circuits on this issue. The court in *Saybrook* held that an appeal from a bankruptcy court's order authorizing cross-collateralization is not mooted by section 364(e). In so ruling, Judge Cox looked to the language of section 364(e) and certain articles written by Professor Charles Tabb, rather than considering the language of the Sixth Circuit or the Ninth Circuit or the writings of Professor White.

According to the *Saybrook* court, the relevant phrase from section 364(e) is the phrase "authorization under this section." With respect to that language, Professor Tabb wrote as follows:

> The primary argument made that lender-preference clauses are not protected by Section 364(e) is that Section 364(e), on its face, only applies to authorizations to incur debt or to obtain credit under this section, and the granting of a priority or lien 'under this section,' meaning, of course, Section 364. It is undisputed that lender-preference clauses are not provided for expressly anywhere in Section 364 (or anywhere else in the Code, for that matter). The apparently straightforward conclusion is that Section 364(e) being limited by its own terms to Section 364 financing orders, does not extend to non-Section 364 financing clauses such as lender-preference clauses. This plain meaning argument is consistent with the underlying purposes of Section 364(e).[33]

Because the *Saybrook* court agreed with Professor Tabb, it had to decide whether cross-collateralization provisions were "authorized" by section 364. As discussed in Part II, it determined that they were not, and thus the court held that section 364(e) did not protect cross-collateralization provisions on appeal. *Saybrook* conflicts with *Adams Apple* in holding that, for section 364(e) purposes, cross-collateralization is not authorized, and conflicts with *Ellingsen* in holding that provisions that are not explicitly authorized by section 364 but that are part and parcel of the financing are not immune from review.

### *Florida West*

After *Saybrook*, a bankruptcy court in the Eleventh Circuit, in *In re Florida West Gateway, Inc.*,[34] applied the *Saybrook* holding regarding the availability of section 364(e) protection very narrowly in upholding a mutual recognition of the prepetition extinguishment of certain claims as part of a section 364 financing agreement. In *Florida West*, the court limited the *Saybrook* holding to cross-collateralization provisions, holding that *Saybrook* is inapposite because "[the lender here] is not collateralizing a prepetition claim. Rather, the Trustee is acknowledging that mutual obligations . . . were cancelled prepetition."[35]

### *Impact of Saybrook on Interpretation of 364(e)*

*Saybrook* has the potential to have a significant impact on postpetition lending practices. If taken to its logical extreme, any provision in a postpetition lending arrangement that does not deal explicitly only with postpetition financing or the security therefor is not protected by section 364(e) and is subject to being overturned on appeal under the *Saybrook* analysis. Lenders concerned about attacks on their security interests, as well as lenders concerned about potential lender liability claims, would likely be far more reluctant to "throw good money after bad" if under the *Saybrook* rule they could potentially not only lose both the good and bad money, but be sued after the case has concluded. Conversely, if the *Saybrook* analysis is limited by subsequent courts to appeals of cross-collateralization provisions, it will have a much smaller impact on the practice of postpetition lending. This is especially true in light of the current tendency, particularly in larger cases, for competitive pressures to force potential postpetition lenders not to insist on cross-collateralization. Resolution in this area will have to await further developments in the case law.

## Gap Period Financing under Section 364

The issue of the availability of cross-collateralization, and the related issue of mootness under section 364(e), are raised fairly frequently in voluntary business bankruptcy cases. In contrast, the availability of postpetition financing pursuant to section 364 is usually not an issue in involuntary bankruptcy 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, because involuntary filings are not planned by the debtor, the debtor in an involuntary case generally has not arranged postpetition financing prior to its filing, a practice that is quite common in voluntary filings and quite necessary if the financing is to be utilized early in the bankruptcy case.[36]

In those involuntary cases in which the debtor does seek credit during the "gap period,"[37] the threshold issue of the ability of an involuntary debtor to utilize section 364 is likely to be raised by those opposing the financing. In such cases, the party or 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 of operating under the supervision of the bankruptcy court, it should not be allowed to utilize any of the benefits of the Bankruptcy Code. Conversely, the debtor may argue that its access to credit has been seriously impaired, if not destroyed, by the filing of an unwarranted bankruptcy petition against it and, consequently, it should be able to use section 364 to restore it to its prepetition credit status.

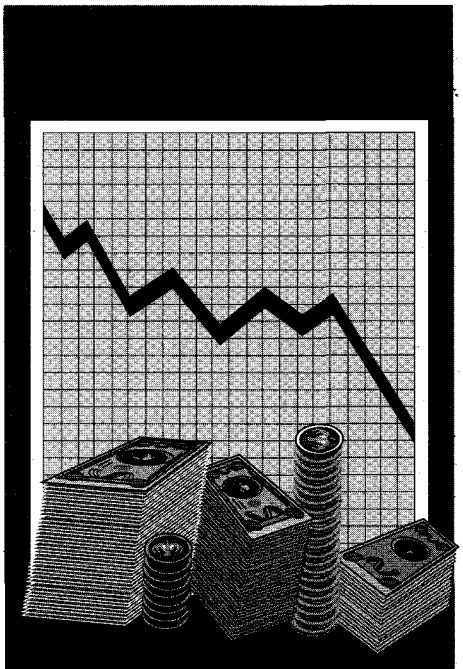
Neither of these two viewpoints is entirely correct. Instead, a middle ground is the most easily supported by sound public policy and by the language and structure of the Bankruptcy Code.

### *Roxy Roller*

There is only one reported case that expressly deals with the issue of whether an involuntary debtor can utilize the benefits of section 364. In that case, *In re Roxy Roller Rink Joint Venture*,[38] the bankruptcy court faced an unusual set of facts.

The *Roxy Roller* case began as an involuntary Chapter 11 case in which the debtor required $120,000 to avoid immediate liquidation. An insider offered to advance the $120,000 and, as a condition of the proposed financing, sought priority over administrative expenses and a first priority lien in an unencumbered lease to secure the financing, both pursuant to section 364(c). At an interim hearing, the court granted the debtor authority to borrow $15,000 from the insider, such sum to be granted administrative expense priority and to be secured by an interest in the lease. At the final hearing on the financing, the court granted the debtor's motion regarding the postpetition financing *in toto* from the bench, and debtor's counsel offered to present an order authorizing the financing for the court's signature later in the week. The insider subsequently made the loan, but the debtor's counsel failed to deliver the order to the court and also 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, and the lender petitioned the bankruptcy court for an order *nunc pro tunc* authorizing the financing.

Faced with the foregoing, the *Roxy Roller* court first determined that the lack of loan documentation prevented any finding that the insider/lender had a lien on the lease.[39] The court further determined that, notwithstanding its previous ruling authorizing the debtor to enter into the financing, it should not enter the order, *nunc pro tunc*, authorizing the financing and granting the insider/lender a claim with priority over administrative expenses, as it was now of the view that an involuntary debtor was not authorized to utilize section 364(c) at all.[40]



It can, of course, be argued that there should not be incentives to lend to companies in bankruptcy. It can also be argued that there should not be a Chapter 11 at all, or that the Atlanta Braves are not America's team, or that Coca-Cola is not good for you. But not by these authors.

### *Roxy Roller Analysis of 364(a)*

After providing an overview of the authority of an involuntary debtor to operate and the avoidability of certain transfers made by the involuntary debtor during the gap period,[41] the *Roxy Roller* court turned to an analysis of the availability of section 364 to involuntary debtors. The court first looked at section 364(a) and made four findings specific to that section. The court first noted that section 364(a) requires that, in order to borrow under that section, the debtor must be operating under, *inter alia*, either section 721 or section 1108 of the Code.[42] Second, it found that the involuntary debtor's authority to operate derives from section 303(f), and not from either section 721 or section 1108.[43] 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.[44] Finally, the court held that an involuntary debtor is not a "trustee" so as to be able to borrow.[45] As a consequence of these findings, the *Roxy Roller* court held that section 364(a) is not available to an involuntary debtor.[46]

### *Roxy Roller Analysis of Section 364(b)*

The *Roxy Roller* court next considered the availability of section 364(b) to an involuntary debtor. The leading multi-volume bankruptcy treatise, *Collier on Bankruptcy*, states that section 364(b) credit is available to an involuntary debtor. More specifically, *Collier* states:

> In an involuntary case credit incurred outside of 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 credit authorized under Section 364(b) from priority under Sections 503(b)(1) and 507(a)(1).[47]

In disagreeing with *Collier*, the *Roxy Roller* court took issue with the statement in *Collier* 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 section 364(b) financing. The *Roxy Roller* opinion attacked this statement in two ways: first, it said that section 502(f) provides "no support" for *Collier*'s assertion.[48] Section 502(f), however, 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 *Roxy Roller* opinion stated that allowing the use by an involuntary debtor of section 364(b), but not 364(a), made little sense, as there was not a "sufficient distinction" between the two sections.[49] This statement makes little sense, as section 364(b) requires court approval, while section 364(a) does not. The imposition of the requirement of court approval allows for regulation by the court of section 364(b) credit extensions and would seem to provide a "sufficient distinction" between the sections.

### *Roxy Roller Analysis of 364(c)*

In its discussion of section 364(b), the *Roxy Roller* court also considered a question critical to the section 364(c) superpriority that the debtor was seeking: does the involuntary debtor have the status of a "trustee" during the gap period? Paragraphs (a), (b), (c), and (d) of section 364 all use the term "trustee." An involuntary debtor can make use of these paragraphs only if it 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 pursuant to section 1101(1), the involuntary debtor could not be a "trustee," as its freedom to operate provided by section 303(f) was inconsistent with the obligations of a "trustee."[50] 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*.[51] Despite that holding, the *Roxy Roller* court did hold that the insider/lender should be paid $15,000 pursuant to its interim order, as that order had never been appealed and was immune from reversal pursuant to section 364(e).[52]

### *Alternative Analysis*

The *Roxy Roller* holding that an involuntary debtor is not a "trustee" for purposes of section 364 appears 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 explicitly does *not* 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 and powers of a "trustee."

Following this analysis, an involuntary debtor is a "trustee" and, provided that it can meet the other section 364 requirements, is eligible to utilize sections 364(b), (c), and (d). It cannot utilize section 364(a), as the *Roxy Roller* court held, but not for the reasons that the *Roxy Roller* court suggested (*i.e.*, that the involuntary debtor does not operate under section 1108, that the involuntary debtor is not a trustee, and that allowing such a priority would conflict with the priority otherwise assigned under section 502(f)). Instead, it is the need for the expense to be "allowable under section 503(b)(1)" that prevents the use of section 364(a) by an involuntary debtor.

The credit that is available under section 364(a) is that obtained in the ordinary course of business and allowable under section 503(b)(1). Credit is only allowable under section 503(b)(1) if it is does not represent a claim allowed under section 502(f). A claim allowed under section 502(f) includes any claim that arises in an involuntary case in the ordinary course of the debtor's business and prior to the entry of an order for relief or the appointment of a trustee. Consequently, unless a trustee has been appointed, section 364(a) is not available to an involuntary debtor[53] because any claim that arises in the ordinary course of an involuntary debtor's business (the first requirement to be eligible for section 364(a) treatment) is eligible for section 502(f) treatment and thus does not fulfill the other requirement for section 364(a) treatment (because it is not otherwise allowable under section 503(b)(1)).

Allowing an involuntary debtor to utilize sections 364(b),[54] (c), and (d), and, if a trustee has been appointed, section 364(a), is consistent not only with the language of the Bankruptcy Code but also with fundamental considerations of fairness. An involuntary debtor has been thrust into a bankruptcy against its will. Its credit is likely to be damaged, if not destroyed. Its cash needs will have increased, as all of its suppliers are likely to have put it on COD. 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 considers that, other than credit granted under section 364(d) and certain 364(c) priorities that have no meaning outside of bankruptcy,[55] all of the priorities

and security interests 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. The fairness of this availability is further enhanced when one considers that all of the types of financing available under this analysis must be approved by some third party (the court with respect to section 364(b), (c), and (d), and the trustee in the limited cases in which section 364(a) is available).

The foregoing analysis presents at least one conceptual difficulty: it only applies to involuntary Chapter 11 cases. A debtor-in-possession is defined in section 1101, which only applies in Chapter 11.[56] Further, a debtor-in-possession has the powers of a trustee pursuant to section 1107, which again only applies in Chapter 11 cases.[57] Chapter 7 has no parallel provision that grants the Chapter 7 involuntary debtor the powers of a trustee and would thus allow it to utilize section 364. Additionally, an actual Chapter 7 trustee is not appointed in an involuntary case until an order for relief is entered.[58] 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; thus, it would seem that an involuntary Chapter 7 debtor could not borrow under any part of section 364.

Despite the foregoing, a Chapter 7 involuntary debtor can access section 364 by taking one of two possible additional steps. First, an involuntary Chapter 7 debtor can move to convert the case to a Chapter 11 case, opening up the availability of credit.[59] Although conversion does cause an order for relief to be entered,[60] the involuntary debtor can always move to dismiss the case for "cause" after the conversion and borrowing.[61] 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.[62]

## Conclusion

This article addresses some of the issues that arise from the decision of the drafters of the Bankruptcy Code to provide incentives to lend money to companies in bankruptcy. We hope that the discussion of those issues herein is helpful.

It can, of course, be argued that there should not be incentives to lend to companies in bankruptcy.[63] It can also be argued that there should not be a Chapter 11 at all, or that the Atlanta Braves are not America's team, or that Coca-Cola is not good for you. But not by these authors.

## ENDNOTES

[1]11 U.S.C. § 101 *et seq*; all sections referred to herein are of the Bankruptcy Code.

[2]Sections 364(c)(1) and 364(d) provide such incentives.

[3]Although section 364 is entitled "Obtaining Credit," it is not the only statutory basis that can be used by a debtor to obtain credit. Debtors generally look first to section 363(c), which governs the use of "cash collateral." By complying with section 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* Joseph Levine, *Debtor-in-Possession's Use of the Proceeds/Collateral*, N.Y.L.J. Nov. 1, 1990; Mark Prager, *Financing the Chapter 11 Debtor: The Lenders' Perspective*, 45 BUS. LAW 2127 (1990); Stephen Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562 (1991); Jack Williams, *Application of the Cash Collateral Paradigm to the Preservation of the Right to Setoff in Bankruptcy*, 7 BANKR. DEV. J. 27 (1990); Note, *Standards and Sanctions for the Use of Cash Collateral Under the Bankruptcy Code*, 63 TEXAS L. REV. 341 (1984). The use of the cash collateral alone is, however, rarely sufficient to meet the cash needs of a debtor over the course of a Chapter 11 case.

[4]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. 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). Although the Code permits the appointment of an independent trustee in a Chapter 11 case to run the business when fraud, dishonesty or gross mismanagement is alleged (*see* 11 U.S.C. §§ 1104, 1108), 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. In an involuntary Chapter 7 case, the trustee is not appointed until an order for relief is entered. *See* 11 U.S.C. § 701. A Chapter 7 trustee is authorized to operate the business during the liquidation. 11 U.S.C. § 721.

[5]11 U.S.C. § 503.

[6]"Notice and a hearing" is defined in 11 U.S.C. § 102(1).

[7]11 U.S.C. § 364(d)(1).

[8]11 U.S.C. § 364(d)(2); "adequate protection" is defined in 11 U.S.C. § 361.

[9]Many commentators have discussed cross-collateralization (*e.g.*, RICHARD BRODY, REORGANIZATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE §6.03(2) (1992); DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, 1 BANKRUPTCY § 4-15 (1992); David Gray Carlson, *Postpetition Security Interests Under the Bankruptcy Code*, 48 BUS. LAW 483 (1993); Mark Prager, *Financing the Chapter 11 Debtor: The Lender's Perspective*, 45 BUS. L. 2127, 2145-2147 (1990); Charles Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109 (1986); Charles Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving A Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109 (1989); Charles Tabb, *Emergency Preferential Orders In Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75 (1991).

[10]"Undersecured" means that the amount of debt is more than the value of the property securing the debt.

[11]963 F.2d 1490 (11th Cir. 1992).

[12]596 F.2d 1092 (2nd Cir. 1979).

[13]*Saybrook*, 963 F.2d at 1492.

[14]*Id.*

[15]11 U.S.C. §§ 363(c), 363(d).

[16]3 BCD 1013 (Bankr. S.D.N.Y. 1977).

[17]596 F.2d at 1098.

[18] 834 F.2d 599 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988).

[19]829 F.2d 1484 (9th Cir. 1987).

[20]*In re Ellingsen*, 834 F.2d at 602.

[21]*Id.* at 603.

[22]*In re Adams Apple*, 829 F.2d at 1489.

[23]31 B.R. 364 (Bankr. E.D.N.Y. 1983).

[24]*See* Benjamin Weintraub & Alan Resnick, *Cross-Collateralization of Prepetition Indebtedness As An Inducement for Postpetition Financing: A Euphemism Comes of Age*, 14 UCC L.J. 86, 90 (1981).

[25]*See also In re* Roblin Industries, 52 B.R. 241 (Bankr. W.D. N.Y. 1985) (adopting the same 4 factor test).

[26]*Saybrook*, 963 F.2d at 1496.

[27]*Id.* at 1490.

[28]1993 WL 408366 (N.D. Ill., September 22, 1993),

[29]*See, e.g., In re* Eagle-Picher Industries, Inc., 124 B.R. 1021 (Bankr. S.D. Ohio 1991); *In re* Gulf Air, Inc., 112 B.R. 154 (Bankr. W.D. La. 1989); *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989); Charles Tabb, *Emergency Preferential Orders in Bankruptcy*, 65 AMER. L.J. 75 (1991); and DOUGLAS C. BAIRD, THE ELEMENTS OF BANKRUPTCY 216, 225 (1992).

[30]To the extent that the relief is granted pursuant to section 105, the protections of section 364(e) would not be available.

[31]*See* Karen Gebbia & Lawrence Oscar, *Saybrook Manufacturing: Is Cross-Collateralization Moot?*, 2 J. OF BANKR. L. AND PRAC. 183, 215-43 (1993).

[32]1 DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, BANKRUPTCY § 4-17 (1992).

[33]Charles Tabb, *Lender-Preference Clauses, supra* note 9, at 119.

[34]147 B.R. 817 (Bankr. S.D. Fla 1992),

[35]*Id.* at 820.

[36]A bankruptcy case is commenced by the filing of a bankruptcy petition. 11 U.S.C. §§ 301, 303(b). This petition can be filed either by the debtor itself or by a number of creditors of a putative debtor. *See* 11 U.S.C. § 303(b). 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 business, 11 U.S.C. § 363, and the debtor may not use "cash collateral" at all without court approval. 11 U.S.C. § 363(b). A voluntary debtor also generally may not pay its prepetition creditors, 11 U.S.C. § 549, and must file regular financial and other reports with the United States Trustee. F.R.B.P. 2015.

Conversely, an involuntary debtor bears none of these burdens until the bankruptcy court enters an order for relief; it may instead "continue to operate [its business], and . . . continue to use, acquire or dispose of its property as if the involuntary case . . . had not been commenced." 11 U.S.C. § 303(f). The special status of an involuntary debtor, however, is a temporary one. The involuntary debtor must timely, F.R.B.P. 1011(b), and successfully controvert the involuntary petition. If it does not, the court will enter an order for relief, 11 U.S.C. § 303(h); F.R.B.P. 1012(b), and the case will proceed, for most purposes, as if it were a voluntary case.

[37]The period between the filing of the involuntary petition and the entry of the order for relief is known as the "gap period."

[38]73 B.R. 521 (Bankr. S.D.N.Y. 1987),

[39]*Id.* at 525.

[40]*Id.*

[41]*Id.* at 525-26.

[42]*Id.* at 526.

[43]*Id.*

[44]*Id.*

[45]*Id.*

[46]*Id.*

[47]2 COLLIER ON BANKRUPTCY ¶ 364.03 (15th Ed. 1987 & Nov. 1991 Supp.).

[48]73 B.R. 526.

[49]*Id.*

[50]*Id.* at 527.

[51]*See* discussion *infra.*

[52]73 B.R. 527.

[53]If the order for relief has been entered, the requirements of section 503 can be met; however, the case is no longer an involuntary one.

[54]Section 364(b) is available only if the unsecured credit is not otherwise allowable under section 364(a) because it is incurred outside the ordinary course of business. In that case, section 502(f) would not be available, and hence the credit can comply with the section 364(b) requirement that it comply with section 503(b). Credit that cannot comply with section 364(a), as not allowable under section 503(b) because it is allowed under section 502(f), is not allowable under section 364(b) for the same reason. This simply means that no credit eligible for section 502(f) (*i.e.*, ordinary course credit obtained by an involuntary debtor in the absence of the appointment of a trustee) is eligible for allowance under sections 364(a) or 364(b).

[55]For example, the priority over administrative expenses provided for in section 364(c)(1).

[56]11 U.S.C. § 103(f).

[57]*Id.*

[58]11 U.S.C. §§ 341(a), 701(a)(1), 702.

[59]11 U.S.C. § 706(a).

[60]11 U.S.C. § 348(a)

[61]11 U.S.C. § 1112(b).

[62]11 U.S.C. § 303(g).

[63]*See* L. Kallen, *Corporate Welfare* 465, 467 (1991)(calling Chapter 11 a "monster" because "the bankruptcy system diverts scarce assets, such as capital, to inefficient producers, thereby allowing them to remain in existence as an added expense to society").