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## Avoiding the Inequities Created by *In re Delco Oil, Inc.*-The Need for An Innocent Vendor Exception

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**AVOIDING THE INEQUITIES CREATED BY *IN RE DELCO OIL, INC.*—THE NEED FOR AN INNOCENT VENDOR EXCEPTION**

ABSTRACT

*In In re Delco Oil, Inc., the Eleventh Circuit addressed whether a chapter 7 trustee can avoid a debtor's unauthorized transfer of cash collateral to a vendor that transacts in good faith and for equivalent value. The Eleventh Circuit strictly interpreted 11 U.S.C. §§ 549 and 550 by holding that the trustee has the power to avoid such a transfer. This decision is problematic for two reasons. First, the innocent vendor had to forfeit the goods that it transferred and any cash collateral received in exchange. Second, the decision created an absurd result by preventing the innocent vendor from obtaining an administrative expense claim even though it conferred a benefit on the estate. This decision effectively prevents an innocent vendor from receiving any compensation for the sale of its goods.*

*This Comment argues that an innocent vendor exception would prevent the negative consequences resulting from Delco and further the goals of bankruptcy. It supports this position in several ways. First, it examines the absurd results caused by Delco and the relevant legislative history of the Bankruptcy Code. Second, it surveys the sizable burden that Delco places on vendors before engaging in transactions. Third, it analyzes other ways in which the court can police the debtor's unauthorized use of cash collateral. Fourth, it examines the extent of § 105 and other case law to delineate the authority to create such an exception.*

*An innocent vendor exception would ensure an equitable result in cases analogous to Delco because it would prevent an innocent vendor, as an innocent transferee, from receiving a double penalty due to the debtor's misconduct. Furthermore, such an outcome would be consistent with the goal of § 550, which is to put the estate in the same position it would have been had the transaction not occurred.*

## INTRODUCTION

The reasoning underlying chapter 11 is that it is generally preferable to continue to operate and reorganize a troubled business rather than to liquidate it.<sup>1</sup> In light of this goal, it is important for the business to preserve its assets for equitable distribution to its creditors.<sup>2</sup> The preservation of assets, however, may create problems for innocent third parties. Consider a scenario where a vendor enters into an agreement with a company through which the vendor will provide goods in exchange for cash. Unbeknownst to the vendor, the company it is selling goods to is in chapter 11 bankruptcy and pays the vendor with its cash collateral.<sup>3</sup> To make matters worse, there may be restrictions on the company's use of cash collateral. If the company's chapter 11 reorganization is converted to chapter 7 liquidation, the appointed trustee may seek to avoid the payment made to the vendor with the cash collateral. It seems clear that the Bankruptcy Code ("Code") authorizes such an avoidance under § 549, which allows the trustee to avoid an unauthorized transaction made postpetition.<sup>4</sup> But an avoidance in this case is far from equitable, as the estate receives a windfall and the vendor is unable to receive compensation for the transfer.

*Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, is the most recent case dealing with the issue of whether an unauthorized transfer of cash collateral by a debtor in possession, who paid for goods used in its ordinary course of business, can be avoided under § 549(a) of the Code.<sup>5</sup> In this case, the Eleventh Circuit determined that a chapter 7 trustee could avoid a debtor's transfer of cash collateral made to an "innocent vendor."<sup>6</sup> The court came to this ruling even though the vendor acted in good faith and arguably exchanged the goods for equivalent value.<sup>7</sup> As a result of this ruling, the vendor was forced to forfeit both the cash consideration it received and the inventory it transferred to the company.<sup>8</sup>

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<sup>1</sup> 7 COLLIER ON BANKRUPTCY ¶ 1100.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

<sup>2</sup> *See id.*

<sup>3</sup> *See infra* Part I.C.

<sup>4</sup> *See* 11 U.S.C. §§ 549–550 (2012).

<sup>5</sup> *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1263 (11th Cir. 2010).

<sup>6</sup> An "innocent vendor" is a vendor that "received cash collateral for value, in good faith and without knowledge of the voidability of the transfers." *Id.* (citing *Hankin v. Mersey Mold & Model Co. (In re Countryside Manor, Inc.)*, 239 B.R. 443, 447 (Bankr. D. Conn. 1999)).

<sup>7</sup> *See id.*

<sup>8</sup> *Id.*

*Delco* has received its fair share of criticism, mainly due to the punishment it imposed on a vendor who dealt in good faith and merely exchanged valued goods in return for payment from a debtor.<sup>9</sup> These innocent vendors are oftentimes not aware that the company they do business with is in bankruptcy, nor are they aware that the company may be using cash collateral to pay for goods without proper authorization.<sup>10</sup> Notwithstanding the inequity resulting from *Delco*, the Eleventh Circuit asserted that there was no other way to police § 363(c)(2) of the Code, which prohibits a debtor's use of cash collateral without court authorization.<sup>11</sup>

The court added that §§ 549 and 550 did not explicitly include an “innocent vendor” exception.<sup>12</sup> The court's plain meaning interpretation of §§ 549 and 550 is another important critique of the Eleventh Circuit's decision, because this approach arguably led to an absurd result.<sup>13</sup> By strictly interpreting §§ 549 and 550, the court prevented an innocent vendor from obtaining an administrative expense claim from the estate, and effectively rendered the innocent vendor's claim unsecured.<sup>14</sup> Additionally, the court failed to address whether the secured creditor or the estate was entitled to receive the avoided funds.<sup>15</sup>

There are ways to avoid these absurd results. Other courts have addressed this issue without resorting to the plain meaning interpretation of §§ 549 and 550, and have instead considered other factors to determine whether unauthorized payment of cash collateral should be avoided.<sup>16</sup> These courts looked beyond the plain meaning of the statute, and considered whether injury to the estate occurred, and whether the result was inequitable and contrary to the purpose of the Code.<sup>17</sup>

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<sup>9</sup> See *id.* (doubly punishing the vendor by causing a loss of not only received cash collateral, but also the inventory it had initially transacted to the debtor).

<sup>10</sup> *Id.* (citation omitted).

<sup>11</sup> 11 U.S.C. § 363(c)(2) (2012); *Delco*, 599 F.3d at 1263.

<sup>12</sup> *Delco*, 599 F.3d at 1263.

<sup>13</sup> See Rashad L. Blossom & Jennifer H. Henderson, *In Re Delco Oil, Inc.—A Cautionary Tale for Vendors Doing Business with Chapter 11 Debtors*, 72 ALA. LAW. 223, 225, 227 (2011).

<sup>14</sup> The innocent vendor should have an administrative expense claim in accordance with § 503 of the Code, but § 502(h) prevents this from happening by allowing avoidance of the transfer via § 549(a); thus, since the trustee recovers under § 550, the innocent vendor's claim is transformed into a prepetition unsecured claim under § 502(h). See 11 U.S.C. §§ 502(h), 503; *infra* Part II.B.2.b.

<sup>15</sup> See *Delco*, 599 F.3d at 1257.

<sup>16</sup> *Abbott v. Arch Wood Prot., Inc. (In re Wood Treaters, L.L.C.)*, 479 B.R. 122, 129 (Bankr. M.D. Fla. 2012); *Rushton v. Bank of Utah (In re C.W. Mining Co.)*, 465 B.R. 226, 230–31 (Bankr. D. Utah 2011), *aff'd*, 477 B.R. 176 (B.A.P. 10th Cir. 2012).

<sup>17</sup> *Wood Treaters*, 479 B.R. at 129; *C.W. Mining*, 465 B.R. at 242.

Additionally, the result of *Delco* runs contrary to the goals and underlying policy of chapter 11. It places a sizable burden on vendors to investigate whether the company it conducts business with is in chapter 11, and if it is, whether it has proper authorization to use cash collateral.<sup>18</sup> Performing this due diligence can be costly and may discourage vendors from conducting further business with companies in reorganization.<sup>19</sup>

This Comment will advocate for a judicial exception for innocent vendors in narrow circumstances similar to *Delco*—where a vendor transacts in good faith and for equivalent value with debtors that paid with cash collateral without proper authorization. This will prevent the negative consequences that result from *Delco*. Part I of this Comment will discuss some relevant provisions of the Code. Part II of this Comment will first discuss *Delco* to understand the court's analysis. Second, it will introduce the criticism that followed *Delco* and assess its validity. More importantly, this section will delve into the absurd results of *Delco*. Part III of this Comment will consider the burden that *Delco* imposes on vendors, and how this burden will likely affect the way vendors will deal with chapter 11 debtors in the future. Part IV will show that, contrary to the Eleventh Circuit's decision in *Delco*, there are other ways of policing § 363(c)(2). Part V of this Comment will show alternative ways courts can avoid the negative consequences caused by *Delco*. First, it will analyze cases similar to *Delco*, where a party looks to avoid a postpetition transfer, to demonstrate that there are other ways to deal with unauthorized postpetition transfers of cash collateral by a debtor. Second, it will look to the authority that courts can use to exempt innocent vendors from §§ 549 and 550. More specifically, it will show how courts can draw authority from § 105 of the Code to prevent the problems from the *Delco* decision. Finally, Part VI will analyze how the proposed exception will further the goals of Code and prevent the absurd results created by *Delco*.

## I. BACKGROUND

A better understanding of §§ 549 and 550 and cash collateral, as well as their respective purposes, is essential to understanding the consequences that result from punishing innocent vendors under § 549(a). The avoidance and

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<sup>18</sup> Jonathan Friedland & Bill Schwartz, *Punishing the Innocent: Lessons from Delco Oil*, AM. BANKR. INST. J., May 2010, at 1, 89.

<sup>19</sup> *See id.*

recovery provisions provided by the Code under §§ 549 and 550 were created to prevent harm to the estate caused by postpetition transfers.<sup>20</sup>

A. *Section 549(a)*

Section 549 is an avoidance provision that allows the trustee or debtor in possession to avoid unauthorized postpetition transfers of property of the estate with the goal to “pursue as equal a distribution of assets to creditors as possible.”<sup>21</sup> “To avoid means to make void [or] annul.”<sup>22</sup> The purpose of this section is to prevent postpetition transfers of the debtor’s property from diminishing the estate.<sup>23</sup> Section 549(a) states:

- (a) Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate —
  - (1) that occurs after the commencement of the case; and
  - (2) (A) that is authorized only under section 303(f) or 542(c) of this title or by the court; or
  - (B) that is not authorized under this title or by the court.<sup>24</sup>

This provision has been widely applied, even when there is fraud by the debtor or good faith on part of the transferee.<sup>25</sup>

B. *Section 550(a)*

Section 550(a) works in conjunction with § 549(a) to promote one of the main goals of bankruptcy law—to preserve the estate’s assets for an equitable distribution to creditors.<sup>26</sup> Once a transfer has been avoided under § 549(a), § 550(a) provides:

- (a) except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —

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<sup>20</sup> See 11 U.S.C. §§ 549–550 (2012).

<sup>21</sup> *Id.* § 549; *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furr’s)*, 294 B.R. 763, 775 (Bankr. D.N.M. 2003) (citing *Begier v. IRS*, 496 U.S. 53, 58 (1990)).

<sup>22</sup> *C.W. Mining*, 465 B.R. at 231 (citation omitted) (internal quotation marks omitted).

<sup>23</sup> 5 COLLIER, *supra* note 1, ¶ 549.02 (citations omitted).

<sup>24</sup> 11 U.S.C. § 549.

<sup>25</sup> 5 COLLIER, *supra* note 1, ¶ 549.02 (citations omitted).

<sup>26</sup> See *Abbott v. Arch Wood Prot., Inc. (In re Wood Treaters, L.L.C.)*, 479 B.R. 122, 126 (Bankr. M.D. Fla. 2012).

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee.<sup>27</sup>

Therefore, the purpose of § 550(a) is to “restore the estate to the financial condition it would have enjoyed if the transfer had not occurred.”<sup>28</sup> Accordingly, its focus “is not on what the transferee gained by the transaction but rather on what the bankruptcy estate lost as a result of the transfer.”<sup>29</sup> To achieve this purpose, the “overwhelming majority of courts interpret the phrase ‘benefit of the estate’ liberally, holding that the property or its *value* may be recovered even if creditors have been paid in full under a plan.”<sup>30</sup>

### C. *The Importance of Cash Collateral*

A company undergoing chapter 11 reorganization is oftentimes deprived of cash.<sup>31</sup> The use of any available funds could be the difference between the company failing or surviving the reorganization period.<sup>32</sup> In an effort to obtain cash, the debtor may even be forced to sell some of its encumbered assets.<sup>33</sup> The Code defines the proceeds of the encumbered assets as cash collateral.<sup>34</sup> More specifically, cash collateral is defined as “cash and cash equivalents” in which both “the estate and [another entity] have an interest.”<sup>35</sup>

Even though cash collateral could provide much needed cash for reorganization efforts, the Code imposes certain restrictions on a debtor’s use of cash collateral.<sup>36</sup> Although the Code allows the debtor in possession—as trustee of the estate—to use the available funds of the estate so long as it is in

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<sup>27</sup> 11 U.S.C. § 550.

<sup>28</sup> *Rushton v. Bank of Utah (In re C.W. Mining Co.)*, 465 B.R. 226, 233 (Bankr. D. Utah 2011) (citations omitted) (internal quotation marks omitted), *aff’d*, 477 B.R. 176 (B.A.P. 10th Cir. 2012).

<sup>29</sup> *Id.*

<sup>30</sup> 5 COLLIER, *supra* note 1, ¶ 549.01 (emphasis added) (citations omitted).

<sup>31</sup> See Donald T. Polednak, *Is the Secured Creditor Really “Secure”?: A Survey of Remedies and Sanctions for a Debtor’s Unauthorized Use of Cash Collateral in Chapter 11 Bankruptcy*, 31 WASHBURN L.J. 344, 346 (1992).

<sup>32</sup> See *id.*

<sup>33</sup> *Id.*

<sup>34</sup> 11 U.S.C. § 363(a) (2012).

<sup>35</sup> *Id.* (“‘[C]ash collateral’ means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts . . . whether existing before or after the commencement of a case under this title.”).

<sup>36</sup> See *id.* § 363(c)(2).

the ordinary course of business, those rights are restricted when the debtor in possession is using cash collateral.<sup>37</sup> Section 363(c)(2) prohibits the use of cash collateral, even during the ordinary course of business, unless the debtor in possession obtains consent from either the secured creditor, or authorization from the bankruptcy court after notice and hearing.<sup>38</sup>

This restriction attempts to balance the conflicting interests of the debtor in possession and the secured creditor.<sup>39</sup> While secured creditors run the risk that their collateral will be consumed, the chapter 11 debtor is short on cash and probably needs to use the cash collateral to rehabilitate its business.<sup>40</sup> By allowing the debtor in possession to use cash collateral only after the secured creditor's objections (if any) have been heard, § 363(c)(2) protects the secured creditor's priority status and the property interest in the collateral should the cash collateral be spent.<sup>41</sup> Unfortunately for the debtor in possession, this restriction may prove too great a hurdle if it does not have the resources to reorganize without the use of the cash collateral.<sup>42</sup>

Unsurprisingly, a debtor in possession may still choose to use cash collateral without authorization, and in such an event, the Code fails to provide a specific penalty for debtors or a remedy for injured secured creditors.<sup>43</sup>

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<sup>37</sup> *Id.*

<sup>38</sup> Section 363(c)(2) states:

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

<sup>39</sup> See Polednak, *supra* note 31, at 346.

<sup>40</sup> See *id.*; John C. Chobot, *Enforcing the Cash Collateral Obligations of Debtors in Possession*, 96 COM. L.J. 136, 143 (1991) ("Once cash collateral has been dissipated and spent, court-fashioned sanctions such as retroactive protection, appointment of a Chapter 11 trustee or prohibitions against the further use of cash collateral can be hollow victories for a secured creditor and do not rise to the level of a 'remedy'. This is especially true where all remaining property of the estate is encumbered and the cash which has been spent without permission cannot be replaced.") (quoting *Williams v. Am. Bank of the Mid-Cities, N.A. (In re Williams)*, 61 B.R. 567, 575 (Bankr. N.D. Tex. 1986)).

<sup>41</sup> See 11 U.S.C. § 363(c)(2); Polednak, *supra* note 31, at 346.

<sup>42</sup> Polednak, *supra* note 31, at 347.

<sup>43</sup> Chobot, *supra* note 40, at 137 (citing *Mercantile Nat'l Bank at Dallas v. Aerosmith Denton Corp. (In re Aerosmith Denton Corp.)*, 36 B.R. 116, 119 (Bankr. N.D. Tex. 1983)).

## II. ANALYSIS: *IN RE DELCO OIL, INC.* AND ITS IMPLICATIONS

In *Delco*, the Eleventh Circuit dealt with the issue of whether a chapter 7 trustee may avoid the postpetition transfer of cash collateral by a debtor in possession under § 549(a) of the Code.<sup>44</sup> This decision harms innocent vendors because it prevents them from recovering the goods they exchanged and forces them to forfeit the cash collateral that was paid to them.<sup>45</sup> This Part walks through the *Delco* opinion and then discusses its negative ramifications.

### A. *The Delco Opinion*

#### 1. *Facts*

Delco Oil, Inc. (Delco) was a distributor of motor fuel and associated products.<sup>46</sup> As part of its motor fuel business, Delco entered into a sales agreement with Marathon Petroleum Co. (Marathon) in 2003 to purchase petroleum products.<sup>47</sup> In 2006, Delco entered into a financing agreement with CapitalSource Finance (CapitalSource), in which Delco pledged as collateral all rights to its personal property, including collections, cash payments, and inventory, to CapitalSource.<sup>48</sup>

On October 17, 2006, Delco filed for chapter 11 bankruptcy and requested authorization to use CapitalSource's cash collateral to continue its operations.<sup>49</sup> The next day, the bankruptcy court authorized Delco to continue its business as a debtor in possession, but did not make a decision regarding Delco's request to use its cash collateral until November 6, when it denied Delco's request.<sup>50</sup> But between October 18 and November 6, Delco had made \$1.9 million in cash distributions to Marathon.<sup>51</sup>

Later that year, the case was converted to a chapter 7 case and a trustee was appointed by the bankruptcy court.<sup>52</sup> The trustee then filed an adversary proceeding against Marathon to avoid the postpetition distributions made to Marathon under § 549(a), on the basis that Delco did not have the

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<sup>44</sup> *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1257 (11th Cir. 2010).

<sup>45</sup> *See id.* at 1257.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

authorization from the secured creditor or bankruptcy court as required by § 363(c)(2).<sup>53</sup> The bankruptcy court ruled in the trustee's favor, and the district court affirmed.<sup>54</sup>

## 2. *Marathon's Arguments*

On appeal in the Eleventh Circuit, Marathon made three arguments for why the payments it received were not avoidable under § 549(a).<sup>55</sup> First, Marathon argued that the funds it received from Delco did not constitute CapitalSource's cash collateral under Florida's version of § 9-332(b) of the U.C.C.<sup>56</sup> The statute provides that "[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party."<sup>57</sup> Marathon relied on this statute to argue that once distributed, the cash-collateral it received from Delco became free of CapitalSource's security interest because Marathon did not act in collusion with Delco.<sup>58</sup> The cash transfer, Marathon argued, had lost its status as cash collateral.<sup>59</sup>

Second, Marathon argued that even if the funds constituted cash collateral, the distribution received is not avoidable because any violation of § 363(c)(2) did not harm CapitalSource or the estate.<sup>60</sup> In other words, Marathon claimed that because the funds it received from Delco were equivalent in value to the inventory exchanged, CapitalSource's interest was not diminished since it had a perfected security interest in Delco's personal property.<sup>61</sup>

Finally, Marathon argued that an "implicit" defense exists under § 549 for ordinary course transfers and for innocent vendors who deal with a debtor in possession.<sup>62</sup> Marathon claimed that this implicit defense exists as a matter of

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<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 1259–62.

<sup>56</sup> *Id.* at 1259 (citing FLA. STAT. § 679.332(2) (2002)).

<sup>57</sup> *Id.* (quoting FLA. STAT. § 679.332(2) (2002)).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 1262; Brief of Appellant at 39, *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255 (11th Cir. 2010) (No. 09-11759), 2009 WL 1512875 ("Accordingly, to recover under section 549(a) the secured party must establish that its interest in the collateral has 'declin[ed] in value.'") (citing *In re Sterling Dev., Inc.*, No. 11-08-14208, 2009 WL 196250, at \*3 (Bankr. D.N.M. Jan. 26, 2006)).

<sup>61</sup> *Delco*, 599 F.3d at 1262.

<sup>62</sup> *Id.* at 1262–63.

policy.<sup>63</sup> Marathon dealt in good faith and was not aware that Delco's cash payments were not authorized. Marathon stated that it was unreasonable to require vendors to investigate whether their customers have permission to utilize their cash collateral in postpetition payments.<sup>64</sup>

### 3. *The Court's Analysis and Decision*

The Eleventh Circuit rejected all of Marathon's arguments.<sup>65</sup> With regard to Marathon's first argument, that the funds it received did not constitute cash collateral, the court stated that U.C.C. § 9-332(b) had no bearing on the following dispositive facts: "(1) The Bankruptcy Code prohibited the transfer to Marathon altogether, because CapitalSource had a perfected security interest in [Delco's] cash proceeds while they were in [Delco's] hands, and (2) the Bankruptcy Code allows the trustee to avoid and take back unauthorized transfers."<sup>66</sup> The court stated that it is beside the point that CapitalSource did not have a security interest in the funds after Delco transferred them to Marathon.<sup>67</sup> The court added that to "determine whether the funds constitute cash collateral," one must examine "the status of the funds while they were in [the] [d]ebtor's hands before the disputed transfer . . . not at the moment after the funds left [the] [d]ebtor's control."<sup>68</sup>

As to Marathon's second argument, that there was no harm to the estate or to CapitalSource, the court focused on the plain meaning of § 549. The court concluded that a "harmless exception to a trustee's [§] 549(a) avoiding power does not exist," and that "all [a trustee] needs to demonstrate to avoid the transfer under [§] 549(a) is: (1) an unauthorized transfer occurred; (2) the property transferred was property of the estate; and (3) the transfer occurred [postpetition]."<sup>69</sup> The court added that § 549 "does not require any analysis of

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<sup>63</sup> *Id.* at 1262.

<sup>64</sup> Shane G. Ramsey, *Avoiding the Pitfalls of In re Delco Oil*, AM. BANKR. INST. J., Apr. 2011, at 62.

<sup>65</sup> *Delco*, 599 F.3d at 1257–63.

<sup>66</sup> *Id.* at 1260 (stating that CapitalSource may recover the funds *Delco* transferred to Marathon not because the creditor continued to have a security interest in those funds, but "because Debtor was not authorized to transfer the funds to anyone postpetition without the permission of CapitalSource or the bankruptcy court").

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* (citations omitted) (adding that if the status of the funds were to be examined after they left the debtor's control, it would allow a debtor to circumvent section 363(c)(2) of the Code, as in such case the proceeds would not be defined as cash collateral).

<sup>69</sup> *Id.* at 1262.

the adequacy of the protection of secured creditors' interests nor does it provide a harmless error exception."<sup>70</sup>

Finally, the court rejected Marathon's third argument that an implicit defense exists under § 549 for ordinary course of business transfers made by innocent vendors dealing with a debtor in possession.<sup>71</sup> The court sought guidance in the language of subsections 363(c)(1) and (2). Noting that subsection 363(c)(2) set a specific limitation on a debtor in possession's express ability to use cash collateral derived from § 363(c)(1), the court concluded that Congress "did not intend to allow the use of cash collateral without the permission of the interested secured creditor or the bankruptcy court, even if used in the ordinary course of business."<sup>72</sup> Referring to the plain meaning of §§ 549(a) and 550, the Eleventh Circuit stated, "Congress knew how to create exceptions based on [the] transferee's status and culpability," and added that "it chose not to do so when it came to initial transferees of [postpetition] transfers of cash collateral."<sup>73</sup>

### B. Criticism of Delco

*Delco* has been heavily criticized.<sup>74</sup> The most relevant point to this discussion is the fact that an innocent vendor received a double penalty—losing both the cash collateral and a claim to the transferred inventory—for receiving cash collateral without knowledge that the chapter 11 debtor had no authorization to do so.<sup>75</sup> This result stems from the Eleventh Circuit's plain meaning interpretation of § 549.<sup>76</sup> In addition, the court did not rule on whether Delco could use the cash collateral it had at the time Delco transferred the funds to Marathon.<sup>77</sup> This Section will review the court's analysis in allowing

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<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 1262–63.

<sup>72</sup> *Id.* at 1263.

<sup>73</sup> *Id.*

<sup>74</sup> Blossom & Henderson, *supra* note 13, at 225 ("*Delco Oil* creates terrible problems for the trial courts, lawyers and vendors who must apply the Court's ruling."); Friedland & Schwartz, *supra* note 18, at 1 ("*Delco* seems to be a bad decision . . . . We get the need for a court to interpret the Bankruptcy Code as written, but the bankruptcy court (and perhaps one of the two appellate courts) could have done that and still have ruled the other way.>").

<sup>75</sup> *Delco*, 599 F.3d at 1263.

<sup>76</sup> *Id.* ("To avoid a transfer under Section 549(a) a trustee need only demonstrate: (1) a postpetition transfer . . . (3) which was not authorized by the Bankruptcy Code or the court . . . Congress knew how to create exceptions based on transferee's status and culpability. But it chose not to do so when it came to initial transferees of postpetition transfers of cash collateral.") (citing 11 U.S.C. § 549(a) (2012)).

<sup>77</sup> *Id.*

the chapter 7 trustee to avoid Delco's unauthorized transfer of cash collateral, and delineate how the court, by strictly construing § 549(a), brought about an absurd result.

### 1. *The Court's Plain Meaning Interpretation*

The plain meaning approach is a default rule of statutory interpretation.<sup>78</sup> In fact, looking at the plain meaning of a statute is “the most obvious and perhaps the most objective focal point to determine what the law requires.”<sup>79</sup> This reasoning comes from the idea that a statute, when read plainly, depicts “what our elected representatives intended . . . the law to mean.”<sup>80</sup>

But many cases illustrate that the plain meaning interpretation of a statute is not always the optimal approach, because its use may bring about an absurd result.<sup>81</sup> This is largely due to the fact that statutory interpretation is a “holistic endeavor.”<sup>82</sup> Although the “plain meaning of legislation should be conclusive . . . [there are] ‘rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.’”<sup>83</sup> If this is the case and an absurd result occurs, “then the intention of the drafters, rather than the strict language, controls.”<sup>84</sup> Additionally, the Supreme Court has stated that “even when the plain meaning did not produce absurd results but merely an unreasonable one ‘plainly at variance with the policy of the legislation as a whole,’” the Court should follow that purpose, “rather than the literal words.”<sup>85</sup>

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<sup>78</sup> WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, *LEGISLATION AND STATUTORY INTERPRETATION* 223 (2000).

<sup>79</sup> *Id.*; see also *Perry v. Commerce Loan Co.*, 383 U.S. 392, 400 (1966) (“There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning.”) (quoting *United States v. Am. Trucking Ass'ns*, 310 U.S. 534, 543 (1940)).

<sup>80</sup> ESKRIDGE, FRICKEY, & GARRETT, *supra* note 78.

<sup>81</sup> *Am. Trucking*, 310 U.S. at 543 (stating that the plain meaning of a statute is followed when words are sufficient to determine the purpose of the legislation, but when that meaning leads to absurd results, the court has looked “beyond the purpose of the act”).

<sup>82</sup> *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988).

<sup>83</sup> *United States v. Ron Pair Enters.*, 489 U.S. 235, 242 (1989) (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)).

<sup>84</sup> *Id.*

<sup>85</sup> *Perry v. Commerce Loan Co.*, 383 U.S. 392, 400 (1966) (quoting *American Trucking*, 310 U.S. at 543).

## 2. *The Absurd Results*

In rejecting Marathon's argument that the trustee could not avoid the payments because Delco's violation of § 363(c)(2) did not cause harm to the estate, the Eleventh Circuit stated that "a 'harmless' exception to a trustee's § 549(a) avoiding powers does not exist."<sup>86</sup> The court added that § 549 "does not require an analysis of the adequacy of protection of secured creditors' interests [or provide] a harmless error exception."<sup>87</sup> The court explained that there were two exceptions within § 549, but neither of those exceptions applied in this case and that if Congress wanted to add an exception for innocent vendors, then they would have done so.<sup>88</sup>

The Eleventh Circuit's plain meaning reading of § 549 in *Delco* brought about two absurd results, which are discussed in detail below.<sup>89</sup> First, it is not clear whether the secured creditor or the estate is entitled to the avoided funds.<sup>90</sup> Second, the court failed to address whether an innocent vendor is entitled to an administrative expense claim upon return of the avoided payment.<sup>91</sup> Due to the court's failure to address these issues, the innocent vendor has to return the cash it received from the debtor, and forfeit the goods it transferred without compensation.

### a. *Where Do the Avoidable Funds Go?*

The Eleventh Circuit's decision failed to address whether the secured party or the estate should receive the funds recovered from the avoidance.<sup>92</sup> This is important because if a court were to follow *Delco*, it would have to decide whether the lender or the estate is entitled to the funds recovered from the postpetition avoidance. But either result would be problematic.<sup>93</sup>

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<sup>86</sup> *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1262 & n.3 (11th Cir. 2010) ("Congress created two exceptions to a trustee's Section 549 avoiding powers. First, subsection (b), which involves only involuntary bankruptcy cases and, second, subsection (c), which protects good faith purchasers of real property. As this is a voluntary bankruptcy involving the transfer of cash in exchange for personal property, neither exception provided by Congress applies.").

<sup>87</sup> *Id.* at 1262.

<sup>88</sup> *Id.* at 1262 n.3, 1263.

<sup>89</sup> *See Blossom & Henderson, supra* note 13, at 224–26; *Friedland & Schwartz, supra* note 18, at 89.

<sup>90</sup> *Blossom & Henderson, supra* note 13, at 226.

<sup>91</sup> *Id.* at 227.

<sup>92</sup> *Id.* at 226.

<sup>93</sup> *Id.*

If the estate is entitled to the recovered funds, then the estate would receive a windfall.<sup>94</sup> Given that the innocent vendor transferred equivalent value for the cash collateral it received, the estate would be able to keep both the recovered cash collateral and the goods it had transacted for.<sup>95</sup> This is where the inequity arises, because the estate arguably received the equivalent value for the cash collateral transferred to the vendor and was not harmed in the first place.<sup>96</sup> This result therefore would allow the trustee to use an avoidance provision meant to restore the estate to the condition it would have been in had the transfer not occurred, when the estate did not actually suffer harm.<sup>97</sup> Due to this, chapter 7 trustees will have an incentive to avoid similar postpetition transactions in an effort to increase the value of the estate.

If a court were to return the recovered funds from a § 549(a) avoidance to the lender instead of the estate, other difficulties arise.<sup>98</sup> Returning the recovered funds to the lender would be contrary to the language of § 550, which grants the *trustee* the power to recover property transferred from a § 549 avoidance as long as it is for the benefit of the estate, not for the benefit of the secured creditor.<sup>99</sup> This is also inconsistent with the goal of § 550, which is to restore the estate to the financial condition it would have been in had the transaction not occurred.<sup>100</sup> The goal and language of § 550 suggest that a secured creditor should not directly benefit from a chapter 7 trustee's avoidance motion. What makes this more problematic is that in a case like *Delco*, the innocent vendor received the funds free from any liens that the cash collateral would have had while in possession of the debtor.<sup>101</sup> As a result, the trustee's recovery for the benefit of the lender would not only be inconsistent with the Code, but would also be contrary to the priority rules established by the U.C.C.—under which the innocent vendor, as a transferee, took possession of the cash collateral free from a security interest.<sup>102</sup>

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<sup>94</sup> *Id.* (allowing for avoidance of a transfer under 549(a), to an innocent vendor prior to conversion to chapter 7, results in the estate keeping both the cash collateral transferred and the funds).

<sup>95</sup> *See id.* (stating that other creditors are the ones who receive the windfall, as they will receive money from the estate).

<sup>96</sup> *See id.*

<sup>97</sup> *See Rushton v. Bank of Utah (In re C.W. Mining Co.)*, 465 B.R. 226, 233 (Bankr. D. Utah 2011), *aff'd*, 477 B.R. 176 (B.A.P. 10th Cir. 2012).

<sup>98</sup> Blossom & Henderson, *supra* note 13, at 226.

<sup>99</sup> *See generally* 11 U.S.C. § 550 (2012).

<sup>100</sup> *See supra* note 28 and accompanying text.

<sup>101</sup> Blossom & Henderson, *supra* note 13, at 227 (citation omitted).

<sup>102</sup> U.C.C. § 9-332(a) (2001) (“A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party.”).

Interpreting *Delco* plainly, it doesn't matter whether the court orders the recovered funds to be transferred to the estate or to the lender, because either action would bring about an absurd result that is either contrary to the purpose of the Code, or contrary to the rules of priority in the U.C.C.

*b. The Right to an Administrative Expense Claim*

The Eleventh Circuit also failed to address whether Marathon was entitled to an administrative expense claim.<sup>103</sup> This is important because even though the vendor lost the cash collateral it received from the debtor in possession, the vendor's transfer of goods still benefitted the estate.<sup>104</sup> Section 503 states that allowed administrative expense claims shall include, "the actual, necessary costs and expenses of preserving the estate."<sup>105</sup> Section 503 is interpreted as requiring that the expense not only be "actual" and "necessary", but also that there be a concrete benefit to the debtor's estate.<sup>106</sup> Given that Delco received petroleum products in exchange for the cash collateral it gave to Marathon, there is no doubt that those goods benefitted the estate. Therefore, pursuant to § 503, the vendor should be entitled to an administrative expense claim by conferring such benefit to the estate.<sup>107</sup> By obtaining an administrative expense claim, the vendor's claim would have priority over prepetition unsecured claims.<sup>108</sup>

Although the vendor should be entitled to an administrative expense claim, the vendor's ability to do so is jeopardized by the court's strict interpretation of § 549(a).<sup>109</sup> This is due to a conflict arising between §§ 502(h) and 503.<sup>110</sup> After moving to avoid the postpetition transactions to Marathon under § 549(a), the trustee proceeded to recover the cash collateral from the innocent vendor via § 550.<sup>111</sup> Section 502(h) states that a "claim arising from the recovery of property under" § 550 shall be treated the same as a prepetition claim.<sup>112</sup> Thus, § 502(h) has the effect of transforming what should be an

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<sup>103</sup> Blossom & Henderson, *supra* note 13, at 227.

<sup>104</sup> See 11 U.S.C. § 503; *infra* text accompanying note 106.

<sup>105</sup> 11 U.S.C. § 503(b)(1)(A).

<sup>106</sup> *In re Beverage Canners Int'l Corp.*, 255 B.R. 89, 92 (Bankr. S.D. Fla. 2000) (citation omitted).

<sup>107</sup> 11 U.S.C. § 503(b)(3); see *Beverage Canners*, 255 B.R. at 92.

<sup>108</sup> See 11 U.S.C. § 507.

<sup>109</sup> See Blossom & Henderson, *supra* note 13, at 225, 227.

<sup>110</sup> See 11 U.S.C. §§ 502(h), 503.

<sup>111</sup> *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1257–59 (11th Cir. 2010); see 11 U.S.C. § 550.

<sup>112</sup> 11 U.S.C. § 502(h).

administrative expense claim under § 503 for the innocent vendor, into an unsecured prepetition claim.<sup>113</sup> This absurd result further highlights the burden that is imposed on innocent vendors and is yet another reason why the court should have created an innocent vendor exception for Marathon in *Delco*.

*c. Legislative History*

The conflict between §§ 502(h) and 503 may have resulted from the way in which §§ 549 and 550 were rewritten from the previous bankruptcy statute. However, it seems unlikely that Congress intended to create a statute that effectively penalizes innocent vendors for receiving cash collateral, by preventing them from recovering the value of the goods transferred through an administrative expense claim. Furthermore, the history of §§ 502(h) and 550 demonstrates that Congress may not have considered the consequences of including postpetition transfers among the types of transfers that may be recovered under § 550.<sup>114</sup>

The current version of § 550 combines “parallel sections under prior law defining the rights and liabilities of transferees when the transfers under which they acquired property of the debtor were avoided.”<sup>115</sup> This change was meant to separate “the concepts of avoidability of transfers and the liability of and recovery from transferees and to consolidate the rules respecting liability and recovery in § 550.”<sup>116</sup> By consolidating the rules respecting liability and recovery in § 550, it is unlikely that the drafters of the Code foresaw that in certain circumstances, such as those demonstrated by *Delco*, that avoiding postpetition transfers under § 550 may produce an absurd result.<sup>117</sup> Accordingly, Congress may not have foreseen that the inclusion of § 549, as a provision under which a trustee can recover property for the benefit of the estate under § 550, would effectively give postpetition transfers the same treatment as unsecured claims.<sup>118</sup>

The legislative history of § 502(h) also offers compelling support for the theory that Congress did not foresee a conflict between § 502(h) and § 503.

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<sup>113</sup> *Id.*; Blossom & Henderson, *supra* note 13, at 227.

<sup>114</sup> See 4 COLLIER, *supra* note 1, ¶ 502.LH[10].

<sup>115</sup> 5 *id.* ¶ 550.LH.

<sup>116</sup> *Id.*

<sup>117</sup> With the exception of § 549, which avoids postpetition transfers, every transfer that is recoverable under § 550 is a prepetition transfer. 11 U.S.C. §§ 549–550; see 5 COLLIER, *supra* note 1, ¶ 550.LH.

<sup>118</sup> See 11 U.S.C. §§ 502(h), 549(a), 550.

The reach of § 502(h) was not always as broad as it is today.<sup>119</sup> In fact, the scope of § 502(h) was limited to § 547 in earlier versions of bankruptcy reform legislation:

A claim arising from the recovery of property under § 550 of this title as a result of the avoidance under § 547 of this title of a setoff shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.<sup>120</sup>

The earlier version of § 502(h) gave prepetition status only to claims arising from the recovery of property that results from an avoidance of a setoff under § 547.<sup>121</sup> Accordingly, the corresponding § 547 granted the trustee the power to avoid preferential transfers.<sup>122</sup>

Although expanding the reach of § 502(h) further clarified the statute,<sup>123</sup> it is unlikely that Congress predicted that, by expanding § 502(h) to include claims arising from recovery of an avoided transfer under § 550, postpetition transfers of cash collateral would be treated the same as prepetition claims. This result precludes innocent vendors from obtaining even an administrative expense claim.<sup>124</sup> It is unlikely that Congress would intentionally penalize an innocent vendor by preventing them from obtaining an administrative expense claim even when it conferred a benefit on the estate.

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<sup>119</sup> 4 COLLIER, *supra* note 1, ¶ 502.LH[10].

<sup>120</sup> *Id.* (quoting S. 2266, 95th Cong. § 502(h) (as reported by S. Comm. on the Judiciary, July 1989); H.R. 8200, 95th Cong. § 502(h) (as passed by the House, February 1978)).

<sup>121</sup> 4 COLLIER, *supra* note 1, ¶ 502.LH[10].

<sup>122</sup> *Id.*

<sup>123</sup> *See id.*

In thus expanding [§] 502(h) in the enacted version of H.R. 8200, [§] 502(h) is closer to the third proviso of [§] 57n of the 1898 Act. As [§] 502(h) is drawn . . . it is unnecessary to draw the distinction drawn by [§] 57n of the 1898 Act between a claim arising by reason of the recovery by the trustee of money or property or the avoidance by the trustee of a lien on property of the estate held by such person.

*Id.*

<sup>124</sup> Congress may not have foreseen that by including § 549 as one of the sections through which recovery can be sought via § 550, a claim would later be treated as a prepetition unsecured claim by § 502(h) and thus be in direct conflict with permitting the vendor from obtaining an administrative claim for benefits conferred on the estate. *See id.* (stating that § 549 is the only section avoiding postpetition transactions through which recovery can be obtained in § 550).

### III. BURDEN ON INNOCENT VENDORS

A direct result of *Delco* is that vendors, unaware that the company with which they do business is in bankruptcy, may lose inventory by transacting with the debtor who pays using cash collateral.<sup>125</sup> Thus, *Delco* imposes upon vendors a significant burden to investigate whether the companies they deal with are in bankruptcy, and if so, to further inquire whether such companies have authority to spend any cash collateral they might possess.<sup>126</sup> This burden discourages vendors from transacting with companies that are in chapter 11 because it imposes an economic cost for vendors to fulfill their due diligence, and as a result may delay the speed in which transactions are made.<sup>127</sup> This Part of the Comment will examine how *Delco* increases the cost of making transactions for vendors, thereby reducing a vendor's incentive to engage in business with companies in chapter 11.

#### A. *Performing Due Diligence*

There are certain steps a vendor must take to avoid suffering the same fate as Marathon. The first step a vendor would take to protect itself from the "inequitable results" arising from the *Delco* decision is to monitor the credit of all the companies with which it is doing business to determine whether they have filed a petition for bankruptcy protection.<sup>128</sup>

Second, and more importantly, the vendor would have to learn whether the debtor has the authority to pay for the vendor's goods.<sup>129</sup> To do this a vendor would need to check the docket for any bankruptcy proceeding that the debtor may have filed, and if the debtor does file for bankruptcy, make sure there is an appropriate order giving the debtor sufficient authority to pay for services.<sup>130</sup>

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<sup>125</sup> See generally *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255 (11th Cir. 2010).

<sup>126</sup> Blossom & Henderson, *supra* note 13, at 227.

<sup>127</sup> See Friedland & Schwartz, *supra* note 18, at 89; Charles M. Oellermann, *Caveat Vendor: Eleventh Circuit Rules That Unauthorized Payments by DIP Using Cash Collateral Must Be Disgorged*, JONES DAY (Sept./Oct. 2010), <http://www.jonesday.com/caveat-vendor-eleventh-circuit-rules-that-unauthorized-payments-by-dip-using-cash-collateral-must-be-disgorged-09-30-2010/> ("Any vendor that receives postpetition payments from [the debtor in possession] is well advised to ensure that the [debtor in possession] has the requisite creditor consent or court authority to make the payments . . . Absent such an assurance, vendors may refuse to deal with a [chapter 11 debtor] whose assets are substantially encumbered.").

<sup>128</sup> Ramsey, *supra* note 64, at 63.

<sup>129</sup> *Id.*

<sup>130</sup> Daniel F. Gosch, *I Have to Give What Back? Are You Serious? How to Deal with the In re Delco Oil Decision*, DICKINSON WRIGHT (Oct. 20, 2010), <http://www.dickinson-wright.com/I-Have-To-Give-What-Back-Are-You-Serious-How-To-Deal-With-The-Delco-Oil-Decision-10-20-2010>.

But the mere existence of an order is not dispositive in determining whether the debtor has the authority to pay a vendor.<sup>131</sup> In fact, the vendor must spend even more resources to ensure that it is adequately protected.<sup>132</sup> This is because a cash collateral order may have provisions limiting the use of the debtor's cash collateral in one way or another.<sup>133</sup> The "budget" that is attached to an order usually defines the categories for which the debtor may use cash collateral.<sup>134</sup> However, even if an order defines these categories, the definitions can be too generic or too narrow, and the vendor may need a second opinion to determine whether their order is covered.<sup>135</sup>

Furthermore, a vendor would need to monitor whether the cash collateral order is terminated.<sup>136</sup> Termination of a cash collateral order may occur when the order reaches a termination date, when the debtor defaults on a chapter 11 payment, or when a creditor files a motion to terminate the debtor's permission to use cash collateral.<sup>137</sup> Therefore, "[a]bsent finding some specific language in a cash collateral order specifically addressing this termination issue when [the vendor has] it reviewed, [the vendor] will need to monitor the case docket on an ongoing basis."<sup>138</sup> This requires careful monitoring, which may substantially reduce the risk of dealing with an unauthorized debtor. On the other hand, such careful monitoring would increase the cost of dealing with chapter 11 debtors.<sup>139</sup> If a vendor finds through due diligence that a debtor did not have authorization to use its cash collateral, then the vendor must try to stop any shipment of goods to the debtor, which could be quite costly.<sup>140</sup>

### *B. Dealing with Executory Contracts*

Although vendors can stop the shipment of goods to a company that they know has no permission to use its cash collateral, this option may not always be available.<sup>141</sup> An example of this situation arises in executory or service

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<sup>131</sup> *Id.*

<sup>132</sup> *See id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* ("A more generic budget may be better for [the vendor] than a more specific one, since a budget that has a line described as 'suppliers' arguably covers everyone supplying goods to the debtor.")

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *See Ramsey, supra note 64, at 63.*

contracts.<sup>142</sup> In these types of contracts, the vendor would consider using state law remedies mirrored from the U.C.C.<sup>143</sup> For example, under § 2-609 of the U.C.C., “if a vendor has reasonable grounds for insecurity about the debtor’s ability to perform its obligations under a sales contract, the vendor may demand that the debtor provide adequate assurance of its ability to perform under the contract.”<sup>144</sup> In service contracts, Article 2 of the U.C.C. is inapplicable, but § 251 of the *Restatement (Second) of Contracts* has been adopted in some jurisdictions and can be used to seek relief.<sup>145</sup> Another option for the vendor is to make a motion under § 365(d)(2) and try to compel the debtor to assume or reject the executory contract.<sup>146</sup>

The constant monitoring of the bankruptcy proceedings by the vendor will not only eat away at the vendor’s resources, but will also likely delay the speed at which transactions occur between the vendor and the debtor in possession.<sup>147</sup> This will discourage vendors from doing business with debtors that are in chapter 11.<sup>148</sup> Additionally, the delays in transactions are likely to hurt the debtor’s ability to succeed in its attempt at reorganization. Transaction delays will translate into long periods of time in which the debtor in possession will not have the necessary materials to continue doing business when the debtor is in a vulnerable state. Therefore, the burden placed on vendors as a result of *Delco* is contrary to one of the main goals of chapter 11, which is to encourage vendors to do business with debtor companies, and help enable their reorganization.<sup>149</sup>

#### IV. OTHER WAYS TO DEAL WITH THE DEBTOR’S UNAUTHORIZED USE OF CASH COLLATERAL

The *Delco* decision focused on the need to police debtors and keep them from violating § 363(c)(2) by using cash collateral without permission from the

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<sup>142</sup> *Id.* at 63, 100.

<sup>143</sup> *Id.* at 100.

<sup>144</sup> *Id.* (citing U.C.C. § 2-609 (2004)).

<sup>145</sup> *Id.* at 63, 100.

<sup>146</sup> *Id.* at 100 (citation omitted) (“Although such a motion is unlikely to be granted at an early juncture in the case, a vendor could use such a motion as an opportunity to obtain a court order approving the payments to it pending the debtor’s decision to assume or reject the contract.”).

<sup>147</sup> See Blossom & Henderson, *supra* note 13, at 227.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*; see Dill v. Hall & Assocs. (*In re* Indian Capitol Distrib., Inc.), No. 09-11558-s7, slip op. at 31 (Bankr. D.N.M. Oct. 5, 2011).

secured creditor or the bankruptcy court.<sup>150</sup> The court suggested that if this policing did not occur, then a debtor could distribute the cash collateral and render the security interest “virtually meaningless.”<sup>151</sup> But avoidance of the debtor’s unauthorized use of cash collateral is not the only way of policing § 363(c)(2), as there are other tools that may be more effective in preventing debtors from using cash collateral without authorization.<sup>152</sup> More importantly, these alternatives do not affect the commercial dynamic between vendors and debtors.<sup>153</sup> This Part will consider possible alternatives that may be used to deter debtors from using cash collateral without proper authorization as outlined in § 363(c)(2).

In *Delco*, the chapter 7 trustee brought an avoidance action to recover cash collateral that a debtor in possession transferred without authorization while the case was in chapter 11.<sup>154</sup> This is worth noting because the trustee sought to avoid Delco’s postpetition transfer of cash collateral while keeping the inventory it had obtained from the transaction.<sup>155</sup> As a result, the secured creditor benefited when it recuperated the cash collateral spent by the debtor.<sup>156</sup> The court justified its decision by pointing out the need to police a debtor in possession’s misuse of cash collateral.<sup>157</sup> In circumstances similar to those in *Delco*, there are other means for a court to remedy the debtor’s misuse of cash collateral, such as granting a secured creditor a higher claim for the value of the cash collateral lost, without sacrificing the payment made to the vendor.<sup>158</sup> The Code, however, is silent as to what specific penalty or sanction should be imposed upon a debtor who misuses cash collateral.<sup>159</sup> In the absence of statutory guidance, bankruptcy courts have applied different remedies and sanctions.<sup>160</sup>

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<sup>150</sup> *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1260–61 (11th Cir. 2010); Friedland & Schwartz, *supra* note 18, at 88.

<sup>151</sup> *Delco*, 599 F.3d at 1261.

<sup>152</sup> Friedland & Schwartz, *supra* note 18, at 88.

<sup>153</sup> *Id.*

<sup>154</sup> *Delco*, 599 F.3d at 1257.

<sup>155</sup> *Id.*

<sup>156</sup> *See id.*

<sup>157</sup> *Id.* at 1261.

<sup>158</sup> *See* Polednak, *supra* note 31, at 360.

<sup>159</sup> *See* 11 U.S.C. § 363 (2012); Chobot, *supra* note 40, at 137; Polednak, *supra* note 31, at 344–45 (citation omitted) (“Despite the importance of cash collateral to both the debtor and secured creditor, the [Code] appears indifferent as to the proper use of cash collateral. Furthermore, the [Code] fails to provide secured creditors with clear protection against a debtor’s misuse of cash collateral.”).

<sup>160</sup> Chobot, *supra* note 40, at 141.

Giving the lender a replacement lien is one of the most common remedies courts use when a debtor uses cash collateral without authorization.<sup>161</sup> Granting the secured creditor a replacement lien would remedy the secured creditor's position by granting the secured creditor a lien on any new unencumbered property the debtor obtains, placing the secured creditor in the same position it was in prior to the transaction.<sup>162</sup> Replacement liens seem like an equitable solution because it re-instates the lender's secured status and allows the debtor to continue to have the opportunity to reorganize. However, this remedy may not always be available because the debtor may not have new unencumbered property at that moment.<sup>163</sup>

An example of a granted replacement lien occurred in *In re Aerosmith Denton Corporation*.<sup>164</sup> In this case, the debtor in possession converted about \$13,000 of encumbered prepetition accounts into cash and commingled them in bank accounts, effectively washing away the identity of the cash.<sup>165</sup> The bank sought a replacement lien on the debtor's postpetition accounts and the imposition of penalties.<sup>166</sup> The court determined that the \$13,000 constituted cash collateral and that the debtor in possession misused the cash collateral, thereby violating § 363(c)(2).<sup>167</sup> The court granted the creditor a replacement lien on the debtor's postpetition accounts to secure the misused \$13,000, and supplemented it with an administrative expense claim.<sup>168</sup> The court also noted that the Code does not explicitly provide remedies or sanctions for a debtor's misuse of cash collateral.<sup>169</sup> However, the court cited to § 105 as giving it authority to grant the replacement lien, stating that the "[c]ourt does have an obligation to carry out the intent of Congress in its enactment of the [Code]."<sup>170</sup>

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<sup>161</sup> Polednak, *supra* note 31, at 360.

<sup>162</sup> *Id.* (citation omitted).

<sup>163</sup> *Id.*; Chobot, *supra* note 40, at 141, 143 ("Once cash collateral has been dissipated and spent, court-fashioned sanctions such as retroactive protection, appointment of a [c]hapter 11 trustee or prohibitions against the further use of cash collateral can be hollow victories for a secured creditor and do not rise to the level of 'remedy'. [sic] This is especially true where all remaining property of the estate is encumbered and the cash which has been spent without permission cannot be replaced.") (quoting *Williams v. Am. Bank of the Mid-Cities, N.A.* (*In re Williams*), 61 B.R. 567, 575 (Bankr. N.D. Tex. 1986)).

<sup>164</sup> Chobot, *supra* note 40, at 142.

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* (citing *Mercantile Nat'l Bank v. Aerosmith Denton Corp.* (*In re Aerosmith Denton Corp.*), 36 B.R. 116, 117 (Bankr. N.D. Tex. 1983)).

<sup>167</sup> *Id.* (citing *Aerosmith*, 36 B.R. at 117).

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Id.* (citing *Aerosmith*, 36 B.R. at 119).

Giving “super priority status” on the portion of the funds misused by the debtor is another common remedy for secured creditors injured by the unauthorized use of cash collateral.<sup>171</sup> To grant the creditor this remedy, the court derives authority from §§ 364(d) and 507(a).<sup>172</sup> “By drawing an analogy between the debtor’s receipt of new funds from a lender and the debtor’s unauthorized use of cash collateral, the bankruptcy courts in effect treat the injured secured creditor like a lender who has given a [postpetition] loan on previously encumbered collateral.”<sup>173</sup> Thus, the portion of collateral that was misused is given “super priority status” by making that amount an administrative expense claim pursuant to § 507(a).<sup>174</sup> Hence, the payment for the recovery of lost funds is virtually guaranteed.<sup>175</sup>

In addition to replacement liens and the grant of super priority status, there are other ways to discourage debtors from violating § 363(c)(2). For example, misuse by the debtor of cash collateral in violation of § 363(c)(2) may constitute a bankruptcy crime under title 18.<sup>176</sup> Additionally, compensatory sanctions can be given to the officers and others who control a debtor that uses cash collateral without proper authority.<sup>177</sup> Officers of a debtor company that uses cash collateral without authorization may face serious penalties, such as personal liability for conversion.<sup>178</sup> For this reason, any officer that participates in the unauthorized use of cash collateral may be jointly and severally liable for conversion, and a monetary judgment may be rendered against him.<sup>179</sup> These tools are preferential to the method adopted in *Delco* because they create a disincentive for debtors tempted to misuse cash collateral, and do not hurt innocent vendors.<sup>180</sup>

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<sup>171</sup> Polednak, *supra* note 31, at 361 (citation omitted).

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* at 362.

<sup>174</sup> *Id.*

<sup>175</sup> *See id.* (citation omitted).

<sup>176</sup> Friedland & Schwartz, *supra* note 18, at 89. *See generally* 18 U.S.C. § 157 (2012).

<sup>177</sup> Friedland & Schwartz, *supra* note 18, at 88.

<sup>178</sup> Dean P. Wyman, *Cash Collateral: The Risks of Non-consensual Use*, AM. BANKR. INST. J., Sept. 1999, at 12 (“Conversion is the ‘wrongful exercise of dominion and control over another’s property in denial of or inconsistent with his rights.’”) (quoting *Amarillo Nat’l Bank v. Komatsu Zenoah Am., Inc.*, 991 F.2d 273, 274 (5th Cir. 1993)).

<sup>179</sup> *Id.*

<sup>180</sup> *See* Friedland & Schwartz, *supra* note 18, at 89.

## V. HOW CAN COURTS AVOID THE NEGATIVE IMPLICATIONS OF *DELCO*?

This part addresses the authority courts have to create an exception for innocent vendors. This authority derives from two concepts in the Code. First, courts have avoided interpreting § 549 in a plain meaning manner. Second, courts can draw authority from § 105 to exempt innocent vendors from the inequities resulting from the avoidance of postpetition transfers like those in *Delco*.

### A. *Different Treatment by Other Courts*

In the wake of *Delco*, some courts have treated the avoidance of a debtor in possession's unauthorized postpetition transfers differently.<sup>181</sup> Although these cases had similar facts, the courts did not apply the same strict interpretation of § 549 as the Eleventh Circuit did in *Delco*. The alternative interpretations did not bring about the absurd result of punishing the innocent vendor for the debtor's act of using cash collateral without permission.<sup>182</sup>

#### 1. Wood Treators

In *Abbott v. Arch Wood Prot., Inc. (In re Wood Treators, L.L.C.)*, a district court within the Eleventh Circuit distinguished *Delco* on comparable facts and came to a different conclusion on the avoidance of postpetition transfers of cash collateral.<sup>183</sup> Instead of looking at the plain meaning of § 549(a), the district court focused on the jurisdictional question of whether there was injury to the estate.<sup>184</sup>

Wood Treators, L.L.C. filed a chapter 11 petition on March 16, 2009.<sup>185</sup> On March 18, Wood Treators obtained permission to operate its business as a debtor in possession.<sup>186</sup> The court entered orders for the debtor in possession to

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<sup>181</sup> See, e.g., *Abbott v. Arch Wood Prot., Inc. (In re Wood Treators, L.L.C.)*, 479 B.R. 122, 126 (Bankr. M.D. Fla. 2012).

<sup>182</sup> See, e.g., *id.* at 133.

<sup>183</sup> See *id.* at 126.

<sup>184</sup> Compare *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1263 (11th Cir. 2010) ("Section 549 does not require any analysis of the adequacy of protection of secured creditors' interests nor does it provide a harmless error exception."), with *Wood Treators*, 479 B.R. at 126 ("[T]he [c]ourt may consider the issue of injury to the estate in determining whether a trustee may avoid a postpetition transfer under § 549(a) . . .").

<sup>185</sup> *Wood Treators*, 479 B.R. at 124.

<sup>186</sup> *Id.*

use the cash collateral of Regions Bank in three different instances.<sup>187</sup> Regions Bank assigned its claim to 2010 Angelina Capital Fund (Angelina) in April 2010.<sup>188</sup> From May to July of 2010, Wood Treaters purchased products from Arch Wood Protection, Inc. in five separate transactions.<sup>189</sup> In July 2010, Angelina filed a motion to terminate the use of cash collateral based on the debtor's violation of the cash collateral order.<sup>190</sup> After the court terminated the debtor's permission to use cash collateral, the case was converted to chapter 7.<sup>191</sup>

The trustee relied on *Delco* to argue that she was only required to prove the three elements of § 549(a): (1) a postpetition transfer was made, (2) of property of the estate, (3) that was not authorized by the Code or the Court.<sup>192</sup> The trustee added that it is "irrelevant" that "the estate received value in exchange for the transfer [of cash collateral]" because "injury to the estate is not an element under § 549(a)."<sup>193</sup> The vendor contended that the trustee lacked standing to bring the action because the trustee had not shown that the transfers of cash collateral caused injury to the estate.<sup>194</sup> The vendor added that the estate was not injured because "it received goods of equal value in exchange for the transfers."<sup>195</sup>

The district court disagreed with the trustee and stated that the facts from *Delco* were "materially different" from this case and that "the issue of injury to the estate was not evaluated by the Eleventh Circuit as a jurisdictional question."<sup>196</sup> The court distinguished the case from *Delco* in two ways.<sup>197</sup> First, it stated that the debtor in *Delco* did not have authority from the bankruptcy court, nor from the lender, to use its cash collateral and that the debtor spent almost \$2 million while its motion requesting permission to use cash collateral was still pending.<sup>198</sup> Second, the court stated that unlike the vendor in *Wood Treaters*, the vendor's defense in *Delco* "focused on whether the lender's interest had been adequately protected, and not on whether the estate had been

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<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 124–25.

<sup>190</sup> *Id.* at 125.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 125–26.

<sup>193</sup> *Id.* at 125 (citation omitted).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* at 126.

<sup>197</sup> *See id.* at 127.

<sup>198</sup> *Id.*

injured.”<sup>199</sup> Due to these differences, the district court said it was not precluded by *Delco* from considering “the question of injury to the estate in determining whether the [t]rustee established her avoidance claim under § 549(a).”<sup>200</sup>

In determining the question of injury to the estate, the district court noted that the Eleventh Circuit did not view this as a jurisdictional question.<sup>201</sup> The court stated that “[a]ny party who invokes federal jurisdiction ‘bears the burden of demonstrating his standing to sue;’” to satisfy the constitutional standing requirement, a plaintiff must demonstrate, among other things, that there is an “injury in fact.”<sup>202</sup> Thus, the court concluded that it may consider the question of injury to the estate as a jurisdictional matter under Article III of the Constitution because the vendor asserted that the debtor’s payments were made in exchange for goods of equivalent value, and due to this, it did not have standing to sue.<sup>203</sup>

The court also found that the determination of whether there is injury to the estate is consistent with the purpose of § 549.<sup>204</sup> The court agreed that the purpose of § 549 is to “allow the trustee to avoid those postpetition transfers which deplete the estate while providing limited protection to transferees who deal with the debtor.”<sup>205</sup> Additionally, the court held that the “focus of § 549 and § 550” is on “what the bankruptcy estate lost as a result of the transfer.”<sup>206</sup> The court deemed the question of injury to the estate to be consistent with the goals of § 549 because if there is injury to the estate, then the avoidance powers of §§ 549 and 550 would be necessary to recover the loss that the estate

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<sup>199</sup> *Id.* The vendor argued that the cash collateral it received did not cause harm to the estate nor to the lender because it gave equivalent value in inventory for the funds transferred to it by the debtor. Unlike *Wood Treaters*, the debtor in *Delco* did not assert that the trustee lacked standing. *Marathon Petroleum Co. v. Cohen* (*In re Delco Oil, Inc.*), 599 F.3d 1255, 1262 (11th Cir. 2010).

<sup>200</sup> *Wood Treaters*, 479 B.R. at 127.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* (quoting *White v. Whittle* (*In re Whittle*), 449 B.R. 427, 429 (Bankr. M.D. Fla. 2011)).

Article III of the Constitution provides that federal courts may only hear cases or controversies. Standing is an essential part of the case or controversy requirement. The constitutional minimum requirements of standing require a plaintiff to demonstrate (1) an injury in fact; (2) that the injury is fairly traceable to the alleged misconduct of the defendant; and (3) that a favorable decision is likely to redress the injury.

*Id.* at 127–28 (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992)).

<sup>203</sup> *See id.* at 128.

<sup>204</sup> *Id.* at 129.

<sup>205</sup> *Id.* at 128–29 (emphasis added) (citations omitted) (quoting *ETS Payphones, Inc. v. AT&T Universal Card* (*In re PSA, Inc.*), 335 B.R. 580, 584 (Bankr. D. Del. 2005)).

<sup>206</sup> *Id.* at 129 (quoting *Rushton v. Bank of Utah* (*In re C.W. Mining Co.*), 465 B.R. 226, 233–34 (Bankr. D. Utah 2011), *aff’d*, 477 B.R. 176 (B.A.P. 10th Cir. 2012)) (internal quotation marks omitted).

suffered.<sup>207</sup> Thus, the court denied the trustee's motion for summary judgment on the ground that the trustee must prove that the estate suffered an injury that is redressable by a judgment in her favor.<sup>208</sup>

## 2. C.W. Mining

Another post-*Delco* case that addressed the avoidance of unauthorized postpetition transfers is *Rushton v. Bank of Utah (In re C.W. Mining Co.)*.<sup>209</sup> Here, the Bankruptcy Court for the District of Utah looked to the question of whether a postpetition transfer of cash to a secured creditor caused injury to the estate to determine if the transfer was avoidable under § 549(a).<sup>210</sup> The court held that unauthorized postpetition transfers of property of the estate should not be avoided when the avoidance of such transfers result in zero benefit to the estate.<sup>211</sup>

C.W. Mining entered into three loan agreements with the Bank of Utah to finance the acquisition of mining equipment.<sup>212</sup> Each loan agreement was fully secured by the equipment and included cross-collateralization provisions covering all of the assets secured by any of the notes.<sup>213</sup> In January 2008, Mining's creditors filed an involuntary bankruptcy proceeding under chapter 11, which was granted on September 26, 2008.<sup>214</sup> The chapter 11 proceeding was later converted into a chapter 7 proceeding, and a trustee was appointed.<sup>215</sup> After the case was converted to chapter 7, the bank liquidated a certificate of deposit in favor of C.W. Mining and obtained \$383,099.<sup>216</sup> The bank used those proceeds and applied them to the notes which the debtor owed.<sup>217</sup> Once the case was converted to chapter 7, the trustee sought to avoid \$383,099 in postpetition payments made by C.W. Mining to the Bank of Utah under § 549(a), and to recover that amount under § 550(a)(1) without cancelling the satisfaction of the bank's lien.<sup>218</sup> Here, the chapter 7 trustee sought to recover

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<sup>207</sup> *See id.*

<sup>208</sup> *Id.* at 130.

<sup>209</sup> *See generally* *Rushton v. Bank of Utah (In re C.W. Mining Co.)*, 465 B.R. 226 (Bankr. D. Utah 2011).

<sup>210</sup> *Id.* at 231.

<sup>211</sup> *See id.* at 234.

<sup>212</sup> *Id.* at 229.

<sup>213</sup> *Id.* (describing how the provision meant that "all of the assets securing any one of the [n]otes secured all of the [n]otes, and the Bank's security interest was properly perfected").

<sup>214</sup> *Id.* at 229–30.

<sup>215</sup> *Id.* at 230.

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *See id.*

the payment made by the debtor to the bank while keeping the reduction of the lien that resulted from the bank applying the proceeds from the certificate of deposit to the outstanding notes.<sup>219</sup>

In analyzing “the consequences of avoiding a transfer to a fully secured creditor,” the court noted that it is “critical to recognize that the transfer that the [t]rustee seeks to avoid was a payment to a fully secured creditor in exchange for satisfaction of a portion of a lien.”<sup>220</sup> In other words, the trustee sought to keep the money and lift the secured creditor’s lien.<sup>221</sup> The court found that the result was inequitable and contrary to the purpose of the Code.<sup>222</sup> This double gain is similar to the windfall evidenced in *Delco*.<sup>223</sup> The court criticized such a result by stating that such actions do “not return the parties to the status quo, is unrelated to any damages, is clearly punitive in nature, and creates a windfall for the bankruptcy estate.”<sup>224</sup>

The court was guided in its analysis by the purpose of § 550.<sup>225</sup> The court acknowledged that § 550(a) is intended to “restore the estate to the financial condition it would have enjoyed if the transfer had not occurred,” and that focus should be placed on “what the bankruptcy estate lost as a result of the transfer.”<sup>226</sup> Looking at the consequences if the avoidance was to be awarded, the court noted that the avoidance of the payment to the bank would bring the same amount of money back into the estate as would be reduced in the bank’s lien.<sup>227</sup> The court categorized the chapter 7 trustee’s approach as a punitive theory of the Code, “which must be rejected.”<sup>228</sup> Therefore, by considering the purpose of § 550 in light of the facts, the court concluded that it would be meaningless to grant judgment to the trustee in the adversary proceeding.<sup>229</sup>

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<sup>219</sup> *Id.*

<sup>220</sup> *Id.* at 231.

<sup>221</sup> *See id.*

<sup>222</sup> *Id.* at 233 (“The Trustee’s attempt to recover the \$383,099 Transfer free and clear of the Bank’s lien is clearly inconsistent with the intent of the Bankruptcy Code.”).

<sup>223</sup> *See* *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1263 (11th Cir. 2010), *aff’d*, 477 B.R. 176 (B.A.P. 10th Cir. 2012).

<sup>224</sup> *C.W. Mining*, 465 B.R. at 231.

<sup>225</sup> *See id.* at 233–34.

<sup>226</sup> *Id.* at 233 (quoting *Rushton v. Drive Fin. Servs. (In re Gardner)*, No. 05-27551, 2007 WL 2915847, at \*3 (Bankr. D. Utah Feb. 23, 2007)) (internal quotation marks omitted).

<sup>227</sup> *Id.* at 234.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

### B. Authority the Court May Use to Create an Exception

Bankruptcy courts have traditionally been recognized as courts of equity.<sup>230</sup> As such, bankruptcy courts should have judicial authority to prevent the absurd result created by the plain meaning interpretation of §§ 549 and 550. In light of this, this section explores the extent of the bankruptcy courts' judicial authority to grant an innocent vendor exception under § 549. First, it will examine the purpose of § 105 and whether its use can be used to exempt innocent vendors. Then, it will examine the way in which critical vendor exceptions were created, and the legal support courts have used to issue critical vendor orders.

Section 105(a) is a general provision that allows for the broad exercise of power in the administration of a bankruptcy case.<sup>231</sup> It states:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.<sup>232</sup>

Section 105 is meant to give bankruptcy courts the necessary power to “take whatever action is appropriate or necessary in aid of the exercise of their jurisdiction.”<sup>233</sup> The status of bankruptcy courts as courts of equity was confirmed in *United States v. Energy Resources Co.*, where the Supreme Court stated that bankruptcy courts have “broad authority to modify creditor-debtor relationships.”<sup>234</sup> Nonetheless, the power given to bankruptcy courts under § 105 is limited, because it does not allow a bankruptcy court to ignore other provisions of the Code, or the requirements of any other state or federal statute.<sup>235</sup>

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<sup>230</sup> 2 COLLIER, *supra* note 1, ¶ 105.01[1] (citation omitted).

<sup>231</sup> *Id.*

<sup>232</sup> 11 U.S.C. § 105(a) (2012).

<sup>233</sup> 2 COLLIER, *supra* note 1, ¶ 105.01 (citations omitted).

<sup>234</sup> *United States v. Energy Res. Co.*, 495 U.S. 545, 549 (1990) (citations omitted).

<sup>235</sup> 2 COLLIER, *supra* note 1, ¶ 105.01 (citations omitted); *see In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004) (quoting *In re Chi., Milwaukee, St. Paul & Pac. R.R.*, 791 F.2d 524, 528 (7th Cir. 1986)) (stating that § 105(a) “does not create discretion to set aside the Code’s rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. . . . ‘The fact that a bankruptcy proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.’”).

Although the boundaries of § 105 are not strictly delineated, an “expansive construction [of § 105] is justified” given the broad power vested in bankruptcy courts to “reorganize debtors, to afford a fresh start to debtors and to distribute funds equitably to creditors.”<sup>236</sup> This broad power has been verified by the Supreme Court, which stated that “[t]he jurisdiction of bankruptcy courts may extend more broadly’ in chapter 11 cases than in chapter 7 cases.”<sup>237</sup>

An important example of how courts have relied on their equitable powers to develop bankruptcy law is the critical vendor exception.<sup>238</sup> Vendors are labeled critical vendors “in the rare instances in which the payment of a prepetition debt may be absolutely vital to the reorganization of a [c]hapter 11 debtor.”<sup>239</sup> For example, payment of the prepetition debt may be vital because the vendor may offer a good or service whose substitute cannot be located at an acceptable price.<sup>240</sup> This judicially created exception is one that is made to further the goals of the Code and has found support in common law and § 105(a).<sup>241</sup> Understanding the mechanism and theory used in granting the critical vendor exception is important to demonstrate that bankruptcy courts are equipped with the judicial authority to create an innocent vendor exception under § 549(a).

Judicial authority to create a critical vendor exception began under the common law doctrine of necessity.<sup>242</sup> The “necessity of payment rule” recognized the importance of allowing the trustee to pay prepetition debts of suppliers who threatened to withhold essential goods or services.<sup>243</sup> The necessity of payment rule was applied mainly to allow for the survival of railroad companies that could not survive without certain suppliers.<sup>244</sup>

Today, it seems unlikely that the doctrine of necessity will be used as authority to provide critical vendor status.<sup>245</sup> For example, the Seventh Circuit found in *In re Kmart* that the Bankruptcy Acts of 1898 and 1978 have

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<sup>236</sup> 2 COLLIER, *supra* note 1, ¶ 105.01[2].

<sup>237</sup> *Id.* ¶ 105.01 (quoting *Celotex Corp. v. Edwards*, 514 U.S. 300, 310 (1995)).

<sup>238</sup> Travis N. Turner, Note, *Kmart and Beyond: A “Critical” Look at Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 434 (2006).

<sup>239</sup> *See id.* at 437 (quoting *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988)).

<sup>240</sup> *Id.* at 437–38.

<sup>241</sup> *Id.* at 446–47.

<sup>242</sup> *See id.* at 443–44.

<sup>243</sup> *See id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* at 445–46.

displaced common law doctrines such as that of the doctrine of necessity.<sup>246</sup> Moreover, the court added that “[o]lder doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text.”<sup>247</sup>

Although § 105(a) has been restricted in some circuits, such as the Seventh Circuit, it has received a more liberal treatment in other circuits.<sup>248</sup> A recent example of a more liberal construction occurred in the Third Circuit.<sup>249</sup> The District Court of Delaware stated in *In re Just for Feet, Inc.* that the “Supreme Court, the Third Circuit and the District of Delaware all recognize the court’s power to authorize payment of prepetition claims when such payment is necessary for the debtor’s survival during chapter 11.”<sup>250</sup> Here, the court referred to the necessity of payment doctrine, noting that although it is not codified, the equitable power given to courts still exists under § 105(a).<sup>251</sup> The district court also referred to the origins of the necessity of payment doctrine and how it aimed to “[recognize] that paying certain [prepetition] claims may be necessary to realize the goal of chapter 11.”<sup>252</sup>

*In re CoServ L.L.C.* is another case in which a court construed § 105(a) liberally.<sup>253</sup> In this case, the District Court for the Northern District of Texas searched for a provision of the Code “that would make the issuance of a critical vendor order necessary to carry out the purposes of the Code.”<sup>254</sup> Another case in which a court considered the equitable nature of a bankruptcy court is *In re Chateaugay Corp.*<sup>255</sup> In this case, the District Court for the Southern District of New York held:

A rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization and of the Act’s grant of equity powers to bankruptcy courts, which is to create a flexible

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<sup>246</sup> *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004).

<sup>247</sup> *Id.* (citations omitted); see also *Turner*, *supra* note 238, at 446.

<sup>248</sup> *Turner*, *supra* note 238, at 447–49.

<sup>249</sup> See *id.* at 449.

<sup>250</sup> *In re Just for Feet, Inc.*, 242 B.R. 821, 825 (D. Del. 1999).

<sup>251</sup> See *id.* at 824.

<sup>252</sup> *Id.* at 825 (citation omitted).

<sup>253</sup> *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002).

<sup>254</sup> *Turner*, *supra* note 238, at 449–50.

<sup>255</sup> See generally *Mich. Bureau of Workers’ Disability Comp. v. Chateaugay Corp.* (*In re Chateaugay Corp.*), 80 B.R. 279 (S.D.N.Y. 1987).

mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.<sup>256</sup>

Further, with respect to the application of pre-plan proceedings required by § 1122,<sup>257</sup> the court added, “[T]he fact that the bankruptcy courts are courts of equity . . . allows exceptions to any strict rules of classification of claims.”<sup>258</sup>

Given that § 105 has been used to make “exceptions to any strict rules of classification of claims” and to further the goals of the Code, it seems reasonable that courts can use § 105 to create an exception for innocent vendors in situations where they receive cash collateral in exchange for goods of equivalent value.<sup>259</sup>

## VI. PROPOSED INNOCENT VENDOR EXCEPTION

The proposed innocent vendor exception would have prevented the inequity resulting from *Delco*.<sup>260</sup> First, it prevents the problem of having the innocent vendor lose the money received even though the estate and the creditor were not harmed.<sup>261</sup> By preventing the avoidance of the debtor’s postpetition payment to the innocent vendor, the court would effectively avoid this problem, because the chapter 7 trustee could not bring an avoidance action under § 549(a) to repair harm made to a secured creditor.<sup>262</sup> Second, it avoids the absurd result that arises when an innocent vendor is prevented from obtaining an administrative expense claim even though it conferred a benefit

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<sup>256</sup> *Id.* at 287.

<sup>257</sup> 11 U.S.C. § 1122 (2012) states:

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

<sup>258</sup> *Chateaugay*, 80 B.R. at 288 (quoting *Brinkley v. Chase Manhattan Mortg. & Realty Trust (In re LeBlanc)*, 622 F.2d 872, 879 (5th Cir. 1980)).

<sup>259</sup> *Id.* (quoting *LeBlanc*, 622 F.2d at 879).

<sup>260</sup> *See generally* *Marathon Petroleum Co. v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255 (11th Cir. 2010).

<sup>261</sup> In a case like *Delco*, the estate would recoup the cash collateral paid to the vendor and the goods received. *See id.* at 1262. By virtue of U.C.C. § 9-315, the creditor should have a security interest in the goods for which the debtor exchanged the cash collateral. U.C.C. § 9-315 (2001).

<sup>262</sup> *But see Delco*, 599 F.3d at 1260 (permitting the trustee to bring an avoidance action).

on the estate.<sup>263</sup> Third, it allows equitable remedies to come into play to help police the debtor's unauthorized use of cash collateral.<sup>264</sup> The court may assign sanctions or penalties against the debtor or its officers, and may assign replacement liens or super priority status on newly unencumbered property in order for the secured creditor to maintain an interest similar to that which it had in the cash collateral.<sup>265</sup> More importantly, these results are equitable because they prevent the innocent vendor, as an innocent transferee, from being punished for the debtor's misconduct and allows the appropriate sanctions to involve both the debtor and the corresponding creditor.

Through analysis of the critical vendor exemption, this Comment has shown that courts do have the authority to create an innocent vendor judicial exception to avoid the absurd results of decisions such as *Delco*. Also, courts would not be stepping over the § 105 boundaries because previous courts have created broader exceptions than the exception proposed in this Comment. Alternatively, as illustrated by *Wood Treathers* and *C.W. Mining Co.*, creating an exception in this narrow instance may not even require the use of § 105.

#### CONCLUSION

To avoid the negative implications that resulted from *Delco*, courts should create an exception for innocent vendors under § 549(a) who transact with debtors that are using cash collateral without proper authorization. This exception should apply when the vendor is innocent and when it exchanges equivalent value for the received cash collateral. *Delco* showed that when § 549(a) is interpreted according to its plain meaning, certain absurd results occur: (1) the innocent vendor loses the payment it received from the debtor even though it transacted goods in return, and (2) the innocent vendor's opportunity to obtain an administrative expense claim pursuant to § 503 of the Code is jeopardized by the mechanics of § 502(h).<sup>266</sup> Additionally, this Comment has demonstrated that the burden the decision places on vendors is too high, as vendors have to spend resources and delay transactions in order to

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<sup>263</sup> See 11 U.S.C. § 502(h) (2012). By virtue of § 502(h), the vendor loses priority in its claim since the transfer was recovered via § 550. Thus, what would have been an administrative expense claim becomes a prepetition unsecured claim.

<sup>264</sup> See Polednak, *supra* note 31, at 346–47.

<sup>265</sup> See *id.* at 347 & nn.24–25 (citations omitted) (summarizing case law using remedies derived from the Code and from other areas of law).

<sup>266</sup> *Delco*, 599 F.3d at 1263.

conduct due diligence and avoid the same fate that Marathon suffered in *Delco*.<sup>267</sup>

Furthermore, the policies and legislative history behind §§ 549 and 550, when combined with the goals of chapter 11, support the creation of an innocent vendor exception.<sup>268</sup> The purpose of sections §§ 549 and 550, to repair any harm that was inflicted on the estate by a postpetition transfer, is consistent with the creation of an innocent vendor exception, because the exception will only apply in instances where the estate suffered no harm as a result of the postpetition transfer of cash collateral.<sup>269</sup> The legislative history of §§ 502 and 550 have shown that the legislature,<sup>270</sup> in drafting the current sections of the Code, did not foresee that the avoidance of a postpetition transfer under § 549(a) would create a conflict with an innocent vendor's priority under § 502(h) by turning a potential administrative expense claim into a prepetition unsecured claim.<sup>271</sup>

This exception will prove useful in the near future for a few reasons. First, it adheres to the interests that § 550 is meant to protect—unauthorized transfers which result in loss to the estate. Second, it protects good faith vendors who run the risk of losing not only their shipment of goods, but also the corresponding payment that comes with it. More importantly, this exception is consistent with the goals of chapter 11 because it increases the likelihood that a debtor's reorganization will be successful. Without the exception, vendors may refuse to work with chapter 11 companies, as they could not be guaranteed payments for their goods.

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<sup>267</sup> Cf. Blossom & Henderson, *supra* note 13, at 227.

<sup>268</sup> See, e.g., *ETS Payphones, Inc. v. AT&T Universal Card (In re PSA, Inc.)*, 335 B.R. 580, 584 (Bankr. D. Del. 2005) (quoting 5 COLLIER ON BANKRUPTCY ¶ 549.02 (15th ed. 2005)) (“The purpose of section 549 is to allow the trustee to avoid those postpetition transfers which deplete the estate while providing limited protection to transferees who deal with the debtor.”).

<sup>269</sup> See *Rushton v. Bank of Utah (In re C.W. Mining Co.)*, 465 B.R. 226, 233 (Bankr. D. Utah 2011), *aff'd*, 477 B.R. 176 (B.A.P. 10th Cir. 2012).

<sup>270</sup> See 5 COLLIER, *supra* note 1, ¶ 550.LH.

<sup>271</sup> See *id.* ¶ 502.LH.

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