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# Seller Beware of the Buyer in Chapter 11

When a customer files a Chapter 11 bankruptcy, companies often question whether they should continue doing business with the customer and, if so, on what terms. Most of the time, because of protections for sellers of necessary goods and services built into the Bankruptcy Code, the answer will be that "business as usual" is safe. A recent case, however, illustrates that careful investigation is prudent.

## *The Case:*

Delco Oil, Inc. ("Delco"), was a distributor of motor fuel and associated products. Since 2003, Delco purchased petroleum products from Marathon Petroleum Company ("Marathon"). Delco borrowed money from Capital Source Finance ("Capital"). In October 2006, Delco filed Chapter 11 bankruptcy.

Capital held a valid security interest in all of Delco's personal property, including Delco's collections from its accounts receivable and the proceeds. The proceeds included all of the cash in Delco's bank accounts. In October and November 2006, while Delco was a Chapter 11 debtor, Delco purchased and paid for $2 million worth of petroleum products from Marathon.

In December 2006, Delco converted from a Chapter 11 debtor to a Chapter 7 debtor. A trustee was appointed. The trustee successfully sued Marathon for the return of the $2 million that Marathon was paid for the products it sold to Delco.

## *The Law:*

When a debtor files bankruptcy owing money to a lender with a security interest in all of the debtor's personal property, including accounts receivable and proceeds (this is the typical "blanket security interest" that most secured lenders obtain), the Bankruptcy Code forbids the debtor from using "cash collateral" without either the agreement of the lender or the bankruptcy court's permission. "Cash collateral" is, among other things, most debtors' cash collected from its accounts receivable.

As debtors cannot use cash collateral without permission or a court order, one of the first things that a Chapter 11 debtor must do after filing bankruptcy is to bring an emergency motion before the bankruptcy court requesting authority to use cash collateral. This motion is almost always granted for at least a short period, even over a lender's objections, because the debtor cannot continue in business if it cannot purchase materials or pay its employees. However, using cash collateral without the lender's consent or the bankruptcy court's permission after bankruptcy is filed is an unauthorized transfer of bankruptcy estate property.

The Bankruptcy Code empowers a bankruptcy trustee to recover unauthorized transfers of estate property. The *Delco* case stands for the proposition that there are *no exceptions* to this power. It does not matter that a Chapter 11 debtor is authorized by the same Bankruptcy Code to operate its business "in the ordinary course." It did not matter that Marathon did not know that Delco did not have either the lender's consent or the bankruptcy court's permission to use cash collateral. Marathon was required to return the $2 million even though Marathon had delivered $2 million worth of product in complete innocence.

### *What It Means:*

If you are selling anything, whether products or services, to a Chapter 11 debtor, you must make sure that the debtor is authorized to use cash collateral or else run the risk of not being able to keep the money that you are paid for the goods or services you provide. In the *Delco* case, the bankruptcy court ultimately denied Delco's request to use cash collateral, so Marathon went unpaid. Unfortunately for Marathon, Delco apparently assumed that it would obtain approval for use of cash collateral and made no provision for operations while its motion was pending, while Marathon sold product to Delco without understanding the scope of Delco's authority to conduct business.

Although the circumstances of the *Delco* case will not arise very often, since the bankruptcy court almost always grants the debtor permission to use cash collateral for at least a short period, vendors to bankruptcy debtors should not rely on what "almost always" happens. How can you be certain that you will be able to keep payments from a Chapter 11 debtor? Having an attorney check the bankruptcy court record is the best way to find out. Whenever a customer who has filed bankruptcy offers to keep doing business with you, a call to your attorney can provide assurance that you will be able to keep the money that the debtor pays you.