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From the Bankruptcy Courts: Eleventh Circuit Holds That Cross-Collateralization in Postpetition Financing Arrangement Is Improper

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ELEVENTH CIRCUIT HOLDS THAT CROSS-COLLATERALIZATION IN POSTPETITION FINANCING ARRANGEMENT IS IMPROPER

The success or failure of a chapter 11 reorganization effort often depends on the debtor's ability to obtain new financing immediately after the filing of the petition. Despite the automatic stay of collection efforts regarding prepetition liabilities,[1] the debtor's inability to obtain sufficient postpetition credit may present an unsurmountable barrier to the continuation of the business during the case and to the ability to confirm a feasible plan of reorganization.

The Bankruptcy Code (the Code) is designed to assist the debtor in obtaining needed financing.[2] First, Section 364(a) of the Code permits the debtor to obtain credit in the ordinary course of business without court approval, resulting in an administrative priority for the creditor.[3] Although this may be sufficient to induce vendors and other trade suppliers to give the debtor short-term credit as usual, it is not helpful regarding extensions of credit outside the ordinary course. Section 364(b) allows the debtor, with court approval, to obtain credit outside the ordinary course, again granting an administrative priority to the creditor.[4] However, granting an administrative priority usually is insufficient to induce banks or other institutional lenders to extend substantial financing to a debtor in possession, often referred to as DIP financing. Therefore, Section 364(c) permits the court to order that a post-petition financer have "superpriority" over all other administrative expenses or be secured by a lien on property of the estate, if necessary to induce the extension of credit.[5] If an existing lien is adequately protected, pursuant to Section 364(d), the court may even authorize the granting of a senior lien when the debtor in possession could not otherwise obtain needed financing.[6]

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[1] See 11 U.S.C. § 362.

[2] For a discussion of the Code's provisions dealing with postpetition financing, see B. Weintraub & A. Resnick, *Bankruptcy Law Manual* (rev. ed. 1992) ¶ 8.11[6].

[3] See 11 U.S.C. § 364(a).

[4] See 11 U.S.C. § 364(b).

[5] See 11 U.S.C. § 364(c).

[6] See 11 U.S.C. § 364(d).

A common source of DIP financing is the debtor's prepetition lender. When the debtor seeks postpetition financing from the prepetition lender, it is common for the lender to demand that, as a condition to the extension of credit, the debtor agrees, with the court's approval, that the lender be granted a security interest in the debtor's assets to secure *both* the lender's postpetition claims and the lender's unsecured prepetition claims. The result of such an order is to convert the lender's prepetition nonpriority unsecured claim into a secured claim as an inducement for the extension of new postpetition financing. Because the new lien secures a prepetition and postpetition debts, this financing arrangement is known as "cross-collateralization."

The Code is silent regarding cross-collateralization, which raises the question of whether bankruptcy courts have the power to authorize it in a case under the Code. The first court of appeals decision to comment on its propriety under the Code was *In re Texlon Corp.*,[7] a case under Chapter XI of the former Bankruptcy Act, where the debtor obtained a court order authorizing it to grant a postpetition financer a security interest in all inventory, equipment, and accounts receivable of the debtor to secure prepetition debt as well as new postpetition financing. The court held that the financing order was improper because it was granted ex parte, thus avoiding the necessity of dealing directly with the question of whether, if notice was proper, the cross-collateralization order could have been upheld. Most importantly the court of appeals, in dictum, commented on Section 364 of the Code, which at that time had not yet become law. "'[W]e see nothing in § 364(c) or in the other provisions of that section that advances the case in favor of 'cross-collateralization.' "[8] However, the court of appeals was quick to add that it would not go so far as to hold that "under no conceivable circumstances could 'cross-collateralization' be authorized."[9] With that brief comment on a law not even applicable to that case, the court of appeals opened the door enough to allow bankruptcy courts to grant cross-collateral orders in situations in which the courts were satisfied that the debtor could not otherwise obtain DIP financing.[10]

The *Saybrook* Decision

The door that was opened in the Second Circuit in 1979 was closed completely in the Eleventh Circuit in 1992 when the court of appeals decided *In re Saybrook Manufacturing Co.*[11] The day after Saybrook Manufacturing Company and relat-

[7] 596 F.2d 1092 (2d Cir. 1979).

[8] *Id.* at 1098.

[9] *Id.*

[10] See, e.g., In re Vanguard Diversified, Inc., 31 Bankr. 364 (Bankr. E.D.N.Y. 1983); In re Roblin Indus., Inc., 52 Bankr. 241 (Bankr. W.D.N.Y. 1985). Contra, e.g., In re Monach Circuit Indus., Inc., 41 Bankr. 859 (Bankr. E.D. Pa. 1984).

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

ed companies filed Chapter 11 petitions, the debtors filed a motion for, among other things, authorization to borrow $3 million from a bank that held prepetition claims against the debtors. The new $3 million loan, secured by a security interest in the debtor's assets, was necessary to facilitate the reorganization effort. On the filing date, the bank was already owed $34 million that was secured by less than $10 million worth of collateral, leaving a prepetition unsecured nonpriority claim of more than $24 million. The bankruptcy court entered an emergency financing order that same day authorizing the debtors to grant the bank a security interest. The financing arrangement included a cross-collateralization provision granting the bank a security interest in all of the debtors' property—including property owned prior to filing the bankruptcy petition and property that is acquired post petition—to secure both the $3 million of postpetition credit *and* the entire $34 million prepetition debt.

It is not surprising that two unsecured creditors objected to this financing arrangement, which greatly enhanced the bank's position vis-à-vis other unsecured creditors in the event of liquidation. As the court of appeals indicated, since the bank's prepetition debt was undersecured by more than $24 million, "It originally would have shared in a pro rate distribution of the debtor's unencumbered assets along with the other unsecured creditors. Under the financing order, however, [the bank's] prepetition debt became fully secured by all of the debtors' assets. If the bankruptcy estate were liquidated, [the bank's] entire debt—$34 million prepetition and $3 million postpetition—would have to be paid in full before any funds could be distributed to the remaining unsecured creditors."[12]

The court of appeals in *Saybrook* distinguished two different forms of cross-collateralization. "*Texlon*-type cross-collateralization" involves the granting of a lien on the debtor's pre- and postpetition collateral to secure prepetition claims as well as postpetition debt. Another type of cross-collateralization that was not involved in that case is the securing of postpetition debt with prepetition collateral. The two objecting unsecured creditors in *Saybrook* challenged only the cross-collateralization of the bank's prepetition debt, not the collateralization of the postpetition debt.

Mootness Doctrine

The bankruptcy court, after a hearing, overruled the objections to the financing order made by the two objecting unsecured creditors. After a notice of appeal was filed, the court denied their request for a stay pending appeal and subsequently dismissed the appeal as moot under Section 364(e), which provides that:

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[12] *Id.* at 1491.

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.[13]

The principle stated in that section of the Code is often referred to as the "mootness doctrine" because it effectively renders moot any appeal attacking the legality of a postpetition financing order in favor of a good faith lender in the absence of a stay pending appeal. As the court of appeals stated in *Saybrook*, "[t]he purpose of this provision is to encourage the extension of credit to debtors in bankruptcy by eliminating the risk that any lien securing the loan will be modified on appeal."[14] The bank argued that Section 364(e) prohibits the court of appeals from reviewing the propriety of the financing order, and cited several cases, including the Ninth Circuit decision in *In re Adams Apple, Inc.*,[15] and the Sixth Circuit decision in *In re Ellingsen MacLean Oil Co.*,[16] where the courts had refused to consider the merits of the question regarding the propriety of cross-collateralization because of the mootness doctrine.

The Court of Appeals for the Eleventh Circuit, rejecting the reasoning of the court in *Adams Apple* and *Ellingsen*, held that the mootness doctrine does not prohibit appellate review of a financing order involving cross-collateralization. In essence, *Adams Apple* and *Ellingsen* "put the cart before the horse" because Section 364(e) only protects from review those postpetition financing orders that are "authorized" under Section 364.[17] "We cannot determine if this appeal is moot under Section 364(e) until we decide the central issue in this appeal—whether cross-collateralization is authorized under section 364."[18] By holding that Section 364(e) does not bar appellate review, the court of appeals removed a long-standing obstacle that had been frustrating the attempts of unsecured creditors to obtain any court of appeals review of cross-collateralization orders.[19]

The Impropriety of Cross-Collateralization

The court of appeals in *Saybrook* then turned to the merits of the issue, which the court recognized as "ex-

[13] 11 U.S.C. § 364(e).

[14] In re Saybrook Mfg. Co., note 11 *supra*, 963 F.2d at 1493.

[15] 829 F.2d 1484 (9th Cir. 1987).

[16] 834 F.2d 599 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988).

[17] In re Saybrook Mfg. Co., note 11 *supra*, 963 F.2d at 1493.

[18] *Id.*

[19] For a discussion of this obstacle to appellate review, see Tabb, "Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma," 50 Ohio St. L.J. 109 (1989).

tremely controversial,"[20] regarding the propriety of cross-collateralization in a case under the Code. Despite this controversy, however, the court was facing a question of first impression that has never been directly decided by any court of appeals. This lack of appellate authority was due primarily to the widespread application of the mootness doctrine under Section 364(e).

The court of appeals noted that the bankruptcy courts that have permitted cross-collateralization usually have done so with great reluctance and only after the debtors have satisfied a four-part test that required the debtor to demonstrate:

> (1) that its business operations would fail absent the proposed financing, (2) that it is unable to obtain alternative financing on acceptable terms, (3) that the proposed lender will not accept less preferential terms, and (4) that the proposed financing is in the general creditor body's interest.[21]

The court of appeals then held that cross-collateralization is not a permissible means of obtaining financing in a case under the Code. After commenting that cross-collateralization is not specifically mentioned in the Code, the court concluded that the practice is inconsistent with the bankruptcy law for two reasons.

> First, cross-collateralization is not authorized as a method of post-petition financing under Section 364. Second cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code.[22]

Focusing on the language of Section 364, the court concluded that "[b]y their express terms, sections 364(c) & (d) apply only to future—i.e., post-petition—extensions of credit. They do not authorize the granting of liens to secure pre-petition loans."[23] In particular, the court emphasized certain phrases of the statute:

> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, *may authorize the obtaining of credit or the incurring of debt*
>
> —(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
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> (3) secured by a junior lien on property of the estate that is not otherwise subject to a lien;
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> (d) (1) The court, after notice and a hearing, *may authorize the obtaining*

[20] In re Saybrook Mfg. Co., note 11 *supra*, 963 F.2d at 1493.

[21] See, e.g., In re Vanguard Diversified, Inc., note 10 *supra*, 31 Bankr. at 364, 366; In re Roblin Indus., Inc., note 10 *supra*, 52 Bankr. at 244–245.

[22] In re Saybrook Mfg. Co., note 11 *supra*, 963 F.2d at 1494–1495.

[23] *Id.* at 1495.

of credit or incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

> (A) the trustee is unable to obtain such credit otherwise; and
>
> (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.[24]

Quoting from an opinion of the bankruptcy court in *In re Monach Circuit Industries, Inc.*,[25] the court of appeals reasoned that "[T]he terms of § 364(c) appear to limit the extent of the priority or lien to the amount of the credit obtained or debt incurred *after* court approval."[26]

Focusing on the bank's argument that bankruptcy courts may permit cross-collateralization under their general equitable powers, the court of appeals stated that the court's equitable power to avoid injustice or unfairness is not unlimited.

> Section 507 of the Bankruptcy Code fixes the priority order of claims and expenses against the bankruptcy estate. . . . Creditors within a given class are to be treated equally, and bankruptcy courts may not create their own rules of superpriority within a single class. . . . Cross-collateralization, however, does exactly that. . . . As a result of this practice, post-petition lenders' unsecured pre-petition claims are given priority over all other unsecured pre-petition claims.[27]

The court of appeals in *Saybrook* also rejected the argument that cross-collateralization may be justified as being consistent with the bankruptcy policy of helping businesses to reorganize and become profitable. "Rehabilitation is certainly the primary purpose of Chapter 11. This end, however, does not justify the use of any means. Cross-collateralization is directly inconsistent with the priority scheme of the Bankruptcy Code. Accordingly, the practice may not be approved by the bankruptcy court under its equitable authority."[28]

In sum, the court of appeals held that, since cross-collateralization is not explicitly authorized by the Code and is contrary to the basic priority structure of the Code, the mootness doctrine under Section 364(e) is not applicable. The order of the district court was reversed and the proceeding was remanded.

Conclusion

It probably will take some time before the actual effects of the *Saybrook* decision become known in the Eleventh Circuit. Will debtors have more difficulty obtaining DIP financing because they no longer can induce their prepetition lenders to extend additional financing by

[24] *Id.*, quoting from 11 U.S.C. §§ 364(c), 364(d) (emphasis added).

[25] 41 Bankr. at 859.

[26] 963 F.2d at 1495, quoting from In re Monach Circuit Indus., Inc., note 10 *supra*, 41 Bankr. at 862 (emphasis in original).

[27] *Id.*, 963 F.2d at 1495–1496.

[28] *Id.* at 1496.

offering them the opportunity to convert their pre-petition unsecured claims to secured claims? Or will the effect be minimal because lenders will still have sufficient incentive in seeing the debtor reorganize successfully so that prepetition claims will be paid, while feeling secure regarding postpetition advances extended on a senior secured basis. We never really know how effective the carrot is in inducing behavior until it is gone.

It also remains to be seen whether other circuits will follow the holding in *Saybrook*. However, its impact in other circuits that have not faced these issues may be as significant as it will be in the Eleventh Circuit because of the court's removal of the mootness doctrine shield against appellate review of orders authorizing cross-collateralization. In essence, a lender offered cross-collateralization in another circuit may find little comfort in a bankruptcy court order approving the financing arrangement because of the possibility that the court of appeals in that circuit may then rule that Section 364(e) offers no protection against subsequent attack. The sanctity of cross-collateralization orders has been placed under a cloud that may, or possibly may not, render it more difficult to obtain needed DIP financing.