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From the Bankruptcy Courts

Benjamin Weintraub* and Alan N. Resnick**

CROSS-COLLATERALIZATION OF PREPETITION INDEBTEDNESS AS AN INDUCEMENT FOR POSTPETITION FINANCING: A EUPHEMISM COMES OF AGE

The springboard for a successful reorganization of an insolvent business is most often the debtor's ability to obtain new financing simultaneously with the commencement of the chapter 11 case. The Bankruptcy Code, as was the former Bankruptcy Act, is designed to assist the debtor in obtaining postpetition financing when necessary to accomplish reorganization.

Although the debtor in possession may obtain, without court approval, unsecured credit in the ordinary course of business resulting in an administrative expense priority for the creditor, such credit rarely is enough to revive the troubled debtor.¹ Thus, Section 364 of the Bank-

ruptcy Code authorizes the court, after notice and a hearing, to permit the procurement of unsecured credit other than in the ordinary course of business.² If needed as an inducement for new financing, the court may order that the potential lender have "superpriority" over all other administrative expenses and/or be secured by a lien on property of the estate.³ If an existing lienor is adequately protected, the court may even authorize the granting of senior lienor status to the postpetition lender when alternative means of financing are unavailable.⁴

The Texlon Saga

The case of *In re Texlon Corporation*⁵ illustrates the need for such postpetition financing and tests the limits of the court's discretion in approving financing arrangements. Preparatory to embarking upon a Chapter XI case under the former Bankruptcy Act, Texlon sought financing from its factor, Manufacturers Hanover Commercial Corpo-

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¹ 11 U.S.C. § 364(a). For a discussion of the risks involved in extending credit in the ordinary course of business, see Weintraub & Resnick, *Bankruptcy Law Manual* ¶ 8.11[5] (1980).

² 11 U.S.C. § 364(b).

³ 11 U.S.C. § 364(c). See former Bankruptcy Act § 344 which authorized the issuance of certificates of indebtedness to obtain fresh financing in Chapter XI cases.

⁴ 11 U.S.C. § 364(d). See former Bankruptcy Act § 116(2), which permitted certificates of indebtedness with priority over secured as well as unsecured claims in Chapter X cases.

⁵ 596 F.2d 1092 (2d Cir. 1979).

ration (Manufacturers). If we read between the lines, Manufacturers was not anxious to factor Texlon's receivables in the Chapter XI case for fear of sustaining additional losses if the debtor in possession was adjudicated a bankrupt. In such an event, it might have been extremely difficult to collect the receivables from the account debtor who in turn might have looked upon this bankruptcy as an opportunity to resist payment by setting up all sorts of defenses against payment.

To minimize its risk, Manufacturers proposed a financing agreement to take effect upon the filing of the Chapter XI case whereby Manufacturers would factor the account receivables of the debtor in possession on a nonrecourse basis with a discretionary right on its part to advance up to \$100,000 to be collateralized by certificates of indebtedness.⁶ As security for this financing, Texlon would grant Manufacturers a security interest in all its inventory and equipment, as well as an equity in the accounts receivable, "not merely for amounts paid under the factoring agreement and for the certificates of indebtedness, *but also for preexisting debt*"⁷ held by Manufacturers which amounted to almost \$700,000. Because the security interest in the debtor's assets secures prepetition, as well as postpetition, indebtedness, this financing arrangement is known as "cross-collateralization."

Bankruptcy Court Authorizes Cross-Collateralization

Upon the filing of the petition under Chapter XI on November 1,

⁶ See former Bankruptcy Act § 344.

⁷ *In re Texlon Corp.*, note 5 *supra*, at 1094 (emphasis added).

1974, the debtor in possession submitted an order and application for authorization to approve the agreement, representing that "any delay in authorizing these arrangements would be prejudicial to Texlon's continued viability, that only immediate approval would enable it to continue in business, and that the need for the relief was urgent and could not await a creditors' committee meeting."⁸ Based on these representations, the bankruptcy judge granted the application *ex parte* and, on November 6, Manufacturers commenced financing the debtor in possession.

On that same day, copies of the order were served upon the attorneys for an informal creditors' committee which had been organized prior to the commencement of the case. On November 19, an unofficial committee was elected and counsel for Texlon informed the creditors' committee of the financing order. This committee subsequently became the official creditors' committee.

During all this time Texlon was suffering heavy losses and, on January 10, 1975, was adjudicated a bankrupt.⁹ By that time, Manufacturers had made postpetition factoring advances of \$567,000 and a loan of \$100,000. After a liquidation of the assets, there was sufficient moneys to repay Manufacturers its postpetition advances to the debtor in possession and to leave a surplus of \$267,000 which represented the chief asset in the estate. Manufacturers contended that this surplus should be applied to its petition

⁸ *Id.* at 1095.

⁹ See former Bankruptcy Act § 376 (2), which provided for the adjudication of the debtor as a bankrupt resulting in liquidation.

indebtedness of between \$660,000 and \$695,000.

Trustee Challenges Bankruptcy Court

On January 16, 1975, the trustee (formerly the secretary to the creditors' committee) moved, through its attorneys (formerly the attorneys for the creditors' committee), to modify the bankruptcy judge's order to the extent that any equity in the collateral after satisfaction of the indebtedness to Manufacturers for its Chapter XI advances should be applied for the benefit of all creditors pro rata. The bankruptcy judge held that reliance on this order by Manufacturers had resulted in vested rights which were ample to deny such modification. However, he did comment that the financing order was "interdicted by the [Bankruptcy] Act' and similar orders should not be entered in the future" because they have the effect of violating the priority provisions of the Bankruptcy Act as well as preferring certain prepetition unsecured creditors over others.¹⁰ The district court agreed that the "cross-collateralization" provision should not have been included in the financing. However, it reversed the bankruptcy court decision, denying the trustee's motion by holding that no supervening equities attached in favor of Manufacturers since reliance was upon a "facially void order" and Manufacturers lost nothing because

payment had been made for all its postpetition advances.¹¹

On appeal, Manufacturers argued that nothing in the Bankruptcy Act forbids "cross-collateralization" and that the district court erred by failing to recognize that the financing order had become final and non-appealable prior to the trustee's application.

Court of Appeals Objects to Ex Parte Order of Bankruptcy Court

The court of appeals, in affirming the district court decision, considered, among other things, the history of the issuance of certificates of indebtedness and preferential treatment of creditors and setoffs. The most interesting features of its opinion, insofar as practice under the present Bankruptcy Code is concerned, were the discussions as to the cross-collateralization of prepetition indebtedness and the adequacy of notice and opportunity to be heard sufficient to sustain such a financing order.

Evidently, the terminology "cross-collateralization" was new in bankruptcy judicial jargon, although colloquially ancient, for the court of appeals stated:

[The appeal] concerns a practice, euphemistically called "cross-collateralization." . . . What this term means is that in return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the

¹⁰ *In re Texlon Corp.*, note 5 *supra*, at 1095. The bankruptcy judge held that the cross-collateralization order violated Sections 64a(1) and 70(d)(5) of the former Bankruptcy Act. The court of appeals rejected the bankruptcy judge's analysis of these actions. *Id.* at 1095-1097.

¹¹ *Id.* at 1095. Compare 11 U.S.C. § 364(e), which protects the good-faith lender against reversal of the financing order unless the order is stayed pending appeal.

date of the order and those created in the course of the Chapter XI proceeding, not only for the new loans, the propriety of which is not contested, *but for existing indebtedness to it.* [Emphasis added.]¹²

The issues, therefore, were whether the bankruptcy court properly authorized the cross-collateralization in the financing order and whether the trustee's challenge to the order was too late to permit its reversal. The court of appeals answered both questions in the negative.

In an effort to bolster its position beyond the authority of the former Bankruptcy Act, Manufacturers turned to the Bankruptcy Code, which at that time had not yet become law. In response, the court of appeals stated: "[We] see nothing in § 364(c) or in the other provisions of that section that advances the case in favor of 'cross-collateralization.'" ¹³ However, the court was quick to add that it would not go so far as to hold that "under no conceivable circumstances could 'cross-collateralization' be authorized."¹⁴ The court's fundamental objection was:

[A] financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order, where the bankruptcy court relies solely on representations by a debtor in possession that credit essential to the maintenance of operations is not otherwise obtainable. The debtor in possession is hardly neutral.¹⁵

The nub of the entire controversy seemed to have revolved around the necessity of a hearing as a basis for granting relief. Such hearing, the court indicated, "might determine that other sources of financing are available; that other creditors would like to share in the financing if similarly favorable terms are accorded them; or that the creditors do not want the business continued at the price of preferring a particular lender."¹⁶ Moreover, in turning to Section 364 of the Bankruptcy Code, the court observed that all orders authorizing a debtor in possession to obtain credit except in the ordinary course of business could be made only after notice and a hearing.

In a recent article,¹⁷ Bankruptcy Judge Ordin, far from condemning cross-collateralization, cites instances where courts authorize the payment of the prepetition debts in order to preserve the potential for rehabilitation (i.e., wages to key employees, hospital insurance premiums, certain debts of suppliers, and the like). Judge Ordin emphasizes the necessity of providing for a speedy hearing at which the circumstances described by the court of appeals in *Texlon* can be considered before the general meeting of creditors, sug-

¹² *Id.* at 1098-1099. For cases dealing with the notice requirement for financing orders under the former Bankruptcy Act, see *In re Third Ave. Transit Corp.*, 198 F.2d 703 (2d Cir. 1952); *In re Prima Co.*, 88 F.2d 785 (7th Cir. 1937); *In re Public Leasing Corp.*, 344 F. Supp. 754 (W.D. Okla. 1972). See also Tondel & Scott, "Trustee Certificates in Reorganization Proceedings Under the Bankruptcy Act," 27 Bus. Law. 21 (1971).

¹⁷ Ordin, Case Comment, 54 Am. Bkcy. L.J. 173 (1980).

¹² *In re Texlon Corp.*, note 5 *supra*, at 1094.

¹³ *Id.* at 1098.

¹⁴ *Id.*

¹⁵ *Id.*

gesting a shorter notice to all or most major creditors. "[T]o the extent that procedures can be devised to achieve creditor protection without the needless sacrifice of the debtor's potential for rehabilitation, the Bankruptcy Court should adopt its procedural techniques to accommodate these conflicting interests."¹⁸

In this connection, it is worthwhile to consider the provisions of Section 102(1)(B)(ii) of the Bankruptcy Code, which authorizes dispensing with an actual hearing if "there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act." Authorization of the act without an actual hearing is proper only if notice as is appropriate in the particular circumstances has been given. For example, a telephone call to the attorneys for major creditors or an unofficial creditors' committee advising them that the order was being presented to the court at a convenient hour of the day may be appropriate in cases of extreme urgency. In addition, the actual hearing may not be avoided if a timely request for such a hearing is made by a party in interest. In view of the significant effect which cross-collateralization has on prepetition creditors, courts should not permit any shortcuts which deprive creditors of an opportunity to be heard prior to the financing order.

Lessons to Be Learned

Is cross-collateralization an evil? Clearly, it has the effect of giving the lender a preference with respect to its unsecured prepetition claim. As pointed out in *Texlon*, Section 364 of the Code does not expressly

provide for it. On the other hand, the Code does not expressly prohibit cross-collateralization either. There is no indication in the legislative history or elsewhere that Section 364 was intended to be the exclusive list of permissible postpetition financing arrangements, or that the powers of the bankruptcy court under the former Act have been narrowed in this context.¹⁹ The court of appeals in *Texlon* did not close the door on the use of cross-collateralization under conceivable circumstances and rejected the bankruptcy court's conclusion that such a financing order was "interdicted by the [former Bankruptcy] Act and similar orders should not be entered in the future."²⁰

There is no doubt, however, that cross-collateralization may be utilized as a last resort only when the debtor is otherwise unable to obtain needed financing on acceptable terms. The list of permissible financing arrangements set forth in Section 364 must prove to be inadequate in the particular circumstances before the approval of cross-collateralization. An illustration of such utilization can be found in the recent case of *In re Allbrand Appliance & Television Co., Inc.*²¹ An application for cross-collateralization was made upon notice to the creditors' committee and other interested parties. At the hearing, testimony was introduced of the necessity for financing the operations of the debtor in possession, its urgency, the inability to obtain credit from other finance

¹⁹ See Comment, "Initial Financing Restrictions in Chapter XI Bankruptcy Proceedings," 78 Columbia L. Rev. 1683, 1698 (1978).

²⁰ *In re Texlon Corp.*, note 5 *supra*, at 1095.

²¹ Dkt. No. 80-B-17736-41 (S.D.N.Y. 1980).

¹⁸ *Id.* at 180.

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companies, and the competitive nature of the agreement in view of the charges to be made by other companies where no cross-collateralization was at stake. The court granted the application.

We conclude that cross-collateralization is more than a euphemism.

It is a means of facilitating new financing for a debtor in possession which may be authorized after a hearing on notice results in the conclusion that no other methods on acceptable terms of financing are available to save the reorganizing debtor from forced liquidation.

TRIVIA GALORE

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