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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

THE USE OF CASH COLLATERAL IN REORGANIZATION CASES

A debtor's ability to use its assets immediately after the filing of a chapter 11 petition is often crucial to the success of the reorganization process. Pursuant to the Bankruptcy Code, a debtor in possession ordinarily may sell, use, or lease its assets in the regular course of its business without court permission.¹

One of the most important limitations on a debtor's use of property in reorganization cases relates to the use, sale, or lease of "cash collateral." Cash collateral includes cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the debtor's estate and another entity have an interest.² An illustration of cash collateral is a case in which a secured party has a security interest in accounts receivable and the cash proceeds of the accounts receivable. When the accounts are collected and deposited in a bank account, the cash and bank deposit are cash collateral subject to the rights of the secured party. The Bankruptcy

Code does not permit the use of cash collateral by the debtor unless the other interested party (i.e., the secured creditor) consents or the court authorizes the use of it after notice and a hearing.³ The debtor is not free to use cash collateral otherwise. The court may authorize such use only if the secured party is adequately protected against loss.⁴

When the debtor has to use cash collateral in the normal operation of the business and is unable to obtain the secured party's consent, it may be necessary to obtain court approval in a very short time. It takes little imagination to realize that a debtor's lifeline may be cut off after the petition for reorganization is filed if it is unable to use cash collateral on very short notice. This is especially so because businesses in trouble often use accounts receivable as security for loans and, therefore, the only major source of cash flow falls within the category of cash collateral.⁵ Congress, too, realized the potential crippling effect of the limitation on the use of cash collateral and therefore provided an ameliorating procedure

³ 11 U.S.C. § 363(c)(2).

⁴ This requirement applies only if the interested party requests adequate protection. See 11 U.S.C. § 363(e).

⁵ According to Section 9-306 of the Uniform Commercial Code, the accounts receivable financier will also have a security interest in the cash proceeds when the accounts are collected.

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¹ 11 U.S.C. § 363(c)(1).

² 11 U.S.C. § 363(a).

to give the debtor an early day in court.

The hearing on the use of cash collateral may be preliminary or may be considered the final hearing on the question of adequate protection for interested parties. If preliminary only, the court may authorize the use, sale, or lease of cash collateral if there is a reasonable likelihood that the debtor in possession or trustee will prevail at the final hearing, that is, if it is likely that the secured party will be adequately protected by substituting other collateral, by making periodic payments, or otherwise. In such an event, the court will permit the use of cash collateral.⁶ The statute is clear in requiring that the hearing be "scheduled in accordance with the needs of the debtor" and that "the court shall act promptly" on requests to authorize the use of cash collateral.⁷ For example, assume that the debtor in possession has a payroll to meet; it is Friday afternoon and paychecks must be handed out today. If the employees are not paid in the customary manner, not only will pandemonium follow, but there may be no workers available on Monday to operate the business. Under these circumstances, proper notice to the secured creditor or its attorney may be by telephone informing either of an application to be submitted to the court within a few hours for the use of cash collateral to meet the payroll. The court may be satisfied with such notice and may grant authorization

after a brief preliminary hearing on the same day whether or not there is an appearance by the secured creditor.⁸ Lacking consent of the secured creditor or court authorization to use cash collateral, the debtor in possession is required to segregate and account for all cash collateral within its control.⁹

In re Markim, Inc.

A case which illustrates the proper treatment of an application to use cash collateral, *In re Markim, Inc.*,¹⁰ involved a debtor in the business of leasing and selling construction equipment. The majority of its rental fleet was secured by liens to certain of its creditors. In Fall 1980, which was prior to the commencement of the chapter 11 case, the debtor called a meeting of those creditors to discuss its financial troubles. As a result of that meeting, the debtor agreed to pay pro rata to its secured creditors a total of \$450,000 per month on account of their liens. The debtor also gave each of its secured creditors a blanket lien on the debtor's accounts receivable as well as on the debtor's equity in its equipment. The secured creditors also were given a junior mortgage on the debtor's real estate.

Payments were made on the agreement until May 1981 when the debtor filed its petition under chapter 11.

⁶ The trustee or debtor in possession has the burden of proof on the issue of adequate protection. 11 U.S.C. § 363(e).

⁷ 11 U.S.C. § 363(c)(3). See 11 U.S.C. § 102(1) with respect to prompt notice.

⁸ See 11 U.S.C. § 102(1) defining "after notice and hearing" and authorizing an act without an actual hearing if notice is given and there is insufficient time for a hearing.

⁹ 11 U.S.C. § 363(c)(4).

¹⁰ 15 B.R. 56 (E.D. Pa. 1981) (Goldhaber, B.J.).

Shortly thereafter, the debtor filed an application authorizing the use of the cash collateral which included the accounts receivable and the proceeds thereof. Objections were filed by a secured and an unsecured creditor, although the majority of the secured creditors had no objection to the use of cash collateral by the debtor with certain restrictions.

The court began its analysis of the problem by focusing on Section 363(c)(2) of the Code which restricts the use of cash collateral unless consented to by "each entity that has an interest" in it, or the court authorizes such use after notice and a hearing. Thus, the fact that at least one secured creditor objected, necessitated a hearing on the issue. The court then proceeded to Section 363(e) which provides that the court must prohibit or condition use of the property "as is necessary to provide adequate protection" to the security interest. With respect to the issue of adequate protection, Section 361 says such protection may be provided by:

- (1) Periodic cash payments to the secured party to the extent that the use of the property results in a decrease in the value of the secured creditor's interests in such collateral;
- (2) Providing the secured creditor with an additional or a replacement lien to the extent that such use results in a decrease in the value of the secured creditor's interest in the collateral; or
- (3) Granting such other relief as will result in a realization by the secured creditor of the "indubitable equivalent" of the

secured creditor's interest in the collateral.

At the hearing, the debtor testified that the secured creditors were or would be adequately protected in several ways:

- (1) The debtor offered to make monthly payments of 80 percent of its cash flow or \$182,000, whichever is more, to be divided among the secured creditors based on what percentage of the cash flow was generated by the equipment in which each creditor had a security interest.
- (2) According to the testimony of the president of the debtor, the secured creditors were adequately protected by the equity which the debtor had in its rental equipment. The value of the equipment was more than \$30 million while the debt secured by it was only \$23.6 million, exclusive of interest.
- (3) The debtor proposed to increase its equity in its equipment by selling or returning to the secured creditors 35 to 40 percent of its rental fleet. This would have the effect of reducing its secured debt and related high interest payments while keeping those pieces of equipment which have high equity, command high rentals, or otherwise are necessary to the debtor's effective reorganization. The court in a prior hearing ordered that the debtor provide notice to all creditors of any such sale for less than 90 percent of the debtor's ap-

praised value of that equipment because such sale would not be in the ordinary course of business.¹¹

- (4) Adequate protection was provided to the secured creditors by granting them additional liens on most of its other assets in Fall 1980, even though the debtor's witness was unable to testify as to how much equity the debtor had in such assets available to the secured creditors.
- (5) Secured creditors were adequately protected by the debtor's improvement in the efficiency of its operations in that the debtor had made substantial cuts in its operating expenses while still maintaining excellent maintenance and repair service for its rental equipment. Also, the debtor's books had been opened for inspection to all creditors who could evaluate the steps the debtor was taking toward reorganization.

At the hearing, one objecting secured creditor introduced testimony that the total amount of debt owed to it was almost \$1 million while the value of the rental equipment which secured that debt was approximately \$700,000. Moreover, its interest on its debt was accruing at the rate of \$13,000 per month while, under the debtor's proposal for monthly payments, it would only receive about \$4,000 in one particular month. In rebuttal, the debtor offered evidence

which the court accepted as true that the value of the equipment securing the debt owed to that creditor was \$900,000 rather than \$700,000. Furthermore, there was testimony to the effect that the debtor intended to reduce its fleet and retain only ten out of about thirty of the pieces of equipment in which the objecting secured creditor had an interest. The result would be to reduce the debt to the secured creditor to approximately \$500,000 while retaining the most valuable equipment which was worth over \$540,000 and which commanded a high rental.

Evidence was also introduced explaining the reason for paying only \$4,000 to that creditor in the particular month mentioned by it. Although that amount represented 80 percent of the cash flow from rentals, it did not represent the total rentals due but not received for that month. It also was not an indication of what the creditor would receive in future months. The debtor's president predicted that in the future the creditor should receive close to 80 percent of \$26,000, which is the estimated monthly rental income from the equipment in which the creditor had a security interest.

The court concluded that, based on all the evidence, the debtor sustained its burden of establishing that the objecting secured creditor's interests were adequately protected. The creditor's evidence focused only on the debtor's lack of equity in the thirty pieces of equipment which secured the debt. The court found, however, that the creditor's blanket security interest in the remainder of the debtor's property adequately protected the interests of all the secured creditors

¹¹*Id.* at 58 n. 2.

because of the debtor's significant equity in such property.

Alternatively, the court found that the interests of secured creditors were adequately protected by the debtor's proposal to make monthly cash payments together with the significant improvements in the efficiency of its operations. For these reasons, the objections to the use of cash collateral were denied and the debtor was authorized to use its accounts receivable and cash receipts in the operation of its business.

Aside from self-help in providing adequate assurance for the use of cash collateral, a debtor's need for the continuing ability to use cash collateral after filing a chapter 11 petition may be alleviated by adequate postpetition financing arrangements. In fact, it is not uncommon for the creditor with a security interest on cash collateral to agree to make postpetition advances while restricting the use of prepetition collateral. An illustration of such an arrangement may be found in *In re Prime, Inc.*¹²

In re Prime, Inc.

In *Prime*, the debtor was "a good sized over-the-road trucking company"¹³ which obtained funds through accounts receivable financing by CIT Corporation. In August 1981, the debtor "purged" a substantial number of accounts as duplicates or as having credits against them. CIT became concerned as to the validity of the accounts and held several meetings with the debtor prior to the filing of the chapter 11 petition on October 15. The next day, CIT

obtained a temporary restraining order prohibiting the debtor from using accounts receivable proceeds pursuant to Section 363(e). A hearing arranged by telephone was scheduled for October 20 and on October 19 the debtor moved for permission to use such proceeds. The October 20 hearing was attended by the largest unsecured creditor, as well as CIT and the debtor.

The debtor's position was that CIT was adequately protected within the meaning of Section 363(e) because the aggregate of accounts receivable was equal to the debt balance and CIT also had a security interest in certain real and personal property. The debtor also was willing to pay CIT the proceeds of accounts in which CIT had no interest. However, CIT refuted this position by questioning the validity of the accounts and by calculating their value to be substantially less than the debt. CIT also contended that there was no credible testimony as to the value of the real and personal property and that the additional accounts had little value.

Focusing on the prepetition financing arrangement, the court noted that the volume of transactions ranged from \$600,000 to \$750,000 weekly. CIT attempted to maintain the advances at about 80 percent of the overall amount of billings and collections. Ineligible bills, including accounts over ninety days old and those considered by experience to be uncollectable, could be rejected and returned to the debtor for collection.

Until the billing system lost its integrity because it lacked adequate safeguards, the arrangement worked well and CIT maintained a sufficient cushion to protect against bad debt.

¹² 15 B.R. 216 (W.D. Mo. 1981) (Pelofsky, B.J.).

¹³ *Id.* at 217.

Prior to bankruptcy, however, substantial accounts were purged and CIT's cushion was punctured. When the petition was filed, total accounts amounted to \$3.39 million, of which \$721,000 were ineligible, leaving a net figure of approximately \$2.57 million. The amount advanced at that time was \$2.6 million.

Turning to the debtor's need for cash for its operations, there was testimony that \$600,000 was needed each week. The debtor would be out of business almost immediately unless the financing arrangement with CIT continued. The court emphasized that "[i]t is not the purpose of a Chapter 11 proceeding to close a business at the beginning."¹⁴ Since CIT was willing to continue financing the debtor's postpetition operations, the court recognized the "challenge . . . to determine that funding arrangement which will keep [the] debtor operating while maintaining adequate protection for the creditor."¹⁵

The court found that the value of accounts and other collateral gave CIT adequate protection with regard to its prepetition debt. However, to maintain that protection, future advances could be made based solely upon new accounts created after the filing of the petition. Focusing on the future financing, the court found that new billings "have been subjected to more rigorous checks and should not suffer much dilution."¹⁶

Although the court stated that it was authorizing the use of cash collateral upon certain terms and condi-

tions, a close reading of those conditions indicates that the use of prepetition cash collateral was prohibited but the use of the proceeds of new postpetition accounts was authorized. Specifically, the conditions on the use of cash collateral dictated into the record at the hearing were as follows:

1. Debtor is to make a daily report of new billings to CIT.
2. CIT, by agreement, will advance such sums of money, from day to day, averaging 70% of the value of eligible accounts receivable assigned by debtor. Such advances are to have an administrative priority.
3. Debtor is to collect and remit to CIT all amounts due and owing on all accounts assigned subsequent to the filing of the bankruptcy petition.
4. Debtor will collect and remit to CIT all amounts due and owing on all accounts assigned prior to the filing of the bankruptcy petition. No advances are to be made on these amounts. CIT agrees to credit such amounts to the pre-petition debt and to credit the excess, if any, against post-petition advances.
5. Debtor is to collect and remit to CIT all amounts due and owing on all accounts returned to debtor by CIT and declared to be ineligible.
6. Debtor is to pay over to CIT all funds collected from accounts receivable from the time of the filing of the bankruptcy to the close of business on October 20, 1981 less any funds expended in the ordinary course of business to the precise time the bankruptcy petition was received by the clerk of the court.
7. Debtor shall account to the Court for all funds expended in the ordinary course of business from the

¹⁴*Id.* at 218.

¹⁵*Id.* at 219.

¹⁶*Id.*

precise time of filing to the close of business on October 20, 1981. Creditor is granted a priority claim as to those funds.

8. Debtor shall account to the Court for all funds collected from the start of business on October 15, 1981 to the precise time of filing. The question as to whether such amount is considered pre-petition debt or a priority claim is reserved.
9. CIT shall have the right to audit debtor's business two days each week, upon one day's notice. The audit is to be conducted in a businesslike manner and will avoid, insofar as possible, disruption of debtor's business activities.
10. CIT will furnish to the Court a weekly report of accounts assigned, payments received and advances made.
11. Debtor is to prepare an operating budget which it deems adequate for its operations. Such budget is to be provided to CIT and to be available at the hearing on November 10, 1981, at which time the Court will review the level of advances and the question of adequate protection.¹⁷

¹⁷*Id.* at 219-220. Upon a rehearing, the court entertained the debtor's request to increase the level of advances, but in so doing granted a lien to CIT as a postpetition lender

Conclusion

The cases illustrate methods the courts will apply in an effort to balance the use of cash collateral by a debtor in possession as against adequately protecting the secured creditor against a loss. In this respect, the courts have given practical interpretations to the language of the statute. In the *Markim* case, periodic payments and significant improvements in the efficiency of the debtor's operations, inter alia, provided adequate protection. In the *Prime* case, accounting controls were a significant factor in providing adequate protection. Indeed, the comment of the court in the *Prime* case may be an indication of a direction the courts may follow in solving the problem: "The challenge is to determine that funding arrangement which will keep debtor operating while maintaining adequate protection for the creditor."¹⁸

pursuant to Sections 364(c)(2) and 364(d) since the issue was not the use of cash collateral (the receivables belonging to the debtor) but resolved itself into the obtaining of postpetition credit by the pledging of the debtor's property.

¹⁸*Id.* at 219.