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Postpetition Security Interests under the Bankruptcy Code

David G. Carlson
Benjamin N. Cardozo School of Law, dcarlson@yu.edu

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*By David Gray Carlson**

In my school-days, when I had lost one shaft,
I shot his fellow of the self-same flight
The self-same way, with more advised watch,
To find the other forth; and by advent'ring both
I oft found both: I urge this childhood proof,
Because what follows is pure innocence.
I owe you much; and, like a wilful youth,
That which I owe is lost: but if you please
To shoot another arrow that self-way
Which you did shoot the first, I do not doubt,
As I will watch the aim, or to find both
Or bring your latter hazard back again,
And thankfully rest debtor for the first.

Bassanio asks Antonio for a postpetition loan in The Merchant of Venice.[1]

INTRODUCTION

In the first few days of a chapter 11 reorganization,[2] a debtor in possession[3] may need cash in a hurry. For example, the debtor in possession may need to meet a payroll at the end of the week. Insiders or the prior lenders to the company are certainly the most likely—perhaps the only—sources of credit. If the debtor in possession faces a credit emergency, it may give enormous concessions to these lenders in order to obtain a quick wire transfer of funds. These concessions typically revolve around security interests on the debtor's free or even already encumbered assets.

*David Gray Carlson is a professor at the Benjamin N. Cardozo School of Law, Yeshiva University.

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1. William Shakespeare, The Merchant of Venice, Act II, sc.2.
2. 11 U.S.C. §§ 1101-1174 (1988).
3. *Id.* § 1101(1).

In an ideal world, the debtor in possession shops around for the cheapest credit. Indeed, this is the debtor in possession's duty as trustee for the general creditors of the bankrupt organization. Often, however, there is no time for comparison shopping. Instead, bankruptcy judges, their chambers invaded by breathless lawyers pronouncing emergency and regretting the absence of time for an adversarial hearing, are under great pressure to bend the rules. These judges often are told that, without an immediate approval of a postpetition loan, with often unconscionable terms, the debtor in possession will have to liquidate and the business will have to be shut down.

These postpetition loans constitute one of the most intractable problems in chapter 11 administration today. This Article surveys those problems and tries to identify the trends in this rapidly developing area of law, concentrating primarily on postpetition security interests granted to lenders in exchange for postpetition advances. To this end, the first part of the Article reviews the structure of security interests supporting postpetition loans, including their priority, their perfection[4] and attachment requirements,[5] their susceptibility to administrative surcharges,[6] and their entitlement to adequate protection.

The second part of the Article discusses the remarkable abuses of the Bankruptcy Code to which postpetition lenders have subjected the bankruptcy courts. These abuses include preferences for prepetition debt ("cross-collateralization"), abandonment of fraudulent conveyance suits and the like, and clauses that give the lender veto power over the conduct of the proceeding. The ratification and continuation of prepetition loan facilities also can constitute an abuse, as the debtor in possession is required to cure past defaults and pay whatever prepetition rate to which the debtor may have agreed.

The third part of this Article discusses the procedural advantages that postpetition lenders have been given, including a rule against appeals, which may immunize whatever abuse may have been perpetrated by bankruptcy courts, though other courts are busy trying to subvert the no-appeal rule.

Finally, the Article recommends that some clear, binding rules be imposed on postpetition lending, similar to those proposed by the Eleventh

4. Roughly speaking, perfection refers to the filing of a public notice of these liens. Article 9 of the Uniform Commercial Code (U.C.C.), for example, requires filing for security interests in personal property. *See* U.C.C. §§ 9-302(1), 9-304(1). There is a serious question whether Article 9 applies to liens approved under the auspices of the federal Bankruptcy Code. *See infra* text accompanying notes 31-48.

5. Attachment is the Article 9 term for the creation of a security interest. Most specifically, U.C.C. § 9-203(1)(a) requires that the debtor sign a security agreement that grants the security interest.

6. Ordinary secured parties may be surcharged for expenses relating to the collateral under § 506(c) of the Bankruptcy Code. 11 U.S.C. § 506(c) (1988).

Circuit in *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.).*[7] In that case, the court simply proclaimed that cross-collateralization clauses violate the Bankruptcy Code.[8] Furthermore, the court held that the anti-appeal rule did not apply when postpetition lenders obtained loans on terms that violate the Bankruptcy Code.[9] Such bright line rules will probably not cut down on available credit, because these abuses are not really needed to induce a lender to advance funds. In addition, lenders will know in advance not to ask for such outrageous concessions, thereby reducing the chaotic flurry of motions a bankruptcy court often faces in the opening days of a chapter 11 proceeding. Instead, the lenders' advantage-taking will be channeled into demands for higher interest rates—a price term that a bankruptcy judge is more likely to recognize as fair or unfair to the bankrupt estate.

THE STRUCTURAL FEATURES OF POSTPETITION SECURITY INTERESTS

SUPERPRIORITY

Because access to quick cash is vital to bankruptcy reorganization, bankruptcy law always has provided the trustee with means to obtain quick cash through postpetition loans.[10] Under the old Bankruptcy Act,[11] a trustee authorized to run a business could obtain unsecured credit in the ordinary course.[12] Credit out of the ordinary course could only be obtained with court approval.[13] Most extraordinarily, a court could grant superpriority

7. 963 F.2d 1490 (11th Cir. 1992).

8. *Id.* at 1496.

9. *Id.* at 1493.

10. *But see* Lynn LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) (suggesting that, because firms with large cash flow need not pay interest to unsecured or undersecured creditors, accumulated cash might replace the need for loans).

11. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed).

12. *See In re* Avorn Dress Co., 78 F.2d 681, 682 (2d Cir.) (making clear that credit in the ordinary course had an administrative priority), *modified*, 79 F.2d 337 (2d Cir. 1935); Rogers v. People's Sav. Bank & Trust Co. (*In re* C.M. Burkhalter & Co.), 182 F. 353, 355 (N.D. Ala. 1910) (liquidation case where bankruptcy receiver was authorized to conduct business); *see also* Chicago Deposit Vault Co. v. McNulta, 153 U.S. 554, 561 (1894) (describing powers of equity receivership). This usually was perceived to be trade credit, rather than ordinary bank borrowing. Charles Jordan Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109, 122 n.79 (1986) [hereinafter Tabb, *Cross-Collateralization*].

13. *See* Wolf v. Nazareth Fair Grounds & Farmers' Mkt., Inc. (*In re* Nazareth Fair Grounds & Farmers' Mkt., Inc.), 280 F.2d 891, 892 (2d Cir. 1960) (per curiam) (punishing creditor by denying interest compensation because the debtor failed to get prior judicial approval); *In re* Public Leasing Corp., 344 F. Supp. 754, 758-59 (W.D. Okla. 1972) (chapter X); *In re* Erie Lumber Co., 150 F. 817, 827-28 (S.D. Ga. 1906) (liquidation).

liens to postpetition lenders who would take priority over existing prepetition lenders.[14]

Bankruptcy Code section 364 has enveloped these rules and now aspires to govern the "fuzzy world of post-petition credit."[15] Under section 364, a trustee authorized to run a business may get unsecured credit in the ordinary course of business.[16] Secured credit, however, may be obtained only upon court order, and requires a showing that the trustee cannot obtain credit by promising the new creditor a mere administrative priority.[17] This secured credit may be obtained without adequate protection of *other* secured creditors, provided the security interest encumbers unencumbered collateral or is junior to any existing liens.[18]

14. First Nat'l Bank v. Prima Co. (*In re* Prima Co.), 88 F.2d 785, 790 (7th Cir. 1937) (emphasizing the importance of adequate protection for junior secured parties). The ability of a trustee to subordinate existing secured parties in order to obtain new credit has a very long history to it. Prior to the Bankruptcy Code, these orders were embodied in a trustee's "certificate of indebtedness." Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1101 (2d Cir. 1979). *See generally* Harvey J. Baker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1 (1976). As early as 1877 it was said that such a power in equity receivers was beyond debate. Wallace v. Loomis, 97 U.S. 146, 162-63 (1877). Sometimes it was said that such a power must be used to "preserve" property, rather than continue mere operations. *Id.* at 162; Baker, *supra*, at 12-14 (describing breakdown of this early distinction). Initially, corporations had to be organizations in which the public had some interest in preserving, such as railroads. Baker, *supra*, at 12. In 1934, however, Congress extended the power of the courts to "authorize the debtor . . . to issue certificates for cash, property, or other consideration approved by the judge for such lawful purposes, and upon such terms and conditions and with such security and such priority in payments over existing obligations, secured or unsecured, as may be lawful in the particular case." Bankruptcy Act § 77B(c)(3), 48 Stat. 916 (1934). Similar powers were enacted for each of the old rehabilitative chapters. Bankruptcy Act § 116(2) (chapter X), ch. 575, 52 Stat. 884-85 (1938); § 344 (chapter XI), ch. 575, 52 Stat. 920 (1938); § 446 (chapter XII), ch. 575, 52 Stat. 920 (1938). Each of these sections allowed for "such security . . . as in the particular case may be equitable." The power to extend superpriority liens was subject to a showing that the trustee could not obtain credit any other way. *Prima Co.*, 88 F.2d at 790.

15. Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 89 B.R. 328, 334 (S.D.N.Y. 1988), *aff'd*, 881 F.2d 6 (2d Cir. 1989).

16. 11 U.S.C. § 364(a) (1988).

17. *Id.* § 364(c). If ordinary administrative priority will not yield a loan, the trustee may promise an administrative priority that takes precedence over all other administrative priorities with court approval. *Id.* § 364(c)(1). *But see In re* Summit Ventures, Inc., 135 B.R. 478, 483 (Bankr. D. Vt. 1991) (holding that "burial expenses"—administrative expenses of a chapter 7 liquidation after a chapter 11 proceeding has been converted—take priority over § 364(c)(1) claims from the earlier chapter 11 proceeding). Under the old Bankruptcy Act, the ability of a court to vary the administrative priorities was in dispute. Tabb, *Cross-Collateralization*, *supra* note 12, at 126-27. Section 364(c) codifies the holding in White Chem. Co. v. Moradian, 417 F.2d 1015, 1020 (9th Cir. 1969), in which the court held that a bankruptcy court could give postpetition lenders a higher administrative priority than the Bankruptcy Act otherwise provided, if necessary to obtain credit.

18. 11 U.S.C. § 364(c), (d) (1988).

In addition, it still remains possible for a court to subordinate an existing lien to a new lien in order to obtain new credit. This requires a showing that the trustee may not obtain credit otherwise,[19] and that "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."[20] Section 364(d)(2) also specifies that the trustee has the burden to prove that the subordinated security interest will be protected adequately.[21]

At first glance, the Bankruptcy Code yields the following generality: the trustee may not subordinate any prepetition secured creditor to a postpetition unsecured creditor.[22] It is possible that a secured creditor can be subordinated to another secured creditor (but only if adequate protection is provided), but there is no express provision for subordinating a secured creditor to an unsecured creditor.

There is, however, one unexploited loophole. Under section 364(c)(1), if a trustee is unable to obtain unsecured credit on the strength of an ordinary administrative priority, the court may approve a superpriority to a postpetition creditor over any other administrative claimant *or* a claimant under section 507(b). Section 507(b) is the remedy a secured party obtains if adequate protection of the security interest fails. In case of failed ad-

19. *Id.* § 364(d)(1)(A). In Bray v. Shenandoah Fed. Sav. & Loan Ass'n (*In re* Snowshoe Co.), 789 F.2d 1085 (4th Cir. 1986), the court wrote:

> [T]he trustee contacted other financial institutions in the immediate geographic area and was unsuccessful. The statute imposes no duty to seek credit from every possible lender before concluding that such credit is unavailable. This is particularly true when, as the court determined here, time is of the essence in an effort to preserve a vulnerable seasonal enterprise.

Id. at 1088; *see also In re* Plabell Rubber Prods., Inc., 137 B.R. 897, 899 (Bankr. N.D. Ohio 1992) (ruling that the debtor did not establish this inability, when the debtor's officer testified to his belief in the futility of looking); *In re* Reading Tube Indus., 72 B.R. 329, 332 (Bankr. E.D. Pa. 1987).

It used to be said that the trustee had to show that a reorganization was likely to be successful. Melniker v. Lehman (*In re* Third Ave. Transit Corp.), 198 F.2d 703, 707 (2d Cir. 1952); Lyman M. Tondel, Jr. & Robert H. Scott, Jr., *Trustee Certificates in Reorganization Proceedings Under the Bankruptcy Act*, 27 BUS. LAW. 21, 28 (1971). But as one commentator has said, a court making such a finding is compelled, unblushingly, to find simultaneously that the business community is so leery of the debtor's reorganization prospects that there is no market at any reasonable rate for notes of certificates of the debtor that do not assure the buyer of a first lien on the debtor's assets in the event of default. Baker, *supra* note 14, at 43.

20. 11 U.S.C. § 364(d)(1)(B) (1988).

21. *Id.* § 364(d)(2). Some courts have held that increases in the value of the collateral generated by the improvements resulting from superpriority financing could constitute adequate protection. *In re* 495 Cent. Park Ave. Corp., 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992); *In re* Sky Valley, Inc., 100 B.R. 107, 114 (Bankr. N.D. Ga. 1988).

22. 11 U.S.C. § 507(b) (1988).

equate protection, the secured party is given a priority higher than any other administrative creditor.

Yet, under section 364(c), a court might give an even higher priority than section 507(b) to a postpetition unsecured creditor. This implies a certain vulnerability of prepetition secured parties to unsecured creditors. If the trustee obtains a loan on the basis of a priority higher than section 507(b), then the cash can be diverted to some lower-priority purpose at the expense of the secured party who has been denied adequate protection. The scope of this extraordinary power rarely has been explored, however, and its potential for subordinating secured creditors remains unexploited.[23] In any case, one commentator has pointed out that section 364(c)(1) authorizes priority over "any or all" such priorities.[24] This language, it is suggested, invites a bankruptcy court to coerce former lenders to lend again, lest their section 507(b) priorities be subordinated.[25]

Finally, section 364(c)(1) might provide priority over a prepetition secured party if the trustee finds a way to avoid the prepetition security interest. Such a means was found in *In re Statbucker,*[26] where a farmer

23. The bankruptcy court apparently authorized a priority over the § 507(b) claims of an earlier postpetition lender in *In re* Summit Ventures, Inc., 135 B.R. 478, 483 (Bankr. D. Vt. 1991). It was not clear whether the collateral of the earlier lender had yet failed, but if it did, the claims of the new lender would supersede the § 507(b) claims of the old lender. The court justified this decision in large part because the second lender was advancing funds to a chapter 7 trustee who had an ultra-superpriority for "burial expenses" under Bankruptcy Code § 726(b)—a priority that outranked the administrative priority claims in the earlier chapter 11. *Id.*

It is interesting to note that § 364(c)(1) expressly authorizes priority over § 507(b) claims, but § 726(b) does not. Nevertheless, § 726(b) authorizes priority over claims under § 503(b) in the earlier chapter 11 proceeding. Claims under § 503(b), of course, give rise to the priority in § 507(a)(1). Meanwhile, § 507(b) requires that the secured party who has lost his or her adequate protection has a claim allowable under § 507(a)(1), and it provides that such a claim outranks all other claims under § 507(a)(1). And, since § 507(a)(1) presupposes allowability under § 503(b), § 507(b) incorporates by reference § 503(b). Therefore, it is possible for a postpetition advance of burial funds under § 726(b) to outrank § 507(b) claims from the earlier chapter 11 proceeding or from the converted chapter 7 proceeding. *See* Citibank v. Transamerica Commercial Fin. Corp. (*In re* Sun Runner Marine, Inc.), 134 B.R. 4, 7 (Bankr. 9th Cir. 1991) (per curiam) (burial expenses outrank § 507(b) priority from earlier chapter 11 proceeding); American State Bank v. Mark (*In re* MacNeil), 102 B.R. 766, 768 (Bankr. 9th Cir. 1989) (per curiam), *vacated on other grounds*, 907 F.2d 903 (9th Cir. 1990); Louis W. Levit, *Use and Disposition of Property Under Chapter 11 of the Bankruptcy Code: Some Practical Concerns*, 53 AM. BANKR. L.J. 275, 290-91 (1979).

In *Sun Runner Marine*, the court rejected the argument that because § 364(c)(1) authorizes a priority over § 503(b) claims *or* § 507(b) claims, the two are not the same thing. 134 B.R. at 6. Hence, when § 724(b) gives priority over § 503(b) claims from the earlier chapter 11 proceeding, it does *not* give priority over the earlier § 507(b) claims. *Id.*

24. Hal Hughes, *"Wavering Between the Profit and the Loss": Operating a Business During Reorganization Under Chapter 11 of the New Bankruptcy Code*, 54 AM. BANKR. L.J. 45, 79 n.236 (1980).

25. *Id.*

26. 4 B.R. 251 (Bankr. D. Neb. 1980).

wanted to plant crops but could not get credit from the pre-existing creditors for whom any crops would have constituted proceeds of prepetition collateral. Another creditor was willing to lend, but there were no assets in the estate to secure the loan, except future crops, as to which the prepetition lenders would have a senior security interest.

Section 552(b) provides that a secured creditor with the prepetition right to cash proceeds continues to have the right to postpetition proceeds, "except to any extent that the court . . . orders otherwise."[27] According to the legislative history, "[t]he provision allows the court to consider the equities in each case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party."[28] The *Statbucker* court therefore held that the prepetition creditors' interest in future crops was inequitable, but awarded an unsecured priority to the new lender, who, by this means, obtained priority over the earlier secured creditors.[29] "Creditors who supply the wherewithal to grow the crops," the court reasoned, "should logically receive the first proceeds, as without such credit no proceeds at all would exist."[30]

PERFECTION AND ATTACHMENT

If a lien is granted pursuant to section 364(d), the lender need not perfect this security interest, as would be the case if the security interest were granted under Article 9 of the U.C.C. This was established in *Small v. Beverly Bank,*[31] a case involving a replacement lien as a means of providing adequate protection. In *Small,* the lender was given a security interest in inventory to replace cash collateral taken by the debtor in possession. The debtor in possession then purchased some supplies which were incorporated into the inventory. The supplier took no security interest in the supplies. The case later was converted to chapter 7 liquidation,[32] and the inventory was abandoned to the lender, who then sold it. The supplier then sued the secured party for conversion for having taken its property.

27. 11 U.S.C. § 552(b) (1988).

28. 124 CONG. REC. H11,097-98 (daily ed. Sept. 28, 1978).

29. *Statbucker,* 4 B.R. at 253.

30. *Id.* In the end, the court was ambiguous as to whether it was awarding an unsecured priority under § 364(c)(1), a lien under § 364(c)(2) or (3), or a superpriority under § 364(d). In any case, the court ruled that the "section 364(c) or (d) priority is to be limited to the proceeds of the crops grown." *Id.* This limitation has been criticized as imposing needless risk on the postpetition lender, as debtor equity in the underlying real estate existed at the time. Ralph C. McCullough, II, *Analysis of Bankrutpcy Code Section 364(d): When Will a Court Allow a Trustee to Obtain Postpetition Financing By Granting a Superpriority Lien?,* 93 COM. L.J. 188, 195 (1988).

31. 936 F.2d 945 (7th Cir. 1991).

32. 11 U.S.C. §§ 701-766 (1988).

There were many problems with this law suit. First, the supplier had no property interest in the supplies sold, though he tried to make up for this deficiency by arguing unsuccessfully that he held an equitable lien.[33] Once it was established that the supplier had no property interest, there was no reason to examine whether the secured party's interest was perfected, because even unperfected secured parties defeat general creditors without judicial liens.[34] Nevertheless, the court asserted strongly that if a lien is sanctioned by a bankruptcy judge, it need never be perfected under state law.[35]

To be distinguished, however, is the security interest in *In re Patch Graphics*.[36] The security interest in that case, granted after confirmation of a chapter 11 plan, was struck down for being unperfected.[37] Confirmation of the plan, however, revests the bankruptcy estate to the debtor.[38] It should follow, therefore, that the security interest was not governed by section 364 at all. The court's jurisdiction over postpetition lending should end with confirmation of a plan that revests the bankruptcy estate in the debtor, unless the plan provides otherwise. Therefore, the security interest in *Patch Graphics* was not extended under the authority of section 364 as the chapter 11 plan had already been confirmed. For this reason, the security interest could fall under the state law perfection rules of the U.C.C.

33. The court held that, under Illinois law, an equitable lien only arises from a contract that reflects an intent to create a lien, or from the equities "in light of the parties' relationship and dealings." *Small*, 936 F.2d at 949. The supplier tried to argue that he had been defrauded and hence qualified for an equitable lien under the second test, but this claim was rejected.

34. *Compare* U.C.C. § 9-201 (secured parties always win unless some other U.C.C. section provides otherwise) *with* § 9-301(1) (failing to list unsecured creditors as among those with rights against unperfected secured parties).

35. *Small*, 936 F.2d at 944-45.

36. 58 B.R. 743 (Bankr. W.D. Wis. 1986).

37. In *Patch Graphics*, the chapter 11 proceeding was converted to a chapter 7 liquidation. In chapter 7, the secured party's security interest was declared void. *Id.* at 744-45. Usually, it is thought that the trustee's strong arm power arises at the beginning of the chapter 11 proceeding. It does not arise again when the case is converted. General Elec. Credit Corp. v. Nardulli & Sons, Inc., 836 F.2d 184, 192 (3d Cir. 1988). Given that the debtor could have filed a *second* petition, thereby triggering the strong arm power, it might be acceptable to associate the conversion to chapter 7 with the start of a new proceeding, for strong arm power purposes. General Elec. Credit Corp. v. Nardulli & Sons Co. (*In re* Nardulli & Sons Co.), 66 B.R. 871, 881 (Bankr. W.D. Pa. 1986), *rev'd*, 836 F.2d 184 (3d Cir. 1988).

Having lost its security interest, the secured party in *Patch Graphics* sought an administrative priority, because its loan benefitted the bankruptcy estate. The court denied the administrative priority because there was no showing that the equipment purchased with the loan actually benefited the estate. 58 B.R. at 746. A better answer would be that *no* expenses incurred between confirmation and conversion are administrative expenses. Rather, they are the simple expenses of a debtor in whom the bankrupt estate has been re-vested. As such, these new expenses must compete for scarce assets in the chapter 7 proceeding with the disappointed unsecured creditors with rights under the failed chapter 11 plan.

38. 11 U.S.C. § 1141(b) (1988).

Attachment, however, might be required.[39] In *In re Roxy Roller Rink Joint Venture,*[40] a partner in a joint venture petitioned it into involuntary bankruptcy.[41] The debtor, via this same partner, then sought permission to borrow from the partner's shareholder on a postpetition secured basis. The court granted the motion at a hearing in which the other partner was not present.[42] The shareholder of the petitioning partner never submitted a proposed order to implement the motion, but nevertheless lent the cash. When the debtor was finally liquidated, the lender sought reimbursement of the funds advanced on a secured basis, even though no order had been submitted. More specifically, the lender sought a *nunc pro tunc* order approving the loan, coupled with an order that the trustee immediately pay back that same loan.[43]

Even though the court thought that a *nunc pro tunc* order might be granted under the right circumstances, it stated:

> No *nunc pro tunc* order can, however, overcome the total absence of loan documentation present in this case. An order merely authorizes
>
> a debtor to enter into a transaction. It does not eliminate the need for appropriate agreements, including security agreements, between the debtor and the lender. The absence of documents effecting a security interest in the Debtor's lease in favor of [the inside lender] is fatal to his claim for treatment as a secured creditor.[44]

This requirement may mean that the lender must still meet the requirements of attachment, as defined in Uniform Commercial Code (U.C.C.) section 9-203(1). The requirements of attachment include a written security agreement signed by the debtor. Therefore, considering *Roxy Roller Rink* together with *Small,* the state law of attachment, but not perfection, governs postpetition lending under the Bankruptcy Code. Yet, if the lien is created pursuant to the Bankruptcy Code, the provisions of the U.C.C. cannot govern it as a formal matter. Therefore, it must be the case that the bankruptcy court in *Roxy Roller Rink* has invented a federal attachment requirement for liens created under section 364.

39. According to U.C.C. § 9-203(1), a security interest does not attach unless:

> (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral . . . ;
>
> (b) value has been given; and
>
> (c) the debtor has rights in the collateral.

40. 73 B.R. 521 (Bankr. S.D.N.Y. 1987).

41. 11 U.S.C. § 303(b)(3) (1988).

42. *Roxy Roller Rink,* 73 B.R. at 523. The first partner's principal assured the court that the absent partner approved of the new loan.

43. *Id.* at 524.

44. *Id.* at 525 (citation omitted). An earlier, separate order was submitted, however, authorizing the advance of a smaller sum. The lender successfully recovered this latter amount. *Id.* at 528.

Article 9, of course, allows antecedent debt to serve as value, for attachment purposes.[45] Section 364(d) differs, according to the bankruptcy court in *In re Roamer Linen Supply, Inc.*[46] The court ruled that lawyers who had already performed postpetition services could not, after the fact, be given a superpriority security interest to secure antecedent debt.[47] On the other hand, lawyers who had not yet extended services but intended to were also not permitted to have a superpriority security interest because section 364(d)(1)(A) requires that the debtor is unable to obtain credit elsewhere. Since lawyers could apply for reimbursement under section 330, this was credit that was "otherwise available."[48]

EXPENSES OF SALE AND SECTION 506(c)

It might seem from the previous discussion that a postpetition secured party's position is relatively secure; but, the expenses of preserving and disposing of collateral under section 506(c) are an emerging inroad. According to section 506: "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."[49] This provision seems to apply to postpetition liens, and postpetition lending orders have been interpreted accordingly. In *In re Saybrook Manufacturing Co.*,[50] the parties reached the following agreement with regard to postpetition credit:

> Nothing herein shall be deemed . . . a waiver of any right . . . to recover from Collateral . . . any cost or expense recoverable under section 506(c). . . . The Banks . . . agree to subordinate the lien and security interests granted hereunder only to payment of amounts not exceeding $150,000.00 without limitation of any right of the Banks to object to any request for such compensation or reimbursement.[51]

The bankruptcy court thought that the limit of $150,000 had nothing to do with section 506(c) expenses.[52] Rather, it represented a "carve-out"[53]

45. U.C.C. § 1-201(44)(b).

46. 30 B.R. 932 (Bankr. S.D.N.Y. 1983).

47. *Id.* at 937.

48. *Id.*

49. 11 U.S.C. § 506(c) (1988).

50. 130 B.R. 1013 (Bankr. M.D. Ga. 1991), *rev'd on other grounds sub. nom.* Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992).

51. *Id.* at 1019 n.19.

52. *Id.* at 1021.

53. A "carve-out" is a portion of a postpetition loan that is reserved to cover administrative expenses. The practice is controversial, because it often implies an intent to favor administrative claimants, with a priority under § 506(a)(1), over secured creditors' claims for § 507(b), which is supposed to have a higher priority. David Gray Carlson, *Secured Creditors and the Expenses of Bankruptcy Administration*, 70 N.C. L. Rev. 417, 448-51 (1992).

for the benefit of ordinary administrative expenses of reorganization.[54] Therefore, legitimate section 506(c) expenses could be charged against the postpetition lender irrespective of the order, even after the $150,000 was depleted.[55] One commentator has gone even further to assert that postpetition lending orders that bar section 506(c) are illegal and should never be enforced.[56] In contrast, the bankruptcy court, in *In re Evanston Beauty Supply, Inc.*,[57] refused to allow section 506(c) charges under like conditions, because the secured creditor did not impliedly consent to the administrative expenses.[58]

If section 506(c) expenses may be charged against postpetition liens with superpriorities, then section 506(c) represents an even higher priority. It is a puzzle to contemplate what constitutes the very highest priority under the Bankruptcy Code. Perhaps it is section 506(c), when applied to whittle down a superpriority under section 364(d).[59]

SECTION 506(c) AS A SUBTERFUGE OF SECTION 364 JURISDICTION

Section 506(c) not only trumps section 364(d) in terms of priority, but may even displace section 364(d) altogether as a means of granting superpriority security interests to postpetition lenders. If so, section 506(c) offers two enormous advantages over section 364(d). First, section 506(c) does not require a court hearing in advance of the loan.[60] Second, section

54. *Saybrook*, 130 B.R. at 1021.

55. *Id.; see also In re* Summit Ventures, Inc., 135 B.R. 478, 483 (Bankr. D. Vt. 1991) (evading the § 506(c) question but implying they are possible charges against postpetition lenders); Guy v. Grogan (*In re* Staunton Indus., Inc.), 74 B.R. 501, 507 (Bankr. E.D. Mich. 1987) (allowing § 506(c) invasion of postpetition superpriority); General Elec. Credit Corp. v. Levin & Weintraub (*In re* Flagstaff Foodservice Corp.), 739 F.2d 73, 76 (2d Cir. 1984) (considering but rejecting claim that lawyers could come within § 506(c) guidelines).

56. Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562, 578-79 (1991).

57. 136 B.R. 171 (Bankr. N.D. Ill. 1992).

58. *Id.* at 177. Equity receiverships frequently subordinated superpriority postpetition lenders to the expenses of bankruptcy administration. Tondel & Scott, *supra* note 19, at 42-43. But this rule was more intrusive than § 506(c) which requires that the trustee's expense directly benefit the collateral. The old equity rule simply promoted *any* administrative expense over the superpriority liens of a postpetition lender.

59. Here is a priority that arguably is even higher. Suppose, in chapter 11, a superpriority lender under § 364(d) suffers a loss of collateral. The remedy is a general creditor's superpriority under § 507(b). This priority beats administrative expenses under § 507(a)(1), which represents administrative claims allowable under § 503. If the reorganization converts to chapter 7, any "burial expenses" of the chapter 7 trustee apparently outrank any claim from the chapter 11 allowable under § 503. Because the superpriority secured lender's claim under § 507(b) depends on § 507(a)(1), which in turn depends on § 503, the lender under § 364(d) is subordinated to claims by the chapter 7 trustee. This priority assumes the collateral has failed, whereas the text assumes the collateral is still good.

60. 11 U.S.C. § 506(c) (1988).

506(c) does not require the adequate protection of junior secured parties.[61] Indeed, section 506(c) charges have been described as the mutually exclusive antithesis of adequate protection.[62]

Section 506(c) does require that the recovery of expenses be limited to expenses incurred to "preserve" or "dispose of" collateral, and that the trustee's recovery is limited "to the extent of any benefit" bestowed upon the subordinate secured party.[63] In contrast, section 364(d) places no limitations on the end to which loan proceeds are directed.[64] Yet, under some liberal readings of section 506(c), an entire chapter 11 proceeding is sometimes seen as "benefiting" a dominant secured party.[65] Under this controversial view, section 506(c) offers a promising alternative by which to pursue postpetition borrowing.

The idea that section 506(c) undermines section 364(d) is likely to upset judges who believe one section of the Bankruptcy Code ought not to swallow another. Courts may be tempted to hold that *loans* must be adjudicated under section 364(d), whereas section 506(c) covers expenses that are not *loans*. This may not be a tenable distinction. By definition, the person who makes a section 506(c) claim against an impaired secured party has not been paid and has therefore extended credit. It could be that the trustee is the person who has extended that credit. Indeed, some courts insist, rather unwisely, that only the trustee has standing to bring claims under section 506(c).[66] Even if this standing rule is insisted upon, however, it is easily transgressed. A trustee could committ to a lender and then pursue a section 506(c) claim, using the proceeds of that claim to reimburse

61. *Id.*

62. Carlson, *supra* note 53, at 419.

63. 11 U.S.C. § 506(c) (1988); *see also* Carlson, *supra* note 53, at 467-78 (further discussion of charging the secured creditor with adminstrative expenses).

64. Under the old Bankruptcy Act, courts sometimes asserted that priming liens could be awarded to postpetition lenders only when the loan was for the purpose of maintaining the status quo of collateral claimed by the subordinated secured parties. Weems v. Scandia Builders, Inc. (*In re* Scandia Builders, Inc.), 446 F. Supp. 115, 118 (N.D. Ga. 1978). No such requirement exists under the Bankruptcy Code. *In re* Dunckle Assocs., Inc., 19 B.R. 481, 484 (Bankr. E.D. Pa. 1982); *see also In re* Dunes Casino Hotel, 69 B.R. 784, 796 (Bankr. D.N.J. 1986) (loan proceeds used to float new securities issue); *In re* Beber Indus. Corp., 58 B.R. 725, 741 (Bankr. S.D.N.Y. 1986) ("neither the language of § 364(d) nor that of § 361 requires that the proceeds of a postpetition loan secured by a lien senior to that held by another creditor be employed to benefit the collateral").

65. Carlson, *supra* note 53, at 484-90.

66. *See generally id.* at 430-33. For the rule that only the trustee has standing, see *In re* Scopetta-Senra Partnership III, 127 B.R. 282, 283 (Bankr. S.D. Fla.), *reh'g granted,* 129 B.R. 700 (Bankr. S.D. Fla. 1991); *In re* Proto-Specialties, Inc., 43 B.R. 81, 83 (Bankr. D. Ariz. 1984); *In re* Codesco, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982). One court has held that another secured creditor has standing to impose § 506(c) expenses on other secured parties. Stable Mews Assocs. v. Togut (*In re* Stable Mews Assocs.), 49 B.R. 395, 398 (Bankr. S.D.N.Y.), *appeal dismissed,* 778 F.2d 121 (2d Cir. 1985). Another court has held that § 506(c) does not give the trustee an exclusive right to seek recovery. *In re* Manchester Hides, Inc., 32 B.R. 629, 632-33 (Bankr. N.D. Iowa 1983).

the lender. Or, if the standing rule is relaxed, as a great many courts have done,[67] section 506(c) becomes a more plausible alternative means for obtaining a postpetition loan—one that avoids court approval and the need to adequately protect the junior secured party.[68]

The moral of the above discussion might simply be this: If the proceeds of the loan will go to benefit or even preserve the collateral, a bankruptcy trustee need not have reference to section 364(d) with its adequate protection requirement. Rather, the proceeds of the loan should be treated as a section 506(c) expense, which can be imposed directly on the junior secured party, without regard to adequate protection.

ADEQUATE PROTECTION

Subordinated secured parties are entitled to adequate protection if a bankruptcy trustee wishes to grant a superpriority security interest to a postpetition lender,[69] but what of the postpetition lender? Is he or she entitled to adequate protection of the lien that secures postpetition credit? The answer here ought to be yes. If prepetition secured parties are entitled to adequate protection, so should postpetition secured creditors. Indeed, section 363(e) does not discriminate against postpetition creditors in requiring adequate protection.[70]

Section 363(e), however, is worded peculiarly:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased . . . by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.[71]

67. For a liberal standing rule, see North County Jeep & Renault, Inc. v. General Elec. Capital Corp. (*In re* Palomar Truck Corp.), 951 F.2d 229, 231-32 (9th Cir. 1991) (per curiam), *cert. denied*, 113 S. Ct. 71 (1992); *In re* Parque Forrestal, Inc., 949 F.2d 504, 511-12 (1st Cir. 1991); New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (*In re* Delta Towers, Ltd.), 924 F.2d 74, 76-77 (5th Cir. 1991); Equitable Gas Co. v. Equibank, N.A. (*In re* McKeesport Steel Castings Co.), 799 F.2d 91, 94 (3d Cir. 1986); *In re* Scopetta-Senra Partnership III, 129 B.R. 700, 702 (Bankr. S.D. Fla. 1991) ("the strict construction of the statute creates an inequitable windfall to the secured creditors").

68. In contrast, another court has ruled that extenders of credit have no standing to seek approval of their loans under § 364(d). *In re* Dunckle Assocs., Inc., 19 B.R. 481, 484-85 (Bankr. E.D. Pa. 1982). In that case, the secured party wished to "winterize" the real estate that served as collateral for its loan, but was denied permission to do so on its own motion under § 364(d). It is not clear, however, why § 506(c) did not authorize this expenditure, in which case the junior secured parties would have absorbed any loss or shortfall the expenditure might inadvertently have caused. *Id.* at 482-83.

69. 11 U.S.C. § 364(d)(2) (1988). It has just been suggested, however, that adequate protection is defeated if the loan qualifies as a § 506(c) expense. *See supra* text accompanying notes 49-59.

70. 11 U.S.C. § 363(e) (1988).

71. *Id.*

Some courts have read this section to mean that the trustee must provide adequate protection only if the secured party *asks* for it.[72] If there is no such request, then the trustee is free to use, sell, or lease the collateral to the prejudice of the secured party.[73] This is a controversial proposition, however.

Support for the proposition that a secured party must *ask* for adequate protection is found in the opening words of section 507(b), which is the provision that supplies the remedy for failed adequate protection. If adequate protection fails, section 507(b) grants a priority higher than the administrative priority granted in section 507(a)(1). The opening words of section 507(b) condition the superpriority as follows: "If the trustee, under section 362, 363, or 364 of this title, provides adequate protection . . ."[74] This condition hints that a trustee need *not* supply adequate protection under some circumstances (as when the secured party has neglected to ask for it).

One case that arguably is consistent with this position as it applies to a postpetition creditor is *Mulligan v. Sobiech.*[75] In that case, a postpetition creditor was given a lien on crops but was expressly denied any administrative priority.[76] The crops failed, and the postpetition creditor ended up having a $413,000 deficit after the disposition of the collateral. After the chapter 11 proceeding was converted to chapter 7, the postpetition creditor claimed to be an administrative creditor under Bankruptcy Code section 503(b),[77] and was, therefore, entitled to a high priority under section 507(a)(1). The debtor[78] claimed the lender had the same priority as an

72. *See, e.g., In re* Kain, 86 B.R. 506, 512 (Bankr. W.D. Mich. 1988) ("Colloquially expressed, if you don't ask for it, you won't get it.").

73. *See generally* David Gray Carlson, *Time, Value, and the Property Rights of Secured Creditors in Bankruptcy, or, When Does Adequate Protection Begin?*, 1 J. BANKR. L. & PRAC. 113 (1991).

74. 11 U.S.C. § 507(b) (1988).

75. 131 B.R. 917 (S.D.N.Y.), *aff'g* 125 B.R. 110 (Bankr. S.D.N.Y. 1991).

76. "Expressly denied" is a comment based on the fact that, in the court's opinion, a postpetition credit order is set forth, with a clause granting administrative priority struck out. Though the meaning of the strike-out is not set forth, it appears to represent language considered and rejected by Bankruptcy Judge Jeremiah Berk.

77. Section 503(b) provides, in relevant part:

> After notice and a hearing, there shall be allowed, administrative expenses . . . including,
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.

11 U.S.C. § 503(b)(1)(A) (1988).

78. The trustee did not join in the initiative to lower the priority of the postpetition creditor deficit. The postpetition creditor challenged the debtor's standing to do this, but the court noted that § 502(a) allowed any "party in interest" to challenge a claim. *Mulligan*, 131 B.R. at 920. The debtor would benefit from the subordination of the postpetition creditor, because subordination would release funds to pay tax claims, which were otherwise nondischargeable.

unsecured prepetition creditor, by virtue of the rule in section 348(d).[79] The bankruptcy court treated the postpetition credit order as a contract, and determined that the parties had intended the postpetition creditor to assume the risk of crop failure.[80] The creditor's argument that an administrative priority was implied in case the collateral failed was rejected.[81]

Mulligan could be read to mean that the postpetition creditor failed to ask for adequate protection and obtain it in the postpetition credit order. Adequate protection is defined in section 361(1) as additional liens, cash payments to the extent the secured party's interest has declined in value, or such other relief that will result in the secured party realizing the "indubitable equivalent" of its interest in the collateral.[82] But, when these devices fail, the remedy is precisely the administrative priority mentioned in section 507(b). Therefore, the postpetition creditor in *Mulligan* was asking for nothing but the remedy for failed adequate protection. But having neglected to obtain this right in the postpetition credit order, the postpetition creditor was not entitled to it.

Alternatively, the case might be interpreted more narrowly. The loan was a crop loan. At the beginning of the loan, the crops did not exist and hence the loan was a speculative venture. Adequate protection applies to *existing* collateral, not to collateral that does not yet exist. Viewed in this way, the case does not speak to the proposition that a postpetition creditor has no right to adequate protection of his or her security interest unless he or she asks for it and gets it in the enabling order.

ABUSES

CROSS-COLLATERALIZATION

The single most controversial issue with regard to postpetition credit is whether a court can approve an order that allows for some sort of ad-

See 11 U.S.C. § 523(a)(5) (1988).

It might be noted that the postpetition creditor was making a claim under § 503(a). It is not clear that the standing of a "party in interest" under § 502(a) spills over to supply standing under § 503(a). Indeed, the debtor did not object to the *existence* of an allowable claim—only its priority. Nevertheless, given the debtor's direct pecuniary interest in the priority accorded to the postpetition creditor, this decision seems correct.

79. Section 348(d) provides:

> A claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1307, or 1208 of this title, other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim has arisen immediately before the date of the filing of the petition.

11 U.S.C. § 348(d) (1988).

80. *Mulligan,* 131 B.R. at 920.

81. *Id.* (citing Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 87 B.R. 835, 839 (Bankr. S.D.N.Y. 1988) ("The mere fact that credit was extended in a postpetition period does not mean that an administrative priority will automatically attach . . ."), *aff'd,* 881 F.2d 6 (2d Cir. 1989)).

82. 11 U.S.C. § 361(1) (1988).

vantage or preference to a *pre*petition creditor in exchange for postpetition credit. For example, to use the numbers from a notorious case,[83] suppose an undersecured creditor claims $34 million but has only $10 million in collateral. The undersecured creditor is willing to advance $3 million more, but only if it receives collateral for its unsecured deficit of $24 million. Can such preferential treatment be given to a creditor willing to advance new funds? Such treatment has been afforded in "cross-collateralization clauses,"[84] wherein new collateral is given to secure both the new and the old loan.

One court of appeals has now categorically declared such clauses to be illegal.[85] Many courts, however, have upheld these clauses[86] and other lender preferences connected with postpetition credit[87] in spite of a strong policy against preferential treatment of undersecured creditors. Prepetition banks and finance companies are often the best, or at least the most convenient, providers of postpetition credit. These creditors often try to condition new credit on securing payment of the old. Many courts seem unwilling to outlaw them altogether.[88]

Undersecured creditors who demand cross-collateralization as the price of postpetition credit obviously face competition from other lenders mak-

83. Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490, 1491 (11th Cir. 1992).

84. The Second Circuit defined cross-collateralization as follows:

> [I]n return for making new loans to a debtor in possession . . . a financing institution obtains a security interest on all assets of the debtor, both those existing at the 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.

Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1094 (2d Cir. 1979).

85. *Saybrook*, 963 F.2d at 1496.

86. *E.g.*, *In re* FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985) (ex parte hearing followed by later contested hearing); *In re* Roblin Indus., Inc., 52 B.R. 241, 245 (Bankr. W.D.N.Y. 1985); *In re* Flagstaff Foodservice Corp., 16 B.R. 132, 133 n.1 (Bankr. S.D.N.Y. 1981); Borne Chem. Co., v. Lincoln First Commercial Corp. (*In re* Borne Chem. Co.), 9 B.R. 263, 269 (Bankr. D.N.J. 1981).

87. *See infra* text accompanying notes 129-49.

88. Even Judge Friendly, who wrote the seminal case on cross-collateralization, Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092 (2d Cir. 1979), could not bring himself to condemn them categorically:

> In order to decide this case we are not obliged, however, to say that under no conceivable circumstances could "cross-collateralization" be authorized. Here it suffices to hold that . . . a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order.

Id. at 1098. For categorical denunciations, see *In re* Tenney Village, Inc. 104 B.R. 562, 569-70 (Bankr. D.N.H. 1989); *In re* Monarch Circuit Indus., Inc., 41 B.R. 859, 861-62 (Bankr. E.D. Pa. 1984) (but especially emphasizing *ex parte* nature of cross-collateralization order); Tabb, *Cross-Collateralization*, *supra* note 12.

ing no such demands. Theoretically, competition ought to curtail the trade in cross-collateralization clauses. Meanwhile, if better terms are not available elsewhere, then cross-collateralization clauses can be viewed as simply the premium needed to attract new credit. Viewed in this light, cross-collateralization can be characterized as simply a different form of interest compensation.[89]

But theory is one thing and practice is another. A trustee contemplating the need for new credit often is tempted to give in to the demand of a prepetition creditor to secure or pay prepetition claims in advance of other prepetition creditors.[90] Borrowing from the existing lender saves time, appeases a potentially angry creditor, and perhaps exploits the old lender's inside information about the debtor.[91] Furthermore, as the extra collateral comes from the bankrupt estate generally, the trustee pays the premium with other people's money—the assets needed to pay general creditors. Undoubtedly, trustees have succumbed to the temptation to give away

89. Burchinal v. Central Wash. Bank (*In re* Adam's Apple, Inc.), 829 F.2d 1484, 1488 (9th Cir. 1987) ("A lender may be willing to extend credit if the arrangement includes a cross-collateralization clause, and a chance for greater profit (or, put differently, to reduce earlier losses) . . .").

Charles Jordan Tabb argues that cross-collateralization always is illegal because postpetition credit priorities under § 364 should be limited to the *inducement* of postpetition credit. Because cross-collateralization did not induce the prepetition extension of credit, it cannot be allowed. Tabb, *Cross-Collateralization, supra* note 12, at 141-44. Yet it must be said that cross-collateralization induces the *postpetition* loan, even if it obviously did not induce the prepetition advance. Therefore, Tabb, who generally argues very effectively against cross-collateralization, does not have a successful argument here.

Tabb certainly recognizes that cross-collateralization could be viewed as a form of compensation for a postpetition loan, but he still objects: "If the lender in fact wants additional compensation for the postpetition loan, it should have to admit as much. The court in deciding whether to approve the requested financing then could more clearly assess the fairness of the amount of compensation sought for the postpetition loan." *Id.* at 143-44; *see also id.* at 168-70. In other words, Tabb's argument reduces to the fact that a judge will not be able to assess the price of a loan that includes cross-collateralization, compared to its alternatives. On this argument, cross-collateralization is not so much illegitimate per se as it is confusing to judges.

90. In warning against ex parte cross-collateralization orders under the old Bankruptcy Act, the court wrote: "The debtor in possession is hardly neutral. Its interest is in its own survival, even at the expense of equal treatment of creditors, and close relations with a lending institution tend to prevent the exploration of other available courses in which a more objective receiver or trustee would engage." *Texlon*, 596 F.2d at 1098. In *Texlon*, the postpetition lender seems to have earned a return of 240% per year for its investment. Tabb, *Cross-Collateralization, supra* note 12, at 169.

91. Charles Jordan Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109, 115 (1989) [hereinafter Tabb, *Appealability*].

assets in order that a loan might be conveniently obtained.[92] Of course, a trustee has a fiduciary duty to the general creditors to obtain the best terms possible for new credit. It is not impossible for a premium in the form of a cross-collateralization clause to be the best terms available,[93] but the circumstances obviously are suspicious.

Bankruptcy judges who favor the use of cross-collateralization clauses frequently place restrictions on them. In New York, the bankruptcy court set forth the following conditions for allowing a cross-collateralization order: (i) Absent the financing, the business will not survive, (ii) the business is unable to obtain financing on acceptable terms, (iii) the lender will not accede to less preferential terms, and (iv) the financing is in the best interests of the general creditor body.[94] Although lender preference clauses have been upheld, courts clearly are hostile to them.[95] If a lender claims cross-collateralization rights in an ambiguous order, courts may read these orders with stinginess on the theory that lender preferences supposedly are illegal.[96]

The leading scholar of postpetition credit, Professor Charles Jordan Tabb, argues for a per se rule against cross-collateralization, a position that has been adopted by the Eleventh Circuit.[97] Tabb argues that section 364 represents the *exclusive* rules for awarding liens for postpetition credit, and because lender preferences are not mentioned in those rules, they are

92. In Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. (*In re* Ellingsen MacLean Oil Co.), 834 F.2d 599, 602 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988), the court noted that in exchange for $235,000 in new credit, the debtor in possession agreed that it would not challenge $4 million in prepetition security interests claimed by the lender for prepetition claims. It upheld this order anyway because of a postpetition lender's immunity from reversal on appeal. *See infra* text accompanying notes 224-57.

93. According to the Ninth Ciruit:

> Cross-collateralization clauses may provide the only means for saving a failing company. . . . [A] lender may be willing to take the risk of advancing funds to a debtor only if the gain derived from cross-collateralization is available. If the lender is the sole lender willing to finance the debtor, a cross-collateralization clause may mean the difference between an ongoing enterprise and a company in liquidation.

Burchinal v. Central Wash. Bank (*In re* Adam's Apple, Inc.), 829 F.2d 1484, 1490 (9th Cir. 1987).

94. *In re* Vanguard Diversified, Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *see* Tabb, *Cross-Collateralization, supra* note 12, at 163-74 (expressing impatience with the *Vanguard* test for its inability to prevent cross-collateralization).

95. *Vanguard*, 31 B.R. at 366 ("Cross-collateralization is a disfavored means of financing.").

96. *In re* Carley Capital Group, 128 B.R. 652, 661 (Bankr. W.D. Wis. 1991) (postpetition lender could not collect for prepetition lawyers' fees under an ambiguous order because cross-collateralization orders are not permitted under the Bankruptcy Code when the creditor is undersecured).

97. Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992).

not permissible.[98] He makes three central arguments in support of his position. First, section 364 is so comprehensive that it must contain the exclusive terms by which liens may be given for postpetition credit.[99] Second, the legislative history describes section 364 as governing "all obtaining of credit and incurring of debt by the estate."[100] Finally, Bankruptcy Code section 102(3) identifies the word *includes* or *including* as a sign of nonexclusivity, yet section 364 does not contain this word.[101]

Tabb concedes that the old Bankruptcy Act's analogous provision for postpetition credit was never deemed exclusive. Therefore, something in the Bankruptcy Code changed pre-Code law.[102] Tabb's riposte is that the extra-statutory innovations allowed under the old Bankruptcy Act were for loans extended in the ordinary course of business and court-approved administrative-priority loans—something now governed specifically by Bankruptcy Code sections 364(a) and (b).[103] Innovation in general has been preempted, Tabb argues, and therefore the legislative history should be taken at its word.[104] Because section 364 does not mention cross-collateralization, it should not be permitted.[105]

If innovation has been abolished, how then to explain the fact that, prior to the enactment of section 364, Bankruptcy Act cases described cross-collateralization as standard?[106] According to Tabb, when Congress codified all extrastatutory means, it was unaware that cross-collateralization orders had been approved.[107] As evidence, he points out that nowhere in the voluminous legislative history is the practice mentioned.[108] Nor was

98. Tabb, *Cross-Collateralization, supra* note 12, at 119-22; *see also* Peter Van Zandt Cobb, Comment, *Initial Financing Restrictions in Chapter XI Bankruptcy Proceedings*, 78 COLUM. L. REV. 1683, 1698 (1978).

99. Tabb, *Cross-Collateralization, supra* note 12, at 131.

100. *Id.* at 120; H. R. REP. No. 595, 95th Cong., 1st Sess 346 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6303; S. REP. No. 989, 95th Cong. 2d Sess. 57 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5843.

101. Tabb, *Cross-Collateralization, supra* note 12, at 120 n.66. Tabb calls this a "mild negative implication in favor of exclusivity." *Id.*

102. Cross-collateralization has been upheld specifically because it was a precode practice, and nothing in § 364(d) specifically contradicts it. *In re* Beker Indus. Corp. 58 B.R. 725, 728 (Bankr. S.D.N.Y. 1986); *see also* Dewsnup v. Timm, 112 S. Ct. 773, 779 (1992) (Blackmun, J.) ("[T]his court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.").

103. Tabb, *Cross-Collateralization, supra* note 12, at 131-32.

104. *Id.* at 134-35.

105. *Id.*

106. Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1094 (2d Cir. 1979) ("a practice . . . which, we are told, has been authorized not infrequently by bankruptcy judges in the Southern District of New York"); *see also* Benjamin Weintraub & Alan N. Resnick, *Cross-Collateralization of Prepetition Indebtedness as an Inducement for Postpetition Financing: A Euphemism Comes of Age*, 14 UCC L.J. 86 (1981).

107. Tabb, *Cross-Collateralization, supra* note 12, at 134.

108. *Id.*

the subject much discussed in the law review literature prior to the enactment of section 364. Although the court's decision in *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*[109] opened the floodgates of commentary, it came too late to influence Congress.

Some have argued that cross-collateralization is within the inherent equitable powers of a bankruptcy court. Tabb responds that equitable powers cannot be used to justify the creation of new property interests.[110] Yet, having just argued that cross-collateralization was an *old* practice that Congress neglected to address in section 364, it is somewhat awkward for him to claim that cross-collateralization constitutes a *new* property interest that equity courts may not create.

In defending cross-collateralization as within the allowable equity powers of a bankruptcy court, cross-collateralization has been compared to the Necessity of Payment Rule.[111] Professor Tabb writes:

> The underlying rationale of the Necessity of Payment Rule, however, is that in cases involving the public interest a creditor with a stranglehold on the debtor may be permitted to extort payment of his prepetition debt, despite the violence this does to established principles of bankruptcy law such as equality of distribution. This extortion premise similarly underlies cross-collateralization. . . . Therefore it is not surprising that the Necessity of Payment Rule has been advanced as a justification for cross-collateralization.[112]

Tabb is not able to deny the resemblance of the Necessity of Payment doctrine to cross-collateralization, and so his categorical views in opposition to cross-collateralization are ultimately not completely satisfactory. Nevertheless, it must be conceded that cross-collateralization clauses are an invitation for abuse by lazy bankruptcy trustees.

One advantage to barring cross-collateralization orders is that it forces postpetition lenders to state their demands in the form of a higher interest

109. 596 F.2d 1092 (2d Cir. 1979).

110. Tabb, *Cross Collateralization, supra* note 12, at 154-55 (citing Butner v. United States, 440 U.S. 48, 55-56 (1979)).

111. Jeff Bohm, *The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases*, 59 AM. BANKR. L.J. 289, 299-301 (1985); Robert L. Ordin, Comment, 54 AM. BANKR. L.J. 173, 177 (1980). On the Necessity of Payment Rule, see generally Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1 (1989). These two commentators collect examples of payments unauthorized by the Bankruptcy Code, but their examples tend to focus on paying employees or key suppliers. No cross-collateralization examples are given.

Courts split on whether this Doctrine of Necessity exists. *Compare* Shoemaker Truck Co. v. B & W Enters., Inc. (*In re* B & W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983) (refusing to extend special railroad rules allowing prepetition creditors to be paid to nonrailroad cases) *with In re* James A. Philips, Inc., 29 B.R. 391, 393 (Bankr. S.D.N.Y. 1983) (allowing prepetition suppliers to be paid in advance of others).

112. Tabb, *Cross-Collateralization, supra* note 12, at 162 (footnote omitted).

rate. Whereas exotic advantages such as cross-collateralization may be difficult to value, especially under emergency conditions, an interest rate is a standard price term with which any judge will be very familiar. Limiting postpetition lenders to this term should make it easier to determine whether the postpetition loan is actually an adequate arrangement for the bankruptcy estate.

One last argument against cross-collateralization is offered by a commentator[113] who nevertheless warmly endorses the concept: if a postpetition lender has received cross-collateralization, then the chapter 11 plan can never be confirmed, because the plan will necessarily discriminate between similarly situated creditors.[114] This commentator goes on to suggest, however, that perhaps creditors are estopped from blocking the plan unless they objected earlier to the cross-collateralization order, but estoppel, as always, is the last resort of a lawyer without *real* arguments.[115] It is perfectly apparent that cross-collateralization amounts to preferential treatment for the postpetition lender, which threatens to sink the confirmability of the plan. Nothing requires a creditor to protest cross-collateralization in order to preserve his or her right to block a reorganization plan that does not conform to the Bankruptcy Code.

Cash Collateral Orders Distinguished

Certain legitimate devices must not be confused with cross-collateralization orders. For example, cash collateral orders often provide adequate protection to prepetition secured parties claiming cash collateral in exchange for using this cash.[116] Use of the cash resembles postpetition credit, with the prepetition creditor doing the lending of its own cash to the debtor. There is no preferential taint to such cash collateral orders because the prepetition creditor is fully secured, to the extent of the cash collateral now being lent to the trustee.[117] Therefore, agreements to use cash collateral should be treated differently from postpetition credit orders. The

113. Bohm, *supra* note 111, at 325.

114. According to Bankruptcy Code § 1124(a)(4), a plan must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." Furthermore, classification may not "discriminate unfairly," *id.* § 1129(a)(b)(1), and many courts believe that the deficit claims of undersecured creditors cannot be classified differently from the other general creditors. *See, e.g.*, Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 948 F.2d 134 (5th Cir. 1991), *vacated in part per curiam*, 948 F.2d 142 (5th Cir.), *cert. denied*, 113 S. Ct. 72 (1992).

115. Bohn, *supra* note 111, at 323-25.

116. *In re* General Oil Distribs., Inc., 20 B.R. 873 (Bankr. E.D.N.Y. 1982) (confounding cross-collateralization with adequate protection).

117. *See* Tabb, *Cross-Collateralization*, *supra* note 12, at 141 n.165.

former are akin to adequate protection agreements,[118] which may not need court approval to be effective.[119]

Nevertheless, one has to admit that, conceptually, the difference between postpetition lending and use of cash collateral begins to collapse.[120] For example, in *In re AMT Investment Corp.*,[121] a secured party agreed that cash collateral could be used in exchange for a superpriority under section 364(c)(1). The court refused this priority because the use of cash collateral was not the same as a loan.[122] Indeed, section 361(3) forbids the use of high general creditor priorities for adequate protection.[123] This decision seems needlessly inflexible. Surely the rule against high priority as a means of adequate protection can be waived by the secured party. Also, the case makes clear how insubstantial the difference is between using cash collateral and obtaining a loan.[124] For example, if the debtor had surrendered the cash collateral to the secured party who then promptly "lent" it back, the superpriority in section 364(c)(1) would have been fully available. Yet

118. The status of these agreements is a little unclear, but there is a decent argument that unapproved adequate protection agreements are either binding or entitled to at least some weight in establishing the rights of secured parties. *In re* California Devices, Inc., 126 B.R. 82 (Bankr. N.D. Cal. 1991). *But see* Travelers Ins. Co. v. American AgCredit Corp. (*In re* Blehm Land & Cattle Co.), 859 F.2d 137, 140 (10th Cir. 1988) (expressing suspicion of such agreements).

119. In Bezanson v. Indian Head Nat'l Bank (*In re* J.L. Graphics), 62 B.R. 750 (Bankr. D.N.H. 1986), a prepetition secured party was both a postpetition lender and the owner of cash proceeds. It entered into a stipulation providing for use of cash collateral and further advances. In exchange for these two separate concessions, the secured party was to have postpetition accounts, which are disencumbered under Bankruptcy Code § 552(a). The court never approved this agreement. It therefore ruled that the entire agreement was an illegal postpetition credit order that could not grant the secured party an effective security interest. *Id.* at 754. This much of the opinion, though harsh, arguably is acceptable, as secured creditors are supposed to get court approval before they can have security interests on property of the estate. *See supra* text accompanying notes 10-21. But that part of the stipulation that granted postpetition receivables in exchange for existing cash collateral might have been upheld. Instead, the court ruled that use of cash collateral was legal because the secured party had consented. *See* 11 U.S.C. § 363(c)(2)(A) (1988). Meanwhile, the security interests were dead because the stipulation was part of an illegal postpetition credit order. *Bezanson*, 62 B.R. at 754-55.

This seems more than a little unfair. The consent of the secured party to the use of cash collateral was contingent upon receiving postpetition receivables in exchange. Even if the postpetition loans were illict, the security interests in exchange for the cash collateral should have been upheld.

120. If so, it is not the first spurious distinction to be identified in this fuzzy area of bankruptcy law. Earlier, it was pointed out that many loans under § 364(d) might also be justified under § 506(c), in which case no adequate protection need be offered to junior secured parties. *See supra* text accompanying notes 60-68.

121. 53 B.R. 274 (Bankr. E.D. Va. 1985).

122. *Id.* at 275-76.

123. *Id.* at 276.

124. *Id.* at 276-77.

cash collateral agreements do not require judicial approval if the secured party consents,[125] while postpetition lending does.[126]

Oversecured Parties and Cross-Collateralization

Also to be distinguished—with equal peril—are cases in which the lender is already oversecured at the time a cross-collateralization order is entered. Several courts have thought that a creditor's previous oversecured state is unobjectionable,[127] though courts should be extra-careful in investigating whether a creditor's oversecured state is really true; otherwise it will have granted preferential cross-collateralization unwittingly. Also, cross-collateralization orders in this context raise the difficult issue of the increased size of the equity cushion and whether this increases a secured party's right to postpetition interest and collection expenses under section 506(b). Courts should not increase the amount of postpetition interest a secured party gets by increasing the size of the equity cushion.[128]

OTHER LENDER PREFERENCES

In addition to cross-collateralization, other lender preferences have been attached as riders to postpetition credit orders.[129] For example, the Sixth Circuit upheld an order where an alleged fraudulent conveyance was forgiven in exchange for a loan.[130] These terms have been called "whitewash clauses."[131] Whitewash clauses have been criticized for allowing settlement of an action without any of the usual safeguards that apply to settlements in bankruptcy.[132] One court found a whitewash clause to be a "shocking . . . attempt to disarm the representative of the bankruptcy estate."[133]

125. 11 U.S.C. § 363(c)(2) (1988).

126. *Id.* § 364(d)(1).

127. *In re* FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985) ("If the creditor's prepetition debts, however, are secured by all of the debtor's assets, and the value of those assets exceeds the claim, the potential for preferential treatment is eliminated."); *In re* General Oil Distribs., Inc., 20 B.R. 873, 874 (Bankr. E.D.N.Y. 1982); Borne Chem. Co. v. Lincoln First Commercial Corp. (*In re* Borne Chem. Co.), 9 B.R. 263, 269 (Bankr. D.N.J. 1981).

128. *Cf. FCX, Inc.*, 54 B.R. at 842 (warning against giving undersecured creditors with cross-collateralization rights entitlements under § 506(b)). The law of the expanding equity cushion is discussed in David Gray Carlson, *Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys' Fees, and Collection Expenses*, 7 BANKR. DEVS. J. 381 (1990) [hereinafter Carlson, *Oversecured Creditors*].

129. *See generally* Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 85-92 (1990) (describing these lender preference clauses) [hereinafter Tabb, *Emergency Preferential Orders*].

130. Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. (*In re* Ellingsen MacLean Oil Co.), 834 F.2d 599, 605 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988); *see also FCX, Inc.*, 54 B.R. at 836 (debtor waived all challenges to prepetition lien of lender).

131. Tabb, *Emergency Preferential Orders*, *supra* note 129, at 86-87.

132. *In re* Roblin Indus., Inc., 52 B.R. 241, 243 (Bankr. W.D.N.Y. 1985); Tabb, *Emergency Preferential Orders*, *supra* note 129, at 87.

133. *In re* Tenney Village Co., 104 B.R. 562, 568 (Bankr. D.N.H. 1989).

Courts also have approved "cross-priority" clauses, which extend administrative superpriority under section 364(c)(1) to prepetition claims in exchange for a loan.[134] These clauses would seem to pose the same problems as cross-collateralization clauses. One court, however, approved a cross-collateralization clause and disapproved a cross-priority clause.[135] In doing so the court stated: "[T]he court may not change the priorities set out in the Bankruptcy Code."[136] Thus, section 364(c)(1) allowed administrative superpriority for the postpetition advance, but not for the prepetition unsecured claim. Why similar reasoning did not sink the cross-collateralization clause was not made apparent.

A clause requiring potentially undersecured creditors to be paid postpetition interest in violation of *United Savings Associates of Texas v. Timbers of Inwood Forest Associates, Ltd.*,[137] was all but approved in *New York Life Insurance Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.)*,[138] though the case was remanded for a specific finding that the postpetition credit order had been filed in good faith, thus triggering the immunity from appeal in section 364(e).[139]

If this order was questionable, it was because postpetition interest would be paid on an undersecured prepetition loan in violation of section 506(b) and *Timbers*. It should be emphasized, however, that section 364 loans are not subject to the rule of *Timbers*. A section 364 order could provide for the payment of interest even if the lender were undersecured or not secured at all. It was the prepetition nature of the claim—not to mention the leveraged buyout quality of the claim—that made the *Revco* case dubious.

A coercive demand for a ten percent kickback from the proceeds of an auction was approved in *In re Defender Drug Stores, Inc.*,[140] where a postpetition loan was due and owing. The debtor begged the lender to extend the maturity a few months, because a profitable sale was in the offing. The

134. *See* Borne Chem. Co. v. Lincoln First Commercial Corp. (*In re* Borne Chem. Co.), 9 B.R. 263, 269-70 (Bankr. D.N.J. 1981).

135. *In re* FCX, Inc., 54 B.R. 833, 841 (Bankr. E.D.N.C. 1985).

136. *Id.*.

137. 484 U.S. 365 (1988).

138. 901 F.2d 1359 (6th Cir. 1990).

139. *Id.* at 1366 ("an implicit finding of 'good faith' in a § 364(e) context is insufficient"). Provocatively, the postpetition interest was being paid on secured claims that financed an infamous leveraged buyout—a transaction that an examiner thought to be a fraudulent conveyance. Whether the secured creditors were undersecured is not very clear. At one point the court announced that *Timbers* did not apply specifically because the secured parties were oversecured. *Id.* at 1365. The court also intimated that the payments were justified because the collateral was depreciating in value. If an oversecured party gets postpetition interest paid regularly, the risk is posed that interest payments will exceed the equity cushion—something *Timbers* also prohibits. *See* Carlson, *Oversecured Creditors, supra* note 128, at 387-97.

140. 126 B.R. 76 (Bankr. D. Ariz. 1991), *aff'd sub nom.* Resolution Trust Corp. v. Official Unsecured Creditors Comm. (*In re* Defender Drug Stores, Inc.), 145 B.R. 312 (Bankr. 9th Cir. 1992).

lender agreed—provided the debtor obtained either a letter of credit for the benefit of the lender, or if the debtor would pay ten percent of the proceeds above and beyond the amount of the loan due and owing. The court agreed such a kickback was reasonable, though one wonders why the automatic stay did not prevent the lender from touching the collateral until the sale in question actually occurred. The court approved the kickback under the authority in section 506(b) because that provision awards secured parties "reasonable fees, costs, or charges provided under the agreement."[141] This is a dangerous argument if the court meant to imply that section 506(b) is the governing provision. Section 506(b) implies that a postpetition lender without an equity cushion would not be entitled to any such negotiated fee, or even postpetition interest at all. Fortunately, the court also indicated that section 364 itself authorized the kickback.[142]

Some other miscellaneous lender preferences have been approved. For example, prepetition creditors ordinarily cannot be paid until the liquidation is over[143] or a reorganization plan is confirmed.[144] Some postpetition lenders, however, have insisted upon and have been granted the right to receive payment on their prepetition claims early.[145] Also, courts have approved "drop dead" clauses, agreements that permit repossession of collateral by the postpetition lender in case of default, in spite of the automatic stay.[146] In at least one case, however, a bankruptcy judge, having obtained a loan for the debtor, refused to enforce a drop dead order where a going concern would have been destroyed.[147]

Many of these ideas have drawn fire as well. For example, a debtor in possession in *In re Tenney Village Co.*[148] presented a very aggresive order

141. *Id.* at 80.

142. *Id.* at 81.

143. 11 U.S.C. § 726(a) (1988).

144. *See* B & W Enters., Inc. v. Goodman Oil Co. (*In re* B & W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983) (refusing to extend special railroad rules allowing prepetition creditors to be paid to nonrailroad cases).

145. *In re* FCX, Inc., 54 B.R. 833, 841 (Bankr. E.D.N.C. 1985): *In re* General Oil Distribs., Inc., 20 B.R. 873, 875 (Bankr. E.D.N.Y. 1982) (bank allowed to draw on cash collateral to pay prepetition debt without court supervision); Borne Chem. Co., v. Lincoln First Commercial Corp. (*In re* Borne Chem. Co.), 9 B.R. 263, 269 (Bankr. D.N.J. 1981) (debtor had to pay prepetition claims on demand in context of a cross-collateralization order).

146. *See* Crown Life Ins. Co. v. Springpark Assocs. (*In re* Springpark Assocs.), 623 F.2d 1377, 1381 (9th Cir. 1980), *cert. denied*, 449 U.S. 956 (1980); *FCX, Inc.*, 54 B.R. at 843; *cf.* B.O.S.S. Partners I v. Tucker (*In re* B.O.S.S. Partners I), 37 B.R. 348, 350-51 (Bankr. M.D. Fla. 1984) (drop-dead clause in stipulation settling a dispute); Philadelphia Athletic Club, Inc. v. Trustees (*In re* Philadelphia Athletic Club, Inc.), 20 B.R. 322, 325 (Bankr. E.D. Pa. 1982) (drop-dead clause in adequate protection agreement); *In re* Philadelphia Athletic Club, Inc., 17 B.R. 345, 347 (Bankr. E.D. Pa. 1982) (same); *In re* Oxford Royal Mushroom Prods., Inc., 19 B.R. 974, 975 (Bankr. E.D. Pa. 1982) (drop-dead clause in cash collateral order).

147. Westinghouse Credit Corp. v. Prime, Inc. (*In re* Prime, Inc.), 26 B.R. 556, 558-59 (Bankr. W.D. Mo. 1983).

148. 104 B.R. 562, 569-70 (Bankr. D.N.H. 1989).

for the court's approval. In the proposed order, the bank had the right to supervise and stop the debtor's refurbishing work. The debtor had to appoint a new chief executive officer approved by the bank, and could not fire this person without bank permission. The debtor had to deposit all cash proceeds of its business with the bank, which would then have setoff rights. The bank had the right to end the automatic stay—a "drop dead" clause—if the debtor tried to confirm a reorganization plan over the opposition of the bank—a repeal of the debtor's cram down rights. Furthermore, the bank was to have a guaranteed priority over any claim by the debtor's lawyers or other professionals. The court responded angrily:

> Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons against it for the bankrupt estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization, and steal a march on other creditors in numerous ways. . . . It runs roughshod over numerous sections of the Bankruptcy Code. Under its rights of approval and supervision, the Bank would in effect operate the Debtor's business. The Code permits this to be done only by a debtor or trustee. All proceeds and rents would go to the Bank. . . . And the Bank would have the ultimate say over the very goal of this Chapter 11 case, a confirmed plan of reorganization. No longer could a plan be confirmed over the Bank's objection under the cram-down provisions of § 1129(b)(2)(A).[149]

Together with the Eleventh Circuit's opinion in *Saybrook*,[150] *Tenney Village* undoubtedly represents the current high water mark of opposition to lender preference clauses.

EXECUTORY CONTRACTS

One lender preference technique that might amount to a preference in the style of cross-collateralization is the assumption of a prepetition revolving credit arrangement under section 365, a strategy that would bypass section 364 altogether. Under section 365(b)(1)(A), the trustee may assume an executory contract only by curing all prepetition defaults. In effect, application of section 365 to a prepetition revolving credit arrangement would permit the trustee to bestow benefits on a lender that resemble the benefits of a cross-collateralization clause.

An impediment to this strategy is section 365(c)(2), which provides that "[t]he trustee may not assume or assign any executory contract or unexpired lease of the debtor . . . if . . . such contract is a contract to make a

149. *Id.* at 568 (citations omitted).

150. Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992).

loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."[151] One court has allowed this assumption of a prepetition loan facility, with its cure of all past defaults, when the prepetition lender consented. In *In re Prime, Inc.*,[152] the court concluded that, literally read, section 365(c)(2) barred assumption.[153] Nevertheless, the spirit of chapter 11 was that "business under reorganization . . . proceed in as normal fashion as possible."[154] The court therefore allowed the assumption of the contract to go forward.[155]

In contrast, *Transamerica Commercial Finance Corp. v. Citibank (In re Sun Runner Marine, Inc.)*[156] held that prepetition loan facilities can never be assumed and cured, even with the consent of the prepetition creditor.[157] In *Sun Runner Marine,* Transamerica had a floor plan with the debtor in which a dealer buying the debtor's boats could borrow the purchase price from Transamerica in exchange for a security interest on the boat. If any dealer defaulted, the debtor was obligated as surety to make up the loss.

After bankruptcy, the debtor and Transamerica agreed to continue the arrangement under the guise of an assumption of an executory contract under section 365. This required payment of prepetition principal and both prepetition and postpetition interest.[158] An undersecured creditor of the debtor objected to this assumption, and the Ninth Circuit agreed that, in spite of the consent between the debtor and Transamerica, the loan agreements could not be assumed by the debtor because, under section 365(c)(2), they inherently are unassumable.[159]

151. So strong is this notion that commitments to lend cannot be assumed that the Ninth Circuit would not allow a beneficiary of a standby letter of credit to collect from the bank that issued it, on the theory that the trustee in bankruptcy was not the same entity as the original beneficiary, and the benefit of the letter of credit could not be assumed. Farmer v. Crocker Nat'l Bank (*In re* Swift Aire Lines, Inc.), 30 B.R. 490 (Bankr. 9th Cir. 1983).

152. 15 B.R. 216 (Bankr. W.D. Mo. 1981).

153. *Id.* at 218.

154. *Id.* at 219.

155. Gill v. Easebe Enters., Inc. (*In re* Easebe Enters., Inc.), 900 F.2d 1417, 1420 (9th Cir. 1990) (though finding no waiver, suggesting it was possible "because there is no provision in the bankruptcy code precluding it"); *In re* Charrington Worldwide Enters., Inc., 98 B.R. 65, 69 (Bankr. M.D. Fla. 1989), *aff'd*, 110 B.R. 973 (M.D. Fla. 1990); Government Mortgage Corp. v. Adana Mortgage Bankers, Inc. (*In re* Adana Mortgage Bankers, Inc.), 12 B.R. 977, 988-89 (Bankr. N.D. Ga. 1980).

156. 945 F.2d 1089 (9th Cir. 1991).

157. *Id.* at 1091-93.

158. 11 U.S.C. § 365(b)(1)(A) (Supp. III 1991).

159. *Sun Runner Marine,* 945 F.2d at 1089. In this regard, *Prime,* discussed *supra* text accompanying notes 151-55, specifically was disavowed for not attending to the unambiguous words of the Bankruptcy Code.

The Ninth Circuit adopted portions of the Bankruptcy Appellate Panel's opinion,[160] which objected that Transamerica's scheme crowded the jurisdiction of section 364, and stated:

> Section 364 does not, however, authorize the debtor to pay the lender's *pre-petition* unsecured claim as a condition precedent to the post-petition financing. Permitting the assumption of a financial accommodation contract would allow a post-petition lender, such as Transamerica in this case, to receive full payment on its pre-petition unsecured claim under § 365(b)(1). This benefit to the lender would be at the expense of the other unsecured creditors . . . because it would diminish the estate assets available to satisfy their claims.[161]

This language, besides striking at the assumption of an executory loan agreement, equally condemns lender preference clauses whenever a term is not specifically authorized by the Bankruptcy Code.[162]

The Ninth Circuit also emphasized that section 365(c)(1), which provides for the assumption of personal service contracts, allows assumption by the trustee if the nondebtor consents, but section 365(c)(2), which provides that there is no assumption of commitments to lend, has no language allowing for consensual assumption.[163] Therefore, because Congress knew how to use the word "consent" in the former case, the absence of the word in the latter case must be significant.[164] Though arguments appealing to the omnicompetence of Congress can carry only so much weight, here it is stronger than usual, in that barring consensual assumption of prepetition loan facilities makes sure that a bankruptcy court has the power to review the facility for its fairness in postpetition market conditions.

A distinction might be drawn, however, with regard to prepackaged chapter 11 plans where, prior to the petition, a lender agrees to extend postpetition credit. In contrast, *Sun Runner Marine* involved the prepetition promise to extend prepetition credit.[165] In *In re T.S. Industries, Inc.*,[166] a debtor had entered into a prepetition contract for postpetition credit, but then wished to renege postpetition on the ground that section 365(c)(2)

160. Citibank v. Transamerica Commercial Fin. Corp. (*In re* Sun Runner Marine, Inc.), 116 B.R. 712 (Bankr. 9th Cir. 1990), *aff'd in part, vacated in part*, 945 F.2d 1089 (9th Cir. 1991).

161. *Sun Runner Marine*, 945 F.2d at 1093 (footnotes omitted); *see also id.* at 1094 (emphasizing that no part of the Bankruptcy Code authorizes the payment of prepetition amounts).

162. Transamerica had argued that since cross-collateralization clauses had been allowed, payments of prepetition amounts should be allowed as well. The court responded that the proposal to *pay*, instead of merely to secure, prepetition amounts was different, and so the issue did have to be addressed. *Id.* at 1094-95.

163. *Id.* at 1092.

164. *Id.*

165. *Sun Runner Marine*, 116 B.R. at 714-15.

166. 117 B.R. 682 (Bankr. D. Utah 1991).

never permits even consensual assumption of a prepetition commitment to lend. The court held that the debtor might be bound to its prepetition consent.[167] Otherwise, the court reasoned, the salubrious practice of prepackaged plans would be severely threatened by their unenforceability.[168]

167. *Id.* at 689. Procedurally, the court denied the debtor's motion to reject the contract but demanded more evidence on the feasibility of the chapter 11 plan. The opinion issued was "to shed light on the issue of whether the pre-petition executory contract to extend financial accommodations to a debtor is capable of being assumed." *Id.* at 684.

168. *Id.* at 689; *see* Paul M. Baisier & David G. Epstein, *Postpetition Lending Under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans,* 27 WAKE FOREST L. REV. 103, 115-16 (1992) (approving the result of *T.S. Industries* provided the court reviewed the prepetition agreement for postpetition credit per § 364).

In *T.S. Industries,* the court noted that § 362(e)(2)(B) authorized *ipso facto* clauses—clauses making bankruptcy an event of default—for prepetition financial accommodation contracts. The court then remarked:

> Reading § 365(c)(2) and (e)(2)(B) together, it is clear that Congress intended to protect creditors who have entered into pre-petition agreements to extend financial accommodations to a debtor from being required to extend money or accommodations to it post-petition if the contract that it entered into was totally or partially unperformed when the debtor filed bankruptcy. These sections prevent a creditor from being required to involuntarily finance a debtor-in-possession's reorganization effort based on a contract that it negotiated without knowledge that the debtor would be filing bankruptcy.

117 B.R. at 686 (footnote omitted) (citing Raymond T. Nimmer, *Executory Contracts in Bankrupcty: Protecting the Fundamental Terms of the Bargain,* 54 U. COLO. L. REV. 507, 533-34, 536 (1983)). Of course, the court also thought that prepackaged financing was on a different footing, because the creditor specifically contemplated the debtor's bankruptcy.

One commentator has objected to the reasoning of *T.S. Industries,* though apparently not the result. *See* Derek N. Pew, Note, *The Need for Speed and Common Sense: Rewriting § 365(c)(2) to Recognize the Practice of Prepetition Agreement for § 364 Debtor-in-Possession Financing,* 140 U. PA. L. REV. 2471, 2488 (1992). Mr. Pew thinks that this protection of lenders from "changed circumstances" is "borrowed from contract law principles of commercial impractibility or frustration." *Id.* at 2488. Because of this origin, the author leaps to the conclusion that the *T.S. Industries* court was doing nothing *but* enforcing a state-law result. For this the court is made to wear the dunce cap:

> [B]y essentially making a contract law argument, the court confuses the respective roles of contract law and bankruptcy law. If state contract law would void the contract in the event of bankruptcy, a court could reason that the contract was not assumable because it was void under state law at the time of filing and, therefore, not property of the estate. Once the contract is deemed to exist, however, (and the court must find that it does to reach the § 365 issue) then bankruptcy law takes over, and it is anomalous to apply state contract law principles in determining the meaning or intent of the Bankruptcy Code.

Id. at 2489 (footnotes omitted). In fact, just because the court sees a distinction between creditors extending ordinary revolving credit and those who intend to finance a prepackaged chapter 11 plan does not mean that it is mistakenly surrendering precious federal prerogatives to state contract law. On the contrary, federal law is quite capable of drawing this distinction on its own.

Mr. Pew also challenges the court's assertion that allowing for assumption of prepackaged financing agreements will facilitate workouts. Pew thinks some lenders will want to extend workout credit only if there is no bankruptcy, while others are willing to lend postpetition. A rule against assumption will therefore have an inconclusive effect on workouts, according

LOANS IN THE ABSENCE OF COURT APPROVAL

Secured credit may be extended only after notice and a hearing before a bankruptcy court.[169] Yet some lenders nevertheless advance funds and take back security interests without court approval. What is the worth of these under-the-counter security interests?

According to the trustee's status as a hypothetical judicial lien creditor on the day of bankruptcy, all of the debtor's property is considered encumbered by the trustee's judicial lien as soon as the petition is filed[170] so that, under state law, any postpetition security interest claimed by the would-be secured party is usually (though not always) subordinate to the rights of the bankruptcy trustee.[171] This conclusion is strengthened by section 549(a), which provides that the trustee may avoid a transfer of property of the estate "that occurs after the commencement of the case; and . . . that is authorized only under section 303(f) or 542(c) of this title; or . . . that is not authorized under this title or by the court."[172] This

to Mr. Pew. But in favor of the court's view, it can be pointed out that the anti-bankruptcy lenders can always add *ipso facto* clauses to their contracts under the authority of § 365(e)(2)(B), thereby separating themselves out from those creditors who are willing to lend postpetition.

Nevertheless, Pew would favor an amendment to § 365(c)(2) so that prepetition financing might be assumed with consent to the creditor. *Id.* at 2495-96.

169. 11 U.S.C. § 364 (1988).

170. *Id.* § 544(a)(1).

171. *See* U.C.C. § 9-301(3) (equating bankruptcy trustee with judicial lien creditor). In New York, for example, this priority is established by Civil Practice Law § 5202(a):

> Where a judgment creditor has delivered an execution to a sheriff, the judgment creditor's rights in a debt owed to the judgment debtor or in an interest of the judgment debtor in personal property . . . are superior to the extent of the amount of the execution to the rights of any transferee of the debt or property, except:
>
> 1. a transferee who acquired the debt or property for fair consideration before it was levied upon; or
>
> 2. a transferee who acquired a debt or personal property not capable of delivery for fair consideration after it was levied upon without knowledge of the levy.

N.Y. CIV. PRAC. L. & R. § 5202(a) (Consol. 1978).

Under this statute, if the bankruptcy trustee is deemed to have delivered an execution *and* has levied, the trustee is superior to the rights of a postpetition secured party. Unfortunately, in New York, at least one court has ruled that the trustee may not imagine a levy—only delivery of an execution. Balaber-Strauss v. Marine Midland Bank (*In re* Marceca), 129 B.R. 369 (Bankr. S.D.N.Y. 1991); *see* David Gray Carlson, *The Trustee's Strong Arm Power Under the Bankruptcy Code*, 45 S.C. L. REV. 841, 878-80 (1992) (criticizing this restriction). On this view, a postpetition lender is always free to obtain security interests free and clear of the trustee's strong arm power.

172. 11 U.S.C. § 549(a) (1988). At issue here are transfers under § 549(a)(2)(B)—those not authorized by the court. Still, there is something mysterious about § 549(a)(2)(A). This provision allows the trustee to avoid *authorized* transfers. Specifically, the trustee can avoid a transfer authorized by § 303(f)—which allows involuntary debtors to continue their business until an adjudication of the involuntary petition. This is comprehensible because § 549(b)

provision[173] suggests that postpetition security interests not authorized by the court are voidable at the behest of the very trustee who made those transfers.[174]

Section 549(a) avoids transfers only if a court has not authorized them.[175] Therefore, the avoidance is defeated if a court is willing to approve the postpetition lending *nunc pro tunc*. Although such a power exists, courts always caution that *nunc pro tunc* "should only be granted in 'unusual circumstances.' "[176] As the Second Circuit commented: "We should emphasize that this equitable power must be cautiously exercised, and that only a foolhardy lender will attempt to make it serve as a substitute for the proper authorization."[177] Furthermore, "[t]he reason that retroactive authorizations are disfavored is that they circumvent Congress' determi-

specifically defends transfer unless they are transfers on prepetition debt.

The trustee also may avoid transfers authorized under § 542(c). Section 542(c) is the codification of Bank of Marin v. England, 385 U.S. 99 (1966). It protects those for example, banks honoring checks that transfer debtor property to another in ignorance of the bankruptcy petition. Section 549(a)(2)(A) seems to nullify § 542(c). Unlike transfers under § 303(f), no part of § 549(a) or any other part of the Bankruptcy Code seems to save § 542(c) from nullification.

Finally, it should be noted that, even if § 542(c) continues to exist after § 549(a) erases it, § 542(a) could not help a lender who in good faith advances funds under a postpetition security agreement without knowledge of the bankruptcy. Section 542(a) protects only transferors of debtor property—i.e., banks that honor checks—whereas a secured party would be the transferee of debtor property.

173. *See also* 11 U.S.C. § 550(a) (1988) ("to the extent that a transfer is avoided under [§ 549], the trustee may recover . . . the value of such property from—(1) the initial transferee of such transfer").

174. Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 881 F.2d 6, 8 (2d Cir. 1989).

175. 11 U.S.C. § 549(a) (1988). The strong arm power, in contrast, has not such qualification, but it is obviously *implied* that if a court may grant security interests under § 364(c) or (d), these security interests are in derogation of the strong arm power.

176. *Photo Promotion*, 881 F.2d at 8; Wolf v. Nazareth Fair Grounds & Farmers' Mkt., Inc. (*In re* Nazareth Fair Grounds & Farmers' Mkt., Inc.), 280 F.2d 891, 892 (2d Cir. 1960) (per curiam).

177. *In re* American Cooler Co., 125 F.2d 496, 497 (2d Cir. 1942). The court stated:

> We think that the judge should not retroactively validate the loan unless he is confident that he would have authorized it if a timely application had been made, and unless, in addition, he is reasonably persuaded that the creditors have not been harmed by a coninuation of the business made possible by then loan.

Id.

Judge James E. Yacos, *nunc pro tunc*'s most formidable opponent, thought that *American Cooler* had been overruled by Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092 (2d Cir. 1979), which rated upon the *ex parte* grant of a postpetition security interest. Since *Texlon* entitled creditors to *prior* notice of a postpetition security interest, *nunc pro tunc* orders were rendered *per se* illicit.

This prediction of Second Circuit law was not vindicated by subsequent events, as the court validated subsequent notice of the grant of a post petition security interest in *Photo Promotion*, 881 F.2d at 9.

nation that before a court authorizes a post-petition transfer, prior notice must be given to creditors,"[178] though, nevertheless, courts seem willing to give *nunc pro tunc* approval commonly enough. Oftentimes, courts that grant *nunc pro tunc* approvals,[179] add some penalties to teach the lender a lesson. For example, interest compensation has been denied.[180]

A different view was taken in *Sapir v. CPQ Colorchrome Corp. (In re Photo Promotion Associates, Inc.),*[181] where the court took away the security interest[182] but allowed an administrative priority under section 507(a)(1) because the photgraphic processing services provided were useful to the bankruptcy estate.[183] It is possible to view this case as a *nunc pro tunc* embellished with a punishment. Although *nunc pro tunc* was discussed, the court rejected the *nunc pro tunc* analysis, thereby nullifying the security interests that were illegally tendered.[184] The court then separately approved an administrative priority for the lender in question.[185] In *Photo Promotion,* this administrative priority was not good enough to reimburse the secured creditor, because the liquidating estate had deteriorated greatly since the loan was advanced.[186]

178. *Photo Promotion,* 881 F.2d at 9.

179. For a case in which *nunc pro tunc* was conceded to be possible, but where the loan did not otherwise qualify for priority under § 364, see *In re* Roxy Roller Rink Joint Venture, 73 B.R. 521, 524-25 (Bankr. S.D.N.Y. 1987).

180. Wolf v. Nazareth Fair Grounds & Farmers' Mkt., Inc. (*In re* Nazareth Fair Grounds & Farmers' Mkt., Inc.), 280 F.2d 891, 892 (2d Cir. 1960) (per curiam).

181. 881 F.2d 6 (2d Cir. 1989).

182. Initially, the secured creditor waived its lien. Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 89 B.R. 328, 335 (Bankr. S.D.N.Y. 1988), *aff'd,* 881 F.2d 6 (2d Cir. 1989). But later, the bankrupt estate had dwindled, and so the secured party (unsuccessfully) asked the Second Circuit for its security interest back.

183. *Photo Promotion,* 881 F.2d at 10; *see also In re* Pizza of Hawaii, Inc., 69 B.R. 60, 62 (Bankr. D. Haw. 1986) (unauthorized loan made into administrative claim). For the view that an unauthorized loan must result in an ordinary general creditor's priority, see John Deskins Pic Pac, Inc. v. Flat Top Nat'l Bank (*In re* John Deskins Pic Pac, Inc.), 59 B.R. 809, 812 (Bankr. W.D. Va. 1986); *In re* Glover, 43 B.R. 322, 325-26 (Bankr. D.N.M. 1984) (accidental postpetition lender who needed no inducement to lend has no claim to administrative priority).

184. *Photo Promotion,* 881 F.2d at 9-10.

185. At first, the bankruptcy court had denied all possibility of an administrative priority. Sapir v. Coppinger Color Lab, Inc. (*In re* Photo Promotion Assocs., Inc.), 72 B.R. 606, 612 (Bankr. S.D.N.Y. 1987), *rev'd sub nom.* Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 89 B.R. 328 (Bankr. S.D.N.Y. 1988). But, on appeal, the court complained that the reasons for this denial were not elucidated adequately. 89 B.R. at 334-35. On remand, the bankruptcy court thought that perhaps an administrative priority could be managed after all—though the court continued to withhold the reasons that sparked the curiosity of the appellate court. Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 87 B.R. 835, 840-41 (Bankr. S.D.N.Y. 1988), *aff'd,* 881 F.2d 6 (2d Cir. 1989).

186. *Photo Promotion,* 881 F.2d at 10. Another leading case took the same posture. *In re* American Cooler Co., 125 F.2d 496, 497 (2d Cir. 1942). *American Cooler* seems to have overruled *In re* Avorn Dress Co., 79 F.2d 337 (2d Cir. 1935), where administrative priority categorically was denied because postpetition loans hurt general creditors by helping to keep

One argument rejected by the lower court in *Photo Promotion* was that, even if an ordinary course lender took security interests without court approval, it should obtain, not a mere administrative priority, but the priority under section 364(a)—the section allowing for unsecured ordinary course credit.[187] It is not clear what the secured party was supposed to gain from this. The priority under section 364(a) is precisely the same priority as that provided in section 507(a)(1). Section 364(a) provides: "If the trustee is authorized to operate the business of the debtor . . . the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business *allowable under section 503(b)(1)* . . ."[188] The benefit of this argument seems to have been that if a secured loan could also be an unsecured loan under section 364(a), then the trustee has inherent authority to enter into the deal; no independent hearing under section 503(b) is needed. Yet section 503(b), to which section 364(a) refers, might imply that even ordinary course unsecured credit must be subject to the scrutiny that section 503(b)(1) requires. On this view, the difference between ordinary course unsecured credit and administrative expense priority would seem nonexistent. But perhaps it can be argued that the *chapeau*[189] of section 503(b) requires the hearing, while section 503(b)(1) sets forth the rule that the administrative claim must have conferred a benefit on the estate. That is to say, because section 364(b) refers to section 503(b)(1), the hearing mentioned in section 503(b)'s *chapeau* is not required. Still, how can one know whether the standard of the subsection has been met unless the hearing in the *chapeau* is actually held?

In remanding this argument back to the bankruptcy court, the district court complained that the secured creditor never intended to give unsecured credit and so should not be allowed to "fall back" on section 364(a)

alive going concerns that properly should be liquidated. One court suggested that *Avorn* involved a deliberate flouting by the trustee of a court order. Groendyke v. Gold (*In re* J.C. Groendyke Co.), 131 F.2d 573, 574 (7th Cir. 1942). But the *Avorn* court order was nothing more than the admonition that the trustee should apply for permission before borrowing out of the ordinary course—a directive that simply repeated what the positive law was anyway. 79 F.2d at 337.

187. The secured creditor had neglected to raise this argument to the bankruptcy court, but, having changed lawyers, it was prepared to make this argument. *Photo Promotion*, 89 B.R. at 329. Though the court "wrestled mightily" with this new argument, it felt that it had "limited expertise in bankruptcy matters," given "the paucity of cases" that had been appealed to it. *Id.* at 336. Accordingly, the court felt that "the prudent course is to err on the side of caution in this case . . . Judge Schwartzberg, with his considerable expertise in such matters, should be given the opportunity to have these issues fairly and fully presented before we rule on appeal." *Id.* Appellate judges often are accustomed to ignoring an argument not raised in the court below, *see* Credit Alliance Corp. v. Dunning Ray Ins. Agency, Inc. (*In re* Blumer), 66 B.R. 109, 111 (Bankr. 9th Cir. 1986), *aff'd*, 826 F.2d 1069 (2d Cir. 1987), but the court seems to have been in an exceptionally generous mood.

188. 11 U.S.C. § 364(a) (1988) (emphasis added).

189. The chapeau—from the French word for hat—refers to the opening words of a statute before the blizzard of subsections hits.

as if an unsecured loan had been intended.[190] On remand, the bankruptcy court agreed that "fall back" was not allowed,[191] though the stated reasons appear to be more akin to assertions than arguments.[192] In the end, if section 364(a) coverage is procedurally easier than ordinary administrative expense priority, why should the ordinary course lender not have it? All that has happened by the ineffective grant of security interests is that the debtor ended up with a better deal—a happy result for the general creditors. Having lost this tactical advantage, why should the secured creditor also lose the benefit of a recourse claim against the debtor?

INVOLUNTARY BANKRUPTCIES

A debtor against whom an involuntary bankruptcy petition has been filed is in limbo until a bankruptcy court rules that the petition is appropriate under section 303(h).[193] Until that time, "except to the extent that the court orders otherwise . . . any business of the debtor may continue to operate, and the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been consummated."[194]

Under this provision, the debtor may grant security interests in his or her property, but, unless the lender has a purchase money lender's superpriority,[195] the lender will be junior to the trustee's judicial lien on the same assets, which is deemed to arise on the day of the bankruptcy petition.[196] No lender who knows of the involuntary petition is likely to advance credit on the strength of nonpurchase-money collateral.[197]

190. *Photo Promotion*, 89 B.R. at 333 ("It might fairly be termed a charade of the most disingenuous sort for us now to pretend that no lien ever existed when it formed such an important part of the Chapter 11 relationship between the parties."). The court excused the views as "speculative justifications" and urged the lower court not to take these views too seriously. *Id.* at 334.

191. Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 87 B.R. 835, 840-41 (Bankr. S.D.N.Y. 1988), *aff'd*, 881 F.2d 6 (2d Cir. 1989).

192. In contrast, the court in General Elec. Capital Corp. v. Hoerner (*In re* Grand Valley Sport & Marine, Inc.), 143 B.R. 840, 855-56 (Bankr. W.D. Mich. 1992), was willing to consider a "fall back" argument but was not ready to issue summary judgment on the record before it.

193. These rulings would include a finding that the requisite number of creditors has signed the petition, 11 U.S.C. § 303(b) (1988), and that the debtor is not paying debts as they fall due, or a custodian has been appointed outside bankruptcy court to take charge of the debtor's property. *Id.* § 303(h). The petition also will be granted if it is not timely controverted by the debtor. *Id.*

194. *Id.* § 303(g).

195. U.C.C. § 9-301(2).

196. 11 U.S.C. § 544(a) (1988).

197. New York lenders have an argument that their postpetition security interests defeat the trustee's strong arm power, but § 549(a) surely makes their security interests voidable postpetition transfers. *See supra* text accompanying notes 169-92.

Might an involuntary debtor seek to grant a security interest to his or her lender under section 364(c) that would be good against the bankruptcy trustee's prior judicial lien? In *Roxy Roller Rink,* the court thought not, because section 364(c) allows only a "trustee" to obtain credit.[198] Prior to the adjudication of the petition, the postpetition debtor is no trustee, and hence has no access to the priorities under section 364(c). The court noted that, according to Bankruptcy Code section 1107(a), chapter 11 debtors are automatically trustees,[199] unless they are disqualified.[200] But this rule did not apply to debtors against whom involuntary petitions had been filed—at least until the adjudication of bankruptcy had occurred. According to the court:

> The statutory scheme makes it evident that Code § 1107(a) does not apply to the debtor during the involuntary gap period. Code § 303(f) allows the involuntary gap debtor to operate as if no petition had been filed, unless otherwise ordered by the court. The freedom explicitly granted by Code § 303(f) to the debtor is plainly inconsistent with the fiduciary obligations imposed on a debtor by Code § 1107(a). It is unreasonable to assume that the Code intended to impose such fiduciary obligations on the unwilling involuntary debtor before the order for relief. As the involuntary gap Chapter 11 debtor cannot qualify as a "trustee", it cannot take advantage of Code § 364(b) or (c) to obtain superpriority for the claims of a lender. It is a sensible statutory scheme to preclude the debtor from taking advantage of the powers of the Bankruptcy Code, such as the right to incur debt under Code § 364 on a priming lien . . . while the debtor opposes the entry for an order for relief and when no order for relief may ever be entered.[201]

While the ruthless and rapacious nature of the debtor prior to the adjudication of an involuntary petition under chapter 11 may justify denial of borrowing rights, it should be remembered that this same debtor, con-

198. *In re* Roxy Roller Rink Joint Venture, 73 B.R. 521, 526 (Bankr. S.D.N.Y. 1987).

199. *See* 11 U.S.C. § 1107(a) (1988).

200. *Roxy Roller Rink,* 73 B.R. at 526-27.

201. *Id.* at 527. It should be noted that the court did approve a loan of $15,000 and ordered that the lender be reimbursed for this loan. *Id.* at 528. The court also said it would approve an order for the further advance of over $100,000. The lender—an insider of the debtor—neglected to submit a proposed order but advanced these funds anyway. After the case was converted to chapter 7 and the trustee was ready to distribute the bankruptcy estate, the lender tried to make up for this error by asking that the postpetition credit order be approved *nunc pro tunc* and simultaneously that the trustee be ordered to pay the lender $120,000. In deciding whether to issue a *nunc pro tunc* order, the court thought that such an order might be possible but that, now that it had discovered involuntary debtors had no right to obtain postpetition credit on a superpriority basis, it would not issue the order. The original order for $15,000—issued in ignorance of the court's later legal discoveries—was allowed to stand.

ceding the validity of the petition, becomes fully able to apply for security interests for his or her postpetition lenders. The adjudication of bankruptcy apparently purges the debtor of the bad character defects that had previously eliminated access to credit. On the strength of this, two commentators have recommended that debtors in involuntary reorganization admit to the validity of the petition, take out their loan, and then seek dismissal of the chapter 11 petition for cause under section 1112(b).[202]

Security interests under section 364(c) were thus eliminated because the involuntary debtor is not a trustee, but sections 364(a) and (b) would allow for a postpetition lender to obtain a high priority within the bankruptcy—an advantage that might still attract a lender in cases where general creditors are expected to receive dividends.[203] In *Roxy Roller Rink,* the court also declined to grant even this priority.[204] First, the court reasoned that section 364(a) allowed for ordinary course credit without court approval, but only if the "trustee" were authorized to do business under section 721 or section 1108 of the Bankruptcy Code.[205] Even if the involuntary debtor were a trustee, it was merely authorized to do business only under section 303(f)—not under section 721 or section 1102—and so could not obtain the administrative priority that section 364(a) promised.[206] Also, creditors whose claims arose under section 303(f) have only a second priority under section 507(a)(2); the court thought granting an even better priority under section 364(a) would do violence to the equilibrium of the Bankruptcy Code.[207]

A tougher argument for the court was whether it could approve credit outside of the ordinary course of business under section 364(b), thereby increasing the lender's priority from section 507(a)(2) to section 507(a)(1). The court thought that section 364(b) was so infinitely close to section 364(a) that defeat of the former theory required defeat of the latter theory.[208] Yet section 507(a)(2) priorities are limited to ordinary course creditors. A creditor outside of the ordinary course who is lending with court approval probably should be entitled to the higher priority that section 364(b) provides.[209]

202. Baisier & Epstein, *supra* note 168, at 121-22. Also, the debtor might obtain an interim trustee for his or her estate prior to the adjudication of bankruptcy. 11 U.S.C. § 303(g) (1988). This interim trustee might obtain credit under § 364(c), "and the appointment of such a trustee would not remove the debtor's ability to contest the petition." Baisier & Epstein, *supra* note 168, at 122.

203. 11 U.S.C. § 264 (a)-(c) (1988).

204. *Roxy Roller Rink,* 73 B.R. at 526.

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *See* Baisier & Epstein, *supra* note 168, at 119.

PROCEDURAL RELIEF

UNDOING ILLEGAL POSTPETITION CREDIT ORDERS UNDER RULE 60(b)

Postpetition credit orders often are signed hastily by judges within days of a bankruptcy filing. These orders often are signed under emergency conditions. When a subordinated secured creditor or some other wronged party feels aggrieved by such an order, there are only two options—ask the bankruptcy judge to change the order, or appeal.[210]

Many courts have amended postpetition credit or cash collateral orders under the authority of rule 60(b) of the Federal Rules of Civil Procedure.[211] According to this rule:

> [T]he court may relieve a party or a party's legal representative from a final judgment, order, or proceeding for the following reasons:
> (1) mistake, inadvertence, surprise, or excusable neglect;
> (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b);
> (3) fraud . . . , misrepresentation, or other misconduct of an adverse party;
> (4) the judgment is void;
> (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or
> (6) any other reason justifying relief from the operation of the judgment.
> The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation.[212]

Courts have entertained motions under rule 60(b) on various theories. For example, when a postpetition credit order subordinates a secured creditor, courts have declared the order void if the creditor received no notice of a hearing on the order. Failure to give notice is a violation of the creditor's due process rights, and unconstitutional judgments are said to be void.[213] A postpetition credit order, however, is not void simply

210. *See infra* text accompanying notes 224-57.

211. *See, e.g., infra* notes 214-16.

212. Fed. R. Civ. P. 60(b).

213. Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1448 (9th Cir. 1985) (notice one day before final hearing not sufficient under the circumstances).

because it is erroneous or contrary to the Bankruptcy Code.[214] Nor has a court that concludes that the postpetition credit order is contrary to the Bankruptcy Code made a mistake within the meaning of rule 60(b)(1).[215] Rather, rule 60(b) refers only to mistakes of the moving party.[216]

Rule 60(b) does contain a one-year statute of limitations, if the grounds for reversal of a postpetition credit order are in subparagraphs (1)-(3) of rule 60(b). The Seventh Circuit has stated, however, that rule 60(b) is not relevant to the reversal of a postpetition credit order, because rule 60(b) applies only to *final* orders.[217] An order pertaining to postpetition credit is not final.[218] Instead, because such a reversal is inherently within the power of a bankruptcy judge, the reversal can take place at any time that is just.[219]

Nevertheless, the Seventh Circuit's opinion also drew from the anti-appeal rule of section 364(e), the principle that not even a bankruptcy judge may backtrack on a postpetition credit order "in the absence of bad

214. *In re* Whitney-Forbes, Inc., 770 F.2d 692, 696 (7th Cir. 1985); Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1098 (2d Cir. 1979). *But see In re* Edwards, 962 F.2d 641, 643-45 (7th Cir. 1992) (Posner, J.) (holding that a judgement is not void just because due process rights were violated; instead, a balancing test is required to see who should take the loss).

215. *Texlon*, 596 F.2d at 1100.

216. Montco, Inc. v. Barr (*In re* Emergency Beacon Corp.), 666 F.2d 754, 759 (2d Cir. 1981); *see also In re* Durkalec, 21 B.R. 618, 620 (Bankr. E.D. Pa. 1982) ("Rule 60(b)(6) is a reservoir of equitable power to do justice in particular cases where relief is warranted.").

217. Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1355 (7th Cir. 1990).

218. *Id.* at 1355. The court also doubted that rule 60(b) applied in bankruptcy, because no bankruptcy rule specifically says so. *Id.* ("Rule 60(b) does not apply to bankruptcy cases save to the extent it has been incorporated into the bankruptcy rules . . ."). But bankruptcy rule 9024 specifically invokes rule 60, except in narrow circumstances not relevant here.

219. *Id.* ("Whether it may be vacated . . . is a question of the law of the case, not of Rule 60(b)."); *accord* Connecticut Nat'l Bank v. Babco, Inc. (*In re* Babco, Inc.), 133 B.R. 286 (Bankr. D. Conn. 1991). In *Babco*, after signing a hasty cash collateral order granting a lender a lien in exchange for a postpetition loan of cash collateral, the court changed its mind. The cash collateral actually taken was withdrawn from a checking account maintained by the bank. The account contained proceeds of a deal in which the debtor returned inventory to a supplier in exchange for reimbursing the debtor for excise tax paid on the inventory. The court figured that the bank's security interest on general intangibles did not reach the funds paid by the supplier. But the court completely overlooked the bank's setoff right. Whether or not the bank could claim the supplier's payment as collateral under its security agreement, proceeds of a setoff are always cash collateral under the Bankruptcy Code. *In re* Archer, 34 B.R. 28, 31 (Bankr. N.D. Tex. 1983).

If an appeal is indeed filed, the bankruptcy court is divested of jurisdiction and can no longer reverse its own order. Burchinal v. Central Wash. Bank (*In re* Adam's Apple, Inc.), 829 F.2d 1484, 1489 (9th Cir. 1987). But, on the court's theory, these orders are not final and, therefore, cannot be appealed for this reason. *See infra* text accompanying notes 224-57.

faith, which is a very narrow exception."[220] Yet one type of bad faith, the court made clear, is a violation of Bankruptcy Code priorities:

> Orders under § 364(c) do not allow a creditor to boost the priority of existing [i.e., prepetition] loans. Section 364(c) speaks of "*obtaining* of credit or the *incurring* of debt;" prior loans and sums disbursed on prior firm commitments fit neither category. Sums paid out after bankruptcy on letters of credit issued before bankruptcy are pre-bankruptcy loans, to which § 364(c) cannot apply, because the bank is committed before the bankruptcy to honor sight drafts tendered with conforming draws. Priority under § 364 is not necessary to obtain this credit for the debtor.[221]

That postpetition credit orders are not final means, of course, that such orders cannot be appealed at all[222]—that the only remedy is under the inherent powers of a bankruptcy court to change its mind with regard to a nonfinal order. Few courts join the Seventh Circuit in this characterization. Most courts seem to believe that any superpriority credit order is final.[223] Yet, even if appealable, these orders enjoy a most unusual immunity from appeal—an immunity to which we now turn.

APPEAL

From time to time, a bankruptcy court will grant a security interest to a postpetition creditor in violation of the Bankruptcy Code. For instance, a superpriority might be granted without having provided adequate protection to the subordinated secured party. Or a cross-collateralization clause might be approved, though its legality is dubious, especially in the Eleventh Circuit where they are *persona non grata.*

Appeal is a customary means of redress. The postpetition creditor, however, might be immune from reversal on appeal in many cases. According to section 364(e):

> 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.[224]

220. *Kham & Nate's Shoes,* 908 F.2d at 1355 (citing Seaboard Sys. R.R. v. United States (*In re* Chicago, Milwaukee, St. Paul & Pac. R.R.), 799 F.2d 317, 329-30 (7th Cir. 1986)).

221. *Id.* at 1356 (citations omitted) (emphasis in the original).

222. *See* 28 U.S.C. § 158(d) (1988) (only final court orders may be appealed).

223. *E.g., Adam's Apple,* 829 F.2d at 1487.

224. 11 U.S.C. § 364(e) (1988).

Approaches to this immunity from reversal on appeal draw radically different reactions from appellate courts. At one extreme, courts have ruled that no exceptions can be allowed.[225] But some courts have diligently managed to locate some exceptions. Indeed, section 364(e) itself provides at least one express exception—the lender must be acting in good faith. One court has ruled that, if a bankruptcy court fails to make an express finding of good faith, appeals must be allowed, at least with the end of remanding the matter to require a finding as to good faith.[226]

What is good faith? It ought to be clear that, when the lender has participated in misrepresentations to the judge who signed the order, section 364(e) permits appeal. One such misrepresentation might involve the availability of alternative sources of credit.[227] For example, if a disgruntled creditor can produce a bank that is willing to lend for less, and if the actual lender and the debtor in possession have failed to use due diligence to locate a lender, an appeal might be possible after all. Another misrepresentation might involve whether creditors were given notice of the order,[228] though absence of notice also indicates a due process violation, which also is grounds to evade the appellate immunity provided by section 364(e).[229]

A more direct confrontation on the good faith issue is whether a lender can claim immunity from appeal in cases where the lender knows the postpetition order violates the Bankruptcy Code. In *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.),*[230] the court took the most aggressive position possible toward cross-collateralization orders, namely that the Bankruptcy Code simply does not allow them.[231] Given this assumption, it easily followed that a secured party relying on such a travesty had no immunity from appeal under section 364(e).[232]

In re EDC Holding Co.[233] involved an order that gave a bank superpriority status in exchange for its paying the lawyers of a labor union from the proceeds of a postpetition loan. These union lawyers did not even have a claim in the bankruptcy, let alone a high administrative priority. In reversing the order, Judge Richard Posner ruled that the order constituted

225. *Adam's Apple,* 829 F.2d at 1488; *see* Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1451 & n.24 (9th Cir. 1985) (where secured party is wrongfully deprived of adequate protection in a postpetition credit order, the secured party's only remedy was § 507(b) superpriority; appellate court could not simply repeal the order because of § 364(e)).

226. New York Life Ins. Co. v. Revco D.S., Inc. (*In re* Revco D.S., Inc.), 901 F.2d 1359 (6th Cir. 1990).

227. Bohm, *supra* note 111, at 311-12 n.76.

228. Tabb, *Appealability, supra* note 91, at 158-59.

229. *See infra* text accompanying notes 278-305.

230. 963 F.2d 1490 (11th Cir. 1992).

231. *Id.* at 1494-95.

232. *Id.*

233. 676 F.2d 945 (7th Cir. 1982).

an obvious violation of the Bankruptcy Code.[234] As such, the postpetition lender had not "extended such credit in good faith," within the meaning of section 364(e).[235] In construing the words "good faith," Judge Posner conceded that bad faith is not mere knowledge that some may object to a postpetition credit order.[236] In rejecting the lender's argument that "good faith" means only that no misrepresentations were made to the bankruptcy court, Judge Posner stated: "If the lender *knows* his priority is invalid but proceeds anyway in the hope that a stay will not be sought or if sought will not be granted, we cannot see how he can be thought to be acting in good faith."[237] The distinction seems to be that aggrieved parties can appeal from egregiously illegal postpetition credit orders, but not from merely suspect orders. If this is what Judge Posner intended, then ordinary cross-collateralization orders, though illegal, are merely suspect and hence completely valid.

Other courts have expressly rejected the argument that lenders who rely on illegal orders are not acting in good faith, at least when the orders permit cross-collateralization.[238] Some have emphasized that cross-collateralization "is neither specifically allowed nor forbidden by the Bankruptcy Code."[239] This statement, though willfully oblivious to the spirit of voidable preference law, provides a loophole through which a postpetition lender would establish that it was acting in good faith, and thus be immune from appeal.[240] Similarly, the fact that some courts, however erroneously, approved cross-collateralization orders has been cited as proof that a postpetition lender is acting in good faith when it extends credit on the strength of such an order.[241] Finally, some courts think that *any* reliance on an order, no matter how illegal, is enough to assure immunity from appeal.[242]

234. *Id.* at 948.

235. *Id.*

236. *Id.*

237. *Id.* at 947.

238. Burchinal v. Central Wash. Bank (*In re* Adam's Apple, Inc.), 829 F.2d 1484, 1488 (9th Cir. 1987); Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 127 B.R. 494, 499-500 (M.D. Ga. 1991), *rev'd on other grounds*, 963 F.2d 1490 (11th Cir. 1992).

239. *Saybrook*, 127 B.R. at 496.

240. *See* Bankr. Rule 8005 (The Bankrutpcy Rules can be found as an appendix to Title 11 of the United States Code).

241. *Adam's Apple*, 829 F.2d at 1490. Professor Tabb calls this "the snowball effect"—the idea that one case approving a dubious postpetition credit order immunizes like orders thereafter. Tabb's solution: strong and repeated appellate dictum against illegal orders. *See* Tabb, *Appealability*, *supra* note 91, at 133.

242. *Adam's Apple*, 829 F.2d at 1489; Unsecured Creditors Comm. v. First Nat'l Bank & Trust Co. (*In re* Ellingsen MacLean Oil Co.), 834 F.2d 599, 605 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988) ("In this case, the Banks may have been uncertain about whether the terms of the order would be challenged or subject to reversal on appeal, but they cannot be deemed to have *known* that the conditions approved were improper.").

The reliance argument seems particularly weak. Conceding that inducing a postpetition lender to make advances is a genuine policy of section 364(e),[243] Professor Charles Jordan Tabb remarks:

> Surely it is not good bankruptcy jurisprudence to exalt one policy—here, the inducing of postpetition loans—over all other bankruptcy policies without even the possibility of appellate review. So interpreted, section 364(e) becomes an invitation to bankruptcy judges to disregard the law. Given the dynamics surrounding the entry of financing orders, in which the lender has the judge at its mercy, this invitation is unwise.[244]

Furthermore, it is apparent that lender preference clauses result in part from debtor apathy,[245] and in part from the monopoly a preexisting undersecured party may have over a bankrupt debtor.[246] A monopolist is defined as a supplier of goods or services who can charge a price higher than the marginal cost of production, and this marginal cost of production always includes the supplier's next best opportunity in another market. To the extent the lender is a monopolist, then, by definition, the lender would have made the same loan for less. Accordingly, so long as the price of a loan is not lowered below the marginal cost of producing that loan, a rational monopolist always will lend for less than what was actually extorted from a desperate or apathetic debtor. This small whiff of economic theory suggests that a postpetition lender does not completely rely on the supracompetitive profit it may be able to wring from the debtor. It might be possible to expose lender preference clauses to appeal, without defeating a postpetition lender's legitimate reliance interest.[247]

Other courts have ruled that appeals may occur so long as the postpetition lender has recouped the postpetition credit actually advanced. Thus, in the case of a cross-collateralization order, if the postpetition amount has been recouped, but the prepetition amount (newly collateralized by the cross-collateralization order) has not been paid, an appeal

243. *Cf. In re* Glover, Inc., 43 B.R. 322, 325-26 (Bankr. D.N.M. 1984) (accidental postpetition lender who needed no inducement to lend has no claim to administrative priority).

244. Tabb, *Appealability, supra* note 91, at 120 (footnote omitted).

245. By apathy is meant the fact that the debtor uses other people's money—the bankrupt estate that otherwise goes to the general creditors—to pay the supracompetitive price of the postpetition lender.

246. *Id.* at 121-22.

247. *See id.* at 123.

can go forward.[248] This approach has been specifically rejected by some courts that enforce the no-appeal rule of section 364(e).[249] In support of this view is that section 364(e) immunizes liens granted "under this section," i.e., under section 364.[250] Because section 364 does not specifically authorize lender preference clauses, it is arguable that these clauses are reviewable on appeal, even if liens for new value are not.[251]

It is apparent, then, that objecting creditors had better obtain a stay of the order pending appeal. A stay on appeal is within the discretion of the bankruptcy court. According to the Fifth Circuit, the standards a bankruptcy judge should apply are as follows:

1. Whether the movant has made a showing of likelihood of success on the merits;
2. Whether the movant has made a showing of irreparable injury if the stay is not granted;
3. Whether the granting of the stay would substantially harm the other parties; and
4. Whether the granting of the stay would serve the public interest.[252]

These standards are difficult to meet. Just having signed a postpetition credit order, it is unlikely that a bankruptcy judge will think that the

248. Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1101 (2d Cir. 1979); *see also* Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. (*In re* Ellingsen MacLean Oil Co.), 834 F.2d 599 (6th Cir. 1987) (Merritt, J., dissenting) (§ 364(e) "is not designed to cut off the right to appeal rulings on *prepetition* matters . . . but only affects authorized postpetition loans and liens to secure such loans"), *cert. denied,* 488 U.S. 817 (1988).

Texlon was a case under the old Bankruptcy Act, which contained no equivalent to Bankruptcy Code § 364(e). Instead, the court was ruling on whether the district court was free to hold a *de novo* hearing on—not an appeal from—a cross-collateralization order. This depended on whether the postpetition lender relied on the order in extending postpetition credit. The court wrote:

> While it may be that [the postpetition lender] would not have engaged in these transactions but for its hope of securing a preferred position for the pre-petition debt, this is not the kind of prejudice that bars reconsideration. The test is whether, upon granting the motion to reconsider, the court will be able to reestablish the rights of the opposing party as they stood when the original judgment was rendered.

596 F.2d at 1101 (citations omitted).

249. Burchinal v. Central Wash. Bank (*In re* Adam's Apple, Inc.), 829 F.2d 1484, 1488-89 (9th Cir. 1987) (holding generally that § 364(e) immunizes cross-collateralization orders, including the prepetition parts).

250. *Id.*

251. Tabb, *Appealability, supra* note 91, at 118-19; Tabb, *Cross-Collateralization, supra* note 12, at 142-44. This argument was noted but ignored in *Ellingsen MacLean Oil,* 834 F.2d at 601.

252. *In re* First South Sav. Ass'n, 820 F.2d 700 (5th Cir. 1987).

aggrieved party has a substantial likelihood of victory on appeal,[253] especially in light of section 364(e)'s no-appeal rule. Furthermore, these orders often are genuine emergencies. Therefore, the stay on appeal substantially would harm the debtor and perhaps others.

For this reason, bankruptcy courts often deny a stay pending appeal.[254] When this occurs, courts have ruled that the appeal cannot be allowed. Thus, in *Burchinal v. Central Washington Bank (In re Adam's Apple, Inc.),*[255] a stay was denied at first, but granted upon a second request.[256] The Ninth Circuit ruled that the second stay came too late to prevent immunity from appeal.[257]

OTHER MEANS OF OBTAINING APPELLATE REVIEW

The preceding section demonstrated that, under a common reading of section 364(e), postpetition lenders have a substantial immunity from losing their postpetition liens on appeal. There may be other methods to prevent the invocation of that immunity, however.

One idea is to characterize the appeal as a request to the district court for a *de novo* review of the bankruptcy judge's postpetition credit order. Because section 364(e) applies only to appeals, an aggrieved party might defeat the postpetition lender's immunity by this means. In *Texlon,* the court, in a case under the old Bankruptcy Act, suggested that a district court simply could rehear a matter on which a bankruptcy court had already ruled.[258] That is, the district court need not view itself as an appellate court but simply could displace the bankruptcy court at the trial level and start over. This idea stems from *Wayne United Gas Co. v. Owens-Illinois Glass Co.*[259] and is conditioned on that fact that "no intervening rights will be prejudiced by its action."[260] In *Texlon,* the court ruled that a postpetition lender was not prejudiced if its cross-collateralization rights were to be reversed by a district court on this theory.[261]

This theory, if accepted, would allow district courts to sidestep the immunity from "appeal" mandated by section 364(e). Accordingly, it is likely

253. *See* Ruiz v. Estelle, 650 F.2d 555, 565 (5th Cir. Unit A June 1981) ("the movant need not always show a 'probability' of success on the merits; instead, the movant need only present a substantial case on the merits when a serious legal question is involved and show that the balance of the equities weighs heavily in favor of granting the stay").

254. Tabb, *Appealability, supra* note 91, at 131 ("Given the standards for issuance of a stay, it is fair to assume that no stay will ever be obtained.").

255. 829 F.2d 1484 (9th Cir. 1987).

256. *Id.* at 1490-91.

257. *Id.* The possibility of obtaining a writ of mandamus from the court of appeals with regard to the stay pending appeal is discussed *infra* text accompanying notes 268-77.

258. Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1100 (2d Cir. 1979).

259. 300 U.S. 131, 137-38 (1937).

260. *Texlon,* 596 F.2d at 1100.

261. *Id.*

that some courts, worried about compromising principles of finality in bankruptcy,[262] will be tempted to hold that the Bankruptcy Code overrules *Wayne United Gas*.[263] Nevertheless, the theory has as its basis the support of section 157(d) of the Judicial Code, which provides: "The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown."[264] This theory has not yet been advanced in a case under the Bankruptcy Code and may yet be accepted by a court that is hostile to the anti-appeal policy of section 364(e).[265]

A second theory whereby section 364(e) might be evaded is to move the district court for a stay pending appeal. According to Bankruptcy Rule 8005:

> A motion for a stay of the judgment, order, or decree of a bankruptcy judge . . . must ordinarily be presented to the bankruptcy judge in the first instance. . . . A motion for such relief, or for modification or termination of relief granted by a bankruptcy judge, may be made

262. The commentators usually decry the holding in *Texlon* as undoing finality. *See* Bohm, *supra* note 111, at 306-07; Ordin, *supra* note 111, at 176-80; Tabb, *Cross-Collateralization*, *supra* note 12, at 137 ("Reorganizations may be threatened if people cannot do business with the debtor with the assurance that benefits granted to them will be honored once the time for appeal has expired.").

Professor Tabb constructs the following argument: the United States trustee system, made national in 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986), is designed to relieve bankruptcy judges from administrative burdens and make them more like real judges. Therefore, their decisions should be deemed final, contrary to the court's views in *Texlon*. Tabb, *Appealability*, *supra* note 91, at 141.

263. Even in 1979, a 1973 Advisory Committee Note to Bankruptcy Rule 924 (incorporating Rule 60(b) into bankruptcy practice) read: "These rules do not preserve the features of the practice pertaining to so-called 'administrative orders,' which have been regarded as subject at any time to reconsideration by the referee or to review by the district court. . . ." Bankr. Rule 924 (Adv. Comm. Note 1973). The court dismissed this remark by noting that rule 924 (now rule 9024) did not overrule cases like *Wayne United Gas* by name; therefore, they were still good. In addition, the *Texlon* court noted that rule 924 could not have the effect of overruling *Wayne United Gas* solely by reference to rule 60(b). 596 F.2d at 1099-1101. Rule 60(b) was also in effect for bankruptcy cases in 1942, when the Supreme Court reaffirmed *Wayne United Gas* in Pfister v. Northern Ill. Fin. Corp., 317 U.S. 144 (1972); *see* Ordin, *supra* note 111, at 174 (referring to this argument as "bland" and finding the court's position "incomprehensible").

Professor Tabb points out, however, that, in 1979, the Bankruptcy Rules were to take precedence over congressional enactments. Pub. L. No. 88-623, 78 Stat. 1001 (1964). Therefore, the court should have paid more attention to the 1973 Advisory Committee Note. Tabb, *Appealability*, *supra* note 91, at 139. This exaltation of the rules over the statutes came to an end in the Bankruptcy Reform Act, Pub. L. No. 95-598, § 247, 92 Stat. 2672 (1978), amending 28 U.S.C. § 2075 (1988).

264. 28 U.S.C. § 157(d) (1988).

265. The *Texlon* court invoked *Wayne United Gas* because the appellant had not reserved his right to appeal within the time required by the applicable rules. Under the *Wayne United Gas* theory, the trustee did not appeal at all, but simply asked the district court to hold a *de novo* hearing.

> to the district court or the bankruptcy appellate panel, but the motion shall show why the relief, modification, or termination was not obtained from the bankruptcy judge.[266]

If a district court can be convinced to intercede, it can issue a stay pending the appeal and then actually decide the appeal without any impediment from section 364(e). If it refuses to intercede, however, no appeal can be taken to a court of appeals.[267]

A third idea for obtaining relief from a bankruptcy court's refusal to stay the postpetition credit order pending appeal is a writ of mandamus from the appellate courts. In *In re First South Savings Ass'n,*[268] a debtor in possession located a new lender who would advance funds in exchange for a superpriority lien over that held by the existing prepetition lienholders. The bankruptcy court granted the debtor's section 364(d) motion.[269] It also denied the secured party's subsequent motion for a stay pending appeal.[270] The district court denied the same motion.[271] The secured party then sought a writ of mandamus from the Fifth Circuit requesting that the district court be required to issue a stay pending appeal. The Fifth Circuit stayed the bankruptcy court's order on an ex parte basis, and revoked the writ following a response from the debtor.[272] Subsequently, the Fifth Circuit granted the secured party's motion to reconsider and so reinstated the writ of mandamus.[273]

The writ of mandamus, the court said, is an extraordinary one:[274]

> Given that the decision to deny a stay pending appeal is one committed to the discretion of the trial court, a clear and indisputable right to the issuance of the writ of mandamus will arise only if the district court has clearly abused its discretion, such that it amounts to a judicial usurpation of power.[275]

Nevertheless, the court found the evidence on the record insufficient to support a holding that the subordinated secured party would be adequately protected from the superpriority lien.[276]

266. Bankr. Rule 8005.

267. National Bank of Commerce v. Barrier (*In re* Barrier), 776 F.2d 1298, 1299 (5th Cir. 1985) (per curiam).

268. 820 F.2d 700 (5th Cir. 1987).

269. *Id.* at 703.

270. *Id.*

271. *See* Bankr. Rule 8005.

272. *First S. Sav. Ass'n,* 820 F.2d at 703.

273. *Id.* at 703-04.

274. *Id.* at 705.

275. *Id.* at 707. The court's remarks are aimed at the premise that it is the district court that may have abused its discretion, not the bankruptcy court. This may stem from the fact that the secured party moved the district court to stay the bankruptcy court's order pending appeal.

276. *Id.* at 713-14.

The postpetition credit order in the *First South Savings Ass'n* cases was not urgent. Therefore, in the typical emergency context where these orders are signed, it is not clear how solid a precedent the case is for using the writ of mandamus to sidestep the no-appeal rule of section 364(e).[277]

DUE PROCESS

From the bankruptcy trustee's perspective, sending notice to the creditors is bothersome and bureaucratic. It is the least entertaining part of the practice. Postpetition credit orders often are given in emergency situations, or so it is usually claimed. Giving notice of these orders under emergency conditions is particularly irksome. Yet creditors are furious when they lose money by some court order or deadline of which they were not informed. Furthermore, the due process clause of the Fifth Amendment to the United States Constitution prohibits the taking of life, liberty or property without due process of law,[278] which ordinarily means that creditors are entitled to notice and a hearing.

Now section 364(c) and (d)(1) already require that postpetition credit be extended only after a notice and a hearing, but section 102(1) states that notice and a hearing:

> (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but
>
> (B) authorizes an act without an actual hearing if such notice is given properly and if—
>
> (i) such a hearing is not requested timely by a party in interest; or
>
> (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.[279]

Meanwhile Bankruptcy Rule 4001(c) requires that only the creditors' committee or (if none) the twenty largest creditors need be informed. This limited notice has been held consistent with due process.[280] Indeed, as Professor Tabb points out, due process can choke a proceeding to death.[281] Such a flexible approach is likely to benefit the smaller creditors much more than a rule that proliferates notice in a useless way.

277. *See* Tabb, *Appealability, supra* note 91, at 130 n.143.

278. U.S. CONST. amend V.

279. 11 U.S.C. § 102(1) (1988).

280. *In re* Photo Promotion Assocs., Inc., 53 B.R. 759, 762-63 (Bankr. S.D.N.Y. 1985).

281. *See* Tabb, *Appealability, supra* note 91, at 151-52. Tabb analogizes the notice requirement to the rules for class actions, where similar relaxations are made in recognition of the fact that burdensome notice requirements can destroy the whole purpose of a class action. *Id.*

Due process considerations weigh heavily in enforcing bar dates against creditors who have not filed claims.[282] In these cases, individual creditors were entitled to notice. Not so in postpetition lending cases. Professor Tabb defends the class-action-style rules for postpetition credit orders as follows:

> Those cases have required individual notice of the bar order. They are distinguishable from financing order cases, however, because the action being noticed affected the specific creditor in an individual way by the direct deprivation of a property right. In the financing order context . . . the class interest is identical, and thus notice to a representative should suffice.[283]

Yet, Tabb points out, there is a difference between class actions and bankruptcy. In a class action, the court must make a determination that the class representative indeed represents the class.[284] No such determination is made in bankruptcy. Instead, the creditors' committee is appointed by the United States Trustee[285] without any specific requirement of a finding on representativeness.[286] Also, when there is no committee, only the twenty largest creditors receive notice.[287] Nevertheless, in the interest of minimizing empty bureaucracy, these rules ought to be deemed enough to satisfy due process concerns.

As for how much notice is required, Rule 4001(c) stipulates fifteen days before a hearing, but a court may hold a hearing earlier "only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing."[288] As Professor Tabb suggests: "At the temporary hearing, the court should only approve the amount of financing absolutely necessary to get through the initial emergency."[289] In particular, the temporary hearing should never be the forum in which a cross-collateralization clause is approved; this should be approved only at the later hearing: "Only then can creditor consent have any real meaning."[290] Indeed, in the final analy-

282. *See generally* Kenneth N. Klee & Frank A. Merola, *Ignoring Congressional Intent: Eight Years of Judicial Legislation*, 62 AM. BANKR. L.J. 1, 22-25 (1988).

283. Tabb, *Appealability, supra* note 91, at 153.

284. Fed. R. Civ. P. 23(c)(1).

285. Bankr. Rule 4001(c)(1).

286. Former Bankruptcy Act § 1102(b)(1), repealed in 1986, authorized the court to change the membership of the creditors' committee to ensure representativeness. This was repealed at the same time the United States Trustee system was put into place.

287. Bankr. Rule 4001(c)(1).

288. Bankr. Rule 4001(c)(2).

289. Tabb, *Emergency Prefential Orders, supra* note 129, at 80.

290. *Id.* at 83.

sis, the court's objection to cross-collateralization in *Texlon Corp.* was that the postpetition credit order was granted at an *ex parte* hearing.[291]

The *ex parte* hearing is the ultimate test of the due process rights of creditors against postpetition lending. But it must be said that, in this modern age of speaker phones and conference calls, a pure *ex parte* hearing should no longer ever be truly necessary. Instead, hearings on extremely short notice, which are constitutionally preferable, should always be possible.[292] Even so, some judges have defended the possibility of postpetition credit on an *ex parte* basis.[293] Supposedly they are acceptable if immediate and irreparable injury would otherwise result.[294] One court thought that *ex parte* orders were acceptable if the postpetition lender already was oversecured,[295] though, of course, this is the finding creditors might challenge if the hearing were contested.

Another question about the due process clause is whether general creditors, who are often the ones challenging postpetition credit, have lost "property" within the meaning of the fifth amendment when the trustee grants a security interest in exchange for a postpetition loan. Some courts have thought so,[296] but this may be doubted. First, the general creditor has no direct right in the property encumbered by the lender's mortgage.[297] Second, even if the mortgage impinged upon the general creditor's "property," it was issued in exchange for hard cash in which the general creditor also had a property interest. For these two reasons, due process seems a dubious ground to evade the admittedly harsh dictates of section 364(e).

291. Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1098 (2d Cir. 1979) ("Here it suffices to hold that . . . a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order. . . ."); Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1448 & n.21 (9th Cir. 1985) (notice one day before final hearing not sufficient under the circumstances, but hinting a preliminary hearing might be held on this basis).

Of course, the notice actually sent had better be accurate. In *Center Wholesale, Inc.*, the fact the notice actually issued indicated that no other security interest would be harmed was cited as another reason why the already defective notice—sent one day before final hearing—was not competent to compromise the position of the junior secured party. *Id.* at 1450; *see also In re* Monach Circuit Indus., Inc., 41 B.R. 859, 860 (Bankr. E.D. Pa. 1984).

292. The classic statement of how much notice is required is Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950), where the court required that only *reasonable* notice be given, depending on the circumstances. *Id.* at 314-15.

293. *In re* Public Leasing Corp., 344 F. Supp. 754 (W.D. Okla. 1972) (upholding an *ex parte* postpetition lending order); *see* Bohm, *supra* note 111, at 291-92; Ordin, *supra* note 102, at 188-89.

294. *In re* Sullivan Ford Sales, 2 B.R. 350 (Bankr. D. Me. 1980) (nevertheless striking down the lien because the debtor could have arranged for notice to the creditors).

295. *In re* FCX, Inc., 54 B.R. 833 (Bankr. N.D.N.C. 1985).

296. Credit Alliance Corp. v. Dunning-Ray Ins. Agency, Inc. (*In re* Blumer), 66 B.R. 109 (9th Bankr. 1986).

297. *See In re* Garland Corp., 6 B.R. 456, 462 (Bankr. 1st Cir. 1980) (emphasizing that general creditors have no adequate protection or fifth amendment due process rights against postpetition lender).

Nevertheless, a junior secured party impaired by a superpriority lien certainly has a due process complaint that a court will hear, as the first Justice Harlan made clear a century ago in *Union Trust Co. v. Illinois Midland Co.*[298]

If, however, a postpetition credit order finally does violate the due process rights of a creditor, then the order is void under rule 60(b)(4).[299] The court, in *Credit Alliance Corp v. Dunning-Ray Insurance Agency, Inc. (In re Blumer),*[300] also thought that a due process defect meant that section 364(e) could not bar the appeal.[301] For this proposition the court cited *Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (In re Center Wholesale, Inc.).*[302] In that case, however, the court seemed to be *upholding,* not renouncing, section 364(e).[303] The *Center Wholesale* court suggested that section 364(e) limited the injured secured party to a mere section 507(b) superpriority. In any case, the court in *Credit Alliance Corp.* made up for the error one year later in *Butler Paper Co. v. Graphic Arts Lithographers, Inc. (In re Graphic Arts Lithographers, Inc.).*[304] Inexplicably citing *Blumer* as authority, the court ruled that due process defects (in this case, three hours' telephonic notice of the hearing) did not justify an appeal, in light of section 364(e).[305]

CONCLUSION

Postpetition lending orders often are granted hastily to prevent some real or imaginary emergency. The pressure on a bankruptcy judge to give in to the exorbitant demands of the postpetition lender is enormous. In light of the oppressive conditions under which a chapter 11 reorganization proceeding commences life, it would be better if clear rules against abuse by lenders were insisted upon, by legislation or otherwise. If nothing else, the abolition of cross-collateralization orders and the like would at least mean that a postpetition lender must state the price in terms of an interest rate. This standard price term is much more likely to alert the judge to

298. 117 U.S. 434, 460 (1886). Against whom a remedy lies, however, is another question. Judge Richard Posner recently ruled that a bona fide purchaser of collateral that was sold without notification to a secured creditor nevertheless takes free and clear of that creditor's lien. *In re* Edwards, 962 F.2d 641, 644 (7th Cir. 1992). This implies that the remedy lies only against the bankruptcy estate or perhaps against the federal government, if the estate is depleted.

299. Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1448-50 (9th Cir. 1985).

300. 66 B.R. 109 (Bankr. 9th Cir. 1986).

301. *Id.* at 113-14.

302. 759 F.2d 1440 (9th Cir. 1985).

303. *Id.* at 1450.

304. 71 B.R. 774 (Bankr. 9th Cir. 1987).

305. *Id.* at 776. The words "due process," however, were never spoken, so that perhaps *Graphic Arts* is a case in which due process was never implicated.

overreaching. Meanwhile, because any lender advantage can be restated in terms of an interest rate, lenders will not be adversely affected if they cannot ask for or receive exotic preferences.

These bright line rules also would effectively destroy the no-appeal rule of section 364(e), as applied to abusive postpetition lending orders. If a bright line test against cross-collateralization and the like existed, any postpetition lender who obtained a loan on those terms would know the order violated the Bankruptcy Code. Such a lender would not be acting in good faith, and the no-appeal would no longer apply.

These firm measures would go a long way toward reducing the chaos that currently exists in the area of postpetition lending.