

Cash Collateral:
The Risks of Non-Consensual Use

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The filing of a Chapter 11 petition automatically creates an estate consisting of all property owned by the debtor at the time of filing.² For any business, this property includes cash. Section 363(a) of the Bankruptcy Code defines cash and cash equivalents as "cash collateral." Often a secured creditor, such as a bank or federal government, holds a security interest in cash collateral.

Under Section 363(c)(2), the debtor is absolutely prohibited from spending cash collateral without the consent of all parties that have an interest in the collateral, or a court order.³ The basis for this prohibition is that security interests are constitutionally protected property rights.⁴

This rule proscribing the use of cash collateral is simple and straightforward. Sometimes a debtor will make expenditures without the consent of the secured creditors or the authority of the court. When this happens, the entire Chapter 11 case is placed at risk and the representative of the debtor who directed the misuse of cash collateral may face significant financial penalties.

I. Implied Versus Express Consent

Typically, the Chapter 11 debtor files an emergency motion for the use of cash collateral when the petition is

¹The views expressed in this article are those of the author and do not necessarily represent the views of, and should not be attributed to, the U.S. Department of Justice or the U.S. Trustee Program.

²11 U.S.C. Section 541(a).

³In re Archer, 34 B.R. 28, 30 (Bankr. N.D. Tex. 1983).

⁴ See In re George Ruggiere Chrysler-Plymouth, 727 F.2d 1017, 1019 (11th Cir. 1984).

filed.⁵ Courts usually grant these emergency motions and authorize debtors to make the appropriate expenditures.

Sometimes a debtor uses the cash collateral and later contends that the secured creditor gave implied consent for expenditures, giving rise to a dispute over whether consent was in fact given. The term "consent" suggests "an act of reason, accompanied with deliberation."⁶ In Freightliner Market Dev. v. Silver Wheel Freight, 823 F. 2d 362, 368-369 (1987), the Ninth Circuit ruled that consent must be expressed and that implied consent is insufficient as a matter of law to satisfy the requirements of Section 363(c)(2)(A).

A contrary ruling was made in Matter of National Safe Northeast, Inc., 76 B.R. 896, 907 (Bankr. D. Conn. 1987), in which the debtor expended cash collateral without the express consent of the secured creditor. In National Safe, the secured creditor knew that the debtor was spending cash collateral but did not seek to prohibit its use. The court placed the burden on the secured creditor:

[A] secured creditor on notice may not choose to ignore unauthorized use of cash collateral until a chapter 11 case is converted and then seek to recover damages for all of the funds so misused.

The same result occurred in In Re Unity Foods, Inc., 75 B.R. 222 (Bankr. N.D. Ga. 1987), in which the secured creditor asserted that the debtor misused its cash collateral. The secured creditor, who was also the principal of the debtor, sought a replacement lien as a remedy for the purported misuse of cash collateral. The court denied the request, noting that the debtor used the cash with the knowledge of the secured creditor and while it was under the control of the secured creditor. The court further emphasized that the secured creditor was the principal of the debtor. Therefore, the equities did not favor the secured creditor.

Despite the authority that a secured creditor may consent to use of cash collateral through acts or failure to protect its interests, the penalties for misuse of cash collateral can be severe. A safer approach is to seek a consensual agreement incorporated into the cash collateral order.

⁵See FED.R.BANKR.P. 4001(b)(2).

⁶Black's Law Dictionary 276 (5th ed. 1979).

II. Risks To The Officers of the Debtors

Courts have imposed a wide range of sanctions upon officers of debtors who misuse cash collateral. There is case law suggesting that counsel may have an obligation to notify the court if counsel becomes aware that the debtor is misusing cash collateral.⁷

The debtor's officers may face the risk of personal liability under the tort of conversion if they misuse the cash collateral.⁸ Conversion is "the wrongful exercise of dominion and control over another's property in denial of or inconsistent with his rights."⁹ Under this cause of action, anyone who participates in the unauthorized use of cash collateral may be jointly and severally liable for the conversion. Therefore, a monetary judgment may be rendered in an adversary proceeding against a corporate officer who actively participated in making unauthorized expenditures.¹⁰

Misuse of cash collateral is a serious enough offense that a judgment against the principal for monetary damages may carry the weight of a non-dischargeable debt. In In re Alvey, 56 B.R. 170 (Bankr. W.D. Ky. 1985), a debtor filed a Chapter

⁷See In re Rivers, 167 B.R. 288 (Bankr. N.D. Ga. 1994)(If a debtor in possession is incompetent, it should be apparent that reorganization is unlikely, if not impossible, and it is the duty of a court-appointed professional to bring that fact to the attention of the United States Trustee and the court)(Citation omitted); See also Midwest Properties No. Two v. Big Hill Inv. Co., 93 B.R. 357, 361 (N.D. Tex. 1988)(District court ruled that sanctions could be imposed against counsel and principal in part because of misuse of cash collateral, but remanded case for new computation and allocation of sanctions between parties).

⁸Matter of Koran Enterprises, Inc., 61 B.R. 321, 326-327 (Bankr. W.D. Mo. 1986).

⁹Amarillo National Bank v. Komatsu Zenoah America, Inc., 991 F. 2d 273, 274 (5th Cir. 1993)(Citation omitted).

¹⁰See Koran Enterprises at 327; see also In re Fay Associates Ltd. Partnership, 225 B.R. 1,7 (Bankr. D.D.C. 1998)(Remedies for misuse of cash collateral include personal liability).

11 case during which he made unauthorized expenditures out of cash collateral. After the Chapter 11 case concluded, he filed a Chapter 7 petition. The secured creditor whose cash collateral was misused filed a complaint objecting to the dischargeability of his debt on the ground that the debt resulted from the debtor's defalcation.

The court ruled that the debt was not discharged except to the extent that any expenditures preserved the secured creditor's collateral. The court stated that "the unauthorized use of cash collateral by a Chapter 11 debtor creates a prima facie case of breach of fiduciary duty in a nondischargeability complaint in a later Chapter 7 proceeding."¹¹

A simpler approach is to require the debtor's principal to repay the secured creditor. In In re Etch-Art, Inc., 48 B.R. 143 (Bankr. D.R.I. 1985), a Chapter 11 debtor spent cash collateral in violation of Section 363(c) and a court order. The secured creditor sought to find the debtor and its principal in contempt. Although the court denied the request for contempt, it ruled that the debtor's principal must compensate the secured creditor for the amount of the loss.

The court stated its view plainly:

[W]e know that some cookies are missing from the jar, and that Nancy Ronci should be ordered to put some back, but we don't know how many.¹²

Sanctions for contempt of court remain a viable remedy for the unauthorized use of cash collateral. In In re Spring Plaza Associates, L.P., 188 B.R. 50 (Bankr. M.D. Fla. 1995), the debtor made payments that were not authorized by a cash collateral order. The secured creditor asked the court to find the debtor in contempt of court. The court granted the motion, but allowed the debtor the opportunity to purge itself of

¹¹In re Alvey, 56 B.R. at 173-174. See also In re Weber, 99 B.R. 1001, 1019-1020 (Bankr. D. Utah 1989)(Debtor's discharge denied, in part, because he had violated terms of cash collateral order); See also In re Aerosmith Denton Corp., 36 B.R. 116, 119 (Bankr. N.D. Tex. 1983)(Proper sanctions can be imposed against those responsible for use of cash collateral).

¹²In re Etch-Art, Inc., 48 B.R. at 147.

contempt by remitting to the secured creditor the amount of the unauthorized payments.

Sometimes the remedy for contempt of court is more punishing. In re Williams, 191 B.R. 497 (Bankr. M.D. Ga. 1996) illustrates the breadth of possible sanctions. In Williams, creditors filed a motion to find the debtors in contempt for violating a cash collateral order. The court found that the debtors violated a cash collateral order by withdrawing segregated funds and continuing to use cash collateral without authority. As a remedy, the court ordered the debtors to repay the misappropriated funds, account for the decline in inventory, pay \$2,500 in punitive damages to each creditor, and reimburse the creditors for their attorneys's fees.¹³ What makes this remedy remarkable is that the court specifically noted that there was "no indication that Debtors diverted any significant amount of Movants' collateral to their own use."¹⁴

III. Risks To the Continuation or Success of the Case

There is no specific provision in the Bankruptcy Code that provides a remedy to be imposed against the Chapter 11 debtor for the misuse of cash collateral.¹⁵ However, courts have cited various sections of the Bankruptcy Code to craft remedies for the misuse of cash collateral.

Section 1112(b) provides that the court may dismiss or convert a Chapter 11 case for cause. This section permits the court to consider a wide range of factors, including an inability to effectuate a plan, an unreasonable delay or an absence of a reasonable likelihood of rehabilitation when

¹³In re Williams, 191 B.R. at 503.

¹⁴Id. See also In re Williams, 61 B.R. 567, 575 (Bankr. N.D. Tex. 1986) (Debtor liable for sanctions for unauthorized use of cash collateral).

¹⁵In re Kleather, 208 B.R. 406, 416 (Bankr. S.D. Ohio 1997). Section 413 of H.R. 833 (the Bankruptcy Reform Act of 1999) states that the "unauthorized use of cash collateral harmful to one or more creditors" is a ground for conversion or dismissal of the case. See proposed 11 U.S.C. § 1112(b)(3)(D).

there is also a diminution of the estate.¹⁶ When the debtor has made unauthorized expenditures out of cash collateral, a traditional remedy is the dismissal of the case, as in In re Alvey, 56 B.R. 170 (Bankr. W.D. Ky. 1985).

A debtor's violation of a cash collateral order may also bring about the "effective termination" of the Chapter 11 case, if the court denies future access to cash collateral. In re Oxford Royal Mushroom Products, Inc., 19 B.R. 974 (Bankr. E.D. Pa. 1982) illuminates the dangers associated with defying cash collateral orders.

In Oxford Royal, a Chapter 11 debtor and secured creditor stipulated to an order under which the debtor was permitted to use cash collateral. The order authorized the court to terminate the future use of cash collateral if the debtor failed to comply with the order. After the debtor breached the terms, the secured creditor obtained an order terminating the use of cash collateral. The debtor subsequently sought court authority to use cash collateral. The court denied the motion with the following reasoning:

We conclude that the proper interpretation of that clause is that the debtor is precluded from using the cash collateral under any circumstances. It does not mean that the debtor has simply lost the ability to use the cash collateral with the consent of the bank, as provided by § 363(c)(2)(A), but it also means that the debtor has likewise lost the right to seek authority from the court for the use of cash collateral pursuant to § 363(c)(2)(B).¹⁷

Without the ability to use cash collateral, it would be unlikely that the debtor could function. Thus, the case would effectively be terminated.

Bankruptcy courts are often reluctant to terminate a Chapter 11 case even if the debtor has misused cash collateral. Nonetheless, the debtor should consider the response that the unauthorized use of cash collateral may invoke from the court and the creditors. Pursuant to Section

¹⁶In re C-TC 9th Avenue Partnership, 113 F.3d 1304, 1311, n. 5 (2nd Cir. 1997).

¹⁷In re Oxford Royal Mushroom Products, Inc., 19 B.R. at 975.

1107(a), a debtor in possession is vested with most of the powers and duties of a trustee. A debtor that acts with indifference to the special treatment afforded to cash collateral undercuts the trust reposed in it and the credibility of its management. The likely result is that its future actions will be viewed with great scrutiny and suspicion. This does not bode well for a successful Chapter 11 case.

Even if the bankruptcy court does not dismiss the case or terminate the use of cash collateral, the debtor remains vulnerable at the confirmation stage of the case. Section 1112(a)(2) provides that to satisfy the requirements for plan confirmation the proponent must comply with the applicable provisions of Chapter 11. In Cothran v. United States, 45 B.R. 836 (S.D. Ga. 1984), this requirement was invoked to deny plan confirmation on the grounds that the debtor had "spent cash proceeds from the sale of collateral without the court's permission." The import of this decision should not be understated: if a debtor violates a cash collateral order, its entire effort in Chapter 11 may be futile.

Conclusion

A debtor in possession is a fiduciary, whose responsibilities include ensuring that cash collateral is not used without the consent of the secured creditor or a court order. The officers of the debtor should not assume that the requirements governing cash collateral are mere technicalities without force and effect. The officer of a debtor that misuses cash collateral, for whatever purpose, is subject to personal liability. This liability may result in the imposition of punitive damages or the entry of an order to refund an amount equal to the cash collateral expended.

The potential consequences to the Chapter 11 debtor and the Chapter 11 case are equally severe. Misuse of cash collateral may cause the dismissal or effective termination of the case. At the end of the case, the debtor may find that confirmation is denied.

Given the serious consequences of misusing cash collateral, the best approach is to ensure that cash collateral is spent only with express authority incorporated in an order of the court.

