

COMMERCIAL BANKRUPTCY

Show Me the Money!

Cash Collateral Orders in Chapter 11 Bankruptcy Cases

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Your borrower, with or without warning, files a Chapter 11 bankruptcy case. You are secured by the borrower's inventory, accounts receivable and/or lease payments. Loan payments are in default, but your rights to pursue collection are automatically stayed until further order of the bankruptcy court. Now what?

The proceeds of a lender's collateral are called "cash collateral," as defined in Section 363 of the Bankruptcy Code. Common examples of cash collateral are monies derived from a debtor's sale of inventory, collections on accounts receivable, and cash from lease payments on the lender's real property collateral. **The bankrupt debtor may not use cash collateral without the lender's consent or a court order authorizing its use.** *In re Cross Baking Co., Inc.*, 818 F.2d 1027 (1st Cir. 1987).

A bankrupt debtor is usually cash poor and needs to use the cash collateral to pay expenses necessary to stay in business. Accordingly, the debtor will file a cash collateral motion with the bankruptcy court, often on the first day of the bankruptcy case, so that the debtor can make payroll; buy additional inventory; and pay ongoing utility bills, insurance premiums, and other expenses necessary to stay in business. On the same day, the Court will enter an interim order (often good for 15 days) and set a follow-up hearing so that the debtor can give sufficient notice of the hearing date to all interested parties. The debtor will then notify the lender of the motion and the hearing date, and press for an agreement for the use of the cash collateral.

This is the secured lender's first opportunity in a Chapter 11 bankruptcy case to set the course of the proceedings with respect to the secured lender's rights. At this early stage of the case, the critical terms of a cash collateral order will include a budget for the debtor's operations during the bankruptcy case and provisions for post-petition liens on the debtor's assets. **Without these provisions, the lender's liens will not attach to the debtor's post-petition inventory and other asset purchases, even if the purchases are made with the lender's own cash collateral.** The lender can also take this opportunity to negotiate other provisions to further secure and protect the lender's rights. For instance, the lender may negotiate the following provisions:

- Adequate protection payments or additional collateral. Depending on the lender's collateral, a potential decrease in its value may justify such payments or additional collateral.
- Agreement as to the balance of the indebtedness and the treatment of the lender's claim as fully secured in the debtor's plan of reorganization, with a valid and enforceable security interest.
- Case deadlines for filing and confirming the debtor's plan of reorganization.
- Access to collateral and the debtor's books and records for inspection or appraisals.
- Additional financial reporting beyond that required by the Bankruptcy Rules and Code.
- Insurance on the lender's collateral.
- Termination of the automatic stay if the debtor defaults under the cash collateral order.
- Other agreements to assist the lender in evaluating the debtor's business operations and protecting the lender's collateral.

Bankruptcy courts are usually reluctant to deny the debtor's motion to use cash collateral, since such denial will likely result in the debtor's business being shut down and the conversion of the case to a Chapter 7 liquidation bankruptcy. However, if the debtor files a bankruptcy case in bad faith, or takes some other egregious action, a secured lender may be justified in opposing the debtor's motion for the use of cash collateral.

Chapter 11 proceedings move quickly in the first several weeks of the case. Thus, it is crucial that a secured lender take prompt action to fully protect its position.

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