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***163 SAYBROOK MANUFACTURING: IS CROSS-COLLATERALIZATION MOOT?**

Karen M. Gebbia [FNa1]

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Introduction [FN1]

One of the first and most critical tasks confronting a business debtor that seeks to reorganize under Chapter 11 [FN2] of the Bankruptcy Code (the Code) *164 is to obtain operating capital; either through the use of cash on hand, cash generated from operations, new financing, or some combination thereof. [FN3] Except in the rare [FN4] circumstance of a debtor in possession (DIP) [FN5] that generates sufficient unencumbered revenues to operate its business, the DIP will need to (1) use its secured creditors' cash collateral [FN6] on a consensual or nonconsensual basis [FN7] or (2) obtain new financing, [FN8] from either an existing lender or a new lender. [FN9]

*165 The recent decision of the U.S. Court of Appeals for the Eleventh Circuit in *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.)* [FN10] has spurred significant controversy through its restrictive interpretation of the incentives and protections that a DIP may offer to lenders to obtain financing under the Code.

Saybrook held that a DIP may not grant postpetition [FN11] liens to secure a creditor's prepetition undersecured claim as part of an arrangement to induce that creditor to provide the DIP with postpetition financing. In so holding, *Saybrook* was the first circuit court unambiguously to condemn the frequently employed financing incentive commonly known as cross-collateralization. [FN12] Lower courts and commentators have debated the merits of cross-collateralization for a number of years. [FN13]

Saybrook further held that the statutory mootness doctrine, which protects a financing order from reversal or modification on appeal in the absence of a stay pending appeal, does not apply to a financing order that grants cross-collateralization liens in favor of a prepetition creditor. [FN14] Critics voice concern that this portion of *Saybrook's* holding may jeopardize DIPs' ability to reorganize because lenders may be reluctant to advance crucial new financing until all appeals from financing orders have been resolved.

This article examines the *Saybrook* decision in the context of prior case law and the general principles underlying the Code. The first section lays the foundation for an analysis of *Saybrook* by identifying the fundamental tenets of the Code and outlining the protections available under the Code to preserve secured creditors' property interests in their collateral and to induce lenders to provide DIPs with new credit. The next section defines cross-collateralization, analyzes the *Saybrook* decision in the context of prior case law, and considers whether cross-collateralization is permissible under the Code's express provisions and general policies. The

*166 authors conclude that the Code's language, history, and policies should be construed to prohibit cross-collateralization liens because such liens violate the Code's policy of equitable distribution among similarly situated creditors and are inconsistent with the provisions of the Code governing the protection of prepetition secured creditors and the inducement of new financing. [FN15] The article next considers whether and to what extent financing orders are protected from modification or reversal on appeal or in collateral proceedings, and concludes that (1) the Code's statutory mootness doctrine applicable to financing orders should be construed to protect against reversal or modification on appeal all terms of a financing order that relate directly to the new post-petition financing, unless the effect of the order has been stayed pending the appeal, but not to protect any terms that relate directly to the lender's prepetition claims, even in the absence of a stay pending appeal and (2) principles of finality, res judicata and collateral estoppel should insulate all terms of a financing order from direct or collateral attack by any party who failed to preserve its challenge by filing a timely notice of appeal. [FN16] This is followed by an attempt to project *Saybrook's* potential precedential effects and impact on DIP financing. Finally, the authors offer a summary of their conclusions and make certain recommendations designed to guide practitioners and courts in drafting and analyzing financing orders.

General Governing Principles

Cross-collateralization is neither expressly permitted nor expressly prohibited under the Code. Any analysis of whether the Code should be interpreted to permit cross-collateralization must be undertaken in light of the Code's general principles and policies. Cross-collateralization also implicates, and must be examined in view of, the Code's carefully designed schemes to protect prepetition secured creditors and to induce extensions of post-petition credit. Although a detailed examination of the general concepts and specific provisions that implement those concepts is beyond the scope of this article, a brief contextual summary is provided. [FN17]

The Twin Pillars of the Bankruptcy Code

The Code is designed to further the dual purposes (commonly known as the twin pillars) of fostering a “fresh start” for debtors and ensuring equitable*167 distribution to creditors. [FN18] In Chapter 11 cases, these fundamental tenets are described more particularly as providing the debtor with an opportunity to reorganize its business and financial affairs and preserve the jobs of its employees while maximizing recovery for creditors and ensuring equitable distribution to similarly situated creditors in accordance with the priorities established under the Code. [FN19] It is against the backdrop of these goals that the specific provisions of the Code and issues arising in cases under the Code must be analyzed.

Much of the debate concerning the propriety of cross-collateralization focuses on the tension between the rehabilitation and equality principles of the Code. [FN20]

Protections Available to a Prepetition Secured Creditor [FN21]

Determination of Secured Status

*168 The Code defines “lien” as a “charge against or interest in property to secure payment of a debt or performance of an obligation.” [FN22] A creditor's secured status is determined as a function of the value of the creditor's lien in property of the DIP's Chapter 11 estate. Specifically:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim. [FN23]

In essence, this provision splits the claim into a secured component and an unsecured component. [FN24] The secured portion is entitled to special protections during the pendency of a bankruptcy case.

***169 Adequate Protection**

The principal safeguard accorded to secured claims under the Code [FN25] is “adequate protection.” [FN26]

***170 The Purpose of Adequate Protection.** The secured creditor's property interest in its collateral underlies and necessitates the concept of adequate protection. [FN27] Adequate protection is designed to reconcile the tension between the prohibition against the taking of property without due process and just compensation established by the Fifth Amendment to the U.S. Constitution [FN28] and the need in a bankruptcy case to impair the rights and remedies of a secured creditor [FN29] in furtherance of the overriding goals of the Code, i.e., the twin pillars. [FN30] To achieve this balance, adequate protection*171 strives to preserve the value of a lien at the commencement of the case throughout the administration of the case. As one leading commentator has succinctly noted:

The most important message of the Code with respect to the treatment of entities with an interest in property of the estate is that their remedies may be suspended, even abrogated, their right of recourse to collateral may be terminated as it is consumed in the business, but the value of their secured position as it existed at the commencement of the case is to be protected throughout the case when adequate protection is required. [FN31]

When Adequate Protection Is Required. Adequate protection is required when the value of the secured creditor's interest in its collateral is susceptible of diminution by virtue of the pendency of a bankruptcy case or actions taken in a bankruptcy case. First, a secured creditor's request for relief from the automatic stay to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate (e.g., to foreclose on collateral) will be granted if the secured creditor's interest in such property is not adequately protected. [FN32] Second, the DIP *172 may not use, sell, or lease property, including cash collateral, in which a creditor has a lien or security interest absent the secured creditor's consent or adequate protection of the secured creditor's interest in such property. [FN33] Finally, the DIP may not take advantage of the extraordinary power to obtain credit secured by a senior or equal lien on encumbered property unless the preexisting lien is accorded adequate protection. [FN34]

What Interest Is Entitled to Adequate Protection. The interest entitled to protection is the value of the lien in property of the bankruptcy estate. For example, a creditor holding a valid lien in collateral owned by the DIP having a value of \$15,000 securing a \$10,000 claim is entitled to have \$10,000 in value protected against decrease; i.e., the amount required to make the creditor whole. If collateral having a value of \$8,000 secures a \$10,000 claim, the creditor is only entitled to protection of the \$8,000 value; i.e., the amount it could have realized from the collateral if bankruptcy had not intervened and it had been permitted to foreclose. Simply stated, adequate protection protects the lesser of the amount of the claim or the value of the collateral securing the claim. [FN35] Thus, adequate protection payments, liens, or equivalents need be furnished only to the extent that the value of the *173 lien entitled to protection decreases during the administration of a bankruptcy case.

[FN36] If at all times the value of the collateral exceeds the amount of the claim, the “equity cushion” will constitute adequate protection of the creditor's interest. [FN37]

Methods of Providing Adequate Protection. The Code does not expressly define “adequate protection.” Rather, it maintains flexibility by proposing three nonexclusive methods by which the DIP may furnish adequate protection. [FN38] The methods identified are (1) making a cash payment or periodic cash payments to the secured creditor to the extent of any decrease in *174 the value of the creditor's interest in collateral that is property of the DIP's estate; (2) providing additional or replacement liens to the extent of any such decrease; and (3) granting such other relief, other than an administrative expense claim, [FN39] as will result in the realization by the creditor of the “indubitable equivalent” of its interest in its collateral. [FN40] This listing is illustrative and not exhaustive or exclusive. [FN41] For example, if a secured creditor holds a lien on a parcel of real property valued at \$1 million to secure a \$1 million claim, and the DIP's and the creditor's experts agree that the value of the real property is likely to decline at a rate of \$1,000 per month (e.g., as a result of deferred maintenance or market conditions), the DIP might provide adequate protection by making cash payments to the secured creditor in the amount of \$1,000 per month or granting the secured creditor an additional lien on unencumbered property with a value sufficient to secure *175 any deficiency caused by the diminution in value of the original collateral. [FN42]

Inadequate Protection Priority. The valuation issues inherent in any proceeding involving adequate protection create the potential for error. An order or agreement providing for adequate protection may fail to achieve its purpose under a number of scenarios, including where (1) the value of the creditor's collateral diminishes at a rate greater than predicted, such that any adequate protection payments, replacement liens, or other protections are inadequate; (2) the value of new collateral in which the secured creditor has been granted additional or replacement liens is less than predicted, such that the additional or replacement liens do not fully compensate for any diminution in value caused by the DIP's use, sale, or lease of the prepetition collateral; or (3) the value of the DIP's equity in the prepetition creditor's collateral is overstated, such that the value of the property is insufficient to satisfy the prepetition creditor's secured claim after payment of a claim secured by a senior priming lien that has been imposed on the property.

If the “adequate” protection accorded a secured creditor proves to be inadequate, the Code grants the secured creditor an administrative priority claim senior to every other priority claim allowable under the Code. [FN43] Administrative and other priority claims are entitled to be paid in full before any distribution is made on general unsecured claims. [FN44] Nevertheless, this safety net is effective only to the extent that the DIP's estate has unencumbered*176 assets sufficient to meet the adequate protection deficiency. In addition, the priority may be preempted if new postpetition credit is extended to the estate on a “superpriority” or secured basis. [FN45]

Continuing Liens on Proceeds

The provisions of the Code that address the postpetition effect of a prepetition security interest complement the concept of adequate protection. [FN46] In general, Section 552(a) terminates the effect of a prepetition secured creditor's contractual “after acquired” property liens in property acquired by the estate postpetition. [FN47] Nevertheless, Section 552(b) preserves a creditor's contractual security interest in the postpetition generated proceeds, product, offspring, rents, and profits of prepetition collateral, to the extent that the security agreement so provides and unless the court orders otherwise. [FN48]

***177 Summary**

Taken together, the Code provisions governing the protection of secured claims suggest a congressional intent to facilitate debtor rehabilitation by permitting the impairment of the secured creditor's contractual rights while preserving the secured creditor's property interest in its collateral and proceeds. By fostering reorganization rather than liquidation, these provisions also are designed indirectly to maximize value for all creditors. [FN49] The special rights accorded to secured creditors do not violate the Code's principle of equitable distribution of assets among creditors because they do not transfer value to the secured creditor from other creditors. Rather, they are designed merely to maintain the value of a prepetition secured creditor's interest in property of the DIP's Chapter 11 estate.

Protections Available to a Postpetition Lender

Specialized Priorities and Liens

Section 364 [FN50] of the Code governs obtaining credit and incurring debt by a trustee or DIP. The provisions of Section 364 serve the goals of debtor rehabilitation and value maximization by providing special liens and priorities designed to induce lenders to extend credit to a DIP. [FN51]

Postpetition Credit. The Code distinguishes among obtaining (1) unsecured credit in the ordinary course of business allowable as an administrative expense; [FN52] (2) unsecured credit out of the ordinary course of business allowable as an administrative expense; [FN53] (3) credit with a specialized priority over all other priority claims (“superpriority”) or secured by a lien on unencumbered property or a junior lien on encumbered property; [FN54] and (4) credit secured by a senior or equal lien on encumbered property. [FN55] These provisions create a hierarchy of protections, beginning with an administrative priority claim and moving up to a priming lien, for extensions of credit to a DIP. Generally, a lender will not be accorded a higher protection*178 unless the DIP is unable to obtain essential credit from any source after reasonable investigation by granting a lower protection. [FN56]

The protections that a lender actually receives are not fixed but will vary from case to case based on the terms of the financing order and any loan agreements approved by the court and incorporated into the order. [FN57] For example, credit secured by a lien is not granted a priority unless the order so provides. [FN58] Conversely, Section 364 does not itemize every possible *179 term that a bankruptcy court may authorize in a financing order. Financing orders and agreements frequently contain detailed interest rate, fee, payment, maturity, covenant, default, termination, “drop-dead,” and other provisions. [FN59] To the extent that such provisions relate directly to the postpetition financing, the bankruptcy court's power to approve orders containing such provisions has not been the subject of serious dispute.

Provisions Relating to Prepetition Claims. Financing orders may also contain terms relating to the lender's prepetition claims, such as cross-collateralization, cross-prioritization, and “white wash” clauses. [FN60] The first fundamental issue addressed in *Saybrook* is whether the liens and priorities contemplated by Section 364 may be granted only to secure and accord priority to postpetition extensions of new credit or whether they may be granted to secure and accord priority to the unsecured portion of a creditor's prepetition claim in order to induce that creditor to provide new postpetition financing.

Protection From Modification or Reversal on Appeal

Section 364(e) of the Code protects a financing order entered under the aegis of Section 364 from the effects of reversal or modification on appeal *180 if the order has not been stayed pending appeal and the lender has acted in good faith. [FN61]

Mootness. Section 364(e) does not, by its terms, mandate that an appeal from a financing order be dismissed in the absence of a stay. Nevertheless, the widely applicable judicial mootness doctrine contemplates that an appeal will be dismissed as moot if no “effective relief” may be granted. [FN62] The consequence of Section 364(e) is that no effective relief may be granted in an appeal of a financing order under which debt has been incurred or liens or priorities have been granted because the validity of such debt, liens, or priorities cannot be affected on appeal absent a stay. As a result, the court cannot return the parties to the respective positions that they occupied before the loans were advanced. [FN63] Thus, courts generally apply Section 364(e) to dismiss an appeal of a financing order as moot if funds have been advanced to the DIP under the order and the order has not been stayed pending appeal. [FN64]

*181 Absent the statutory mootness doctrine of Section 364(e), lenders might be reluctant to advance funds until they had received assurance that the liens and priorities they negotiated would not be eliminated on appeal. [FN65] A DIP's inability to obtain access to critical financing until the resolution of all appeals could increase the potential for liquidation or business interruption. [FN66]

Stay Pending Appeal The hurdle of obtaining a stay poses a significant obstacle for an appellant. [FN67] The grant of a stay pending appeal is in the discretion of the court; it is not a matter of right. [FN68] In order to obtain a stay, the appellant must demonstrate (1) a likelihood of success on the merits; (2) irreparable harm in the absence of a stay; (3) absence of substantial harm to other parties if the stay is granted; and (4) absence of harm to the public interest if the stay is granted. [FN69] Even if these elements are satisfied, the court may, in its discretion, require that the appellant post a bond or other appropriate security to protect other parties from losses arising as a result of the stay. [FN70] Where the harm to be suffered by the DIP from the stay of a financing order is liquidation, the cost of the bond may be prohibitive for the appellant.

***182 Summary**

In summary, Section 364 of the Code is designed to induce lenders to extend credit to DIPs by making specialized priorities and liens available to postpetition lenders and by protecting such priorities and liens from reversal or modification on appeal, in the absence of a stay pending appeal. The scope of protection available under Section 364(e) to a financing order providing for cross-collateralization is the second fundamental issue addressed in *Saybrook*. [FN71]

Cross-Collateralization

A Definition of Cross-Collateralization

The previous discussion reflects the circumstances in which the Code expressly provides for the postpetition grant or continuation of liens and security interests in estate property; i.e., (1) to continue a prepetition secured creditor's liens in its prepetition collateral; [FN72] (2) as adequate protection against any diminution in value

caused by the DIP's retention, use, sale, or lease of a prepetition secured creditor's collateral; [FN73] (3) as adequate protection against the imposition of a priming lien on a prepetition secured creditor's collateral; [FN74] (4) to preserve a prepetition secured creditor's continuing*183 lien on the proceeds of its collateral; [FN75] and (5) to secure new credit extended to the DIP postpetition. [FN76] As we shall see, the type of collateralization prohibited by the *Saybrook* court does not fall within any of these categories.

“Cross-collateralization” in the Chapter 11 context generally is defined as the practice of either (1) granting a postpetition lender a lien on assets generated prepetition to secure the lender's postpetition loans or (2) granting a prepetition creditor a lien on postpetition estate assets (including assets first arising postpetition and assets existing on the filing date that are not subject to the creditor's prepetition liens) to secure the creditor's prepetition claims. [FN77] This definition has led to some ambiguity in the case law and scholarly commentary because it encompasses different types of liens without regard to whether such liens are expressly permitted under the Code.

Collateralization of Postpetition Loans

The collateralization of postpetition loans is not accurately labeled “cross-collateralization” because nothing “crosses” the imaginary barrier between the prepetition debtor and the postpetition DIP. The loan is made to the DIP and is secured by property of the estate of the DIP. [FN78] Granting a postpetition lender liens in estate property to secure its new postpetition loan is expressly authorized by Section 364, and does not present any problems per se. [FN79]

**184 Collateralization of Prepetition Claims*

The postpetition collateralization of prepetition claims is more appropriately designated “cross-collateralization” because a claim arising prepetition is secured by assets of the postpetition estate. [FN80] Nevertheless, not every postpetition lien granted in favor of a prepetition creditor should be deemed to constitute cross-collateralization or held to be improper. As previously discussed, the Code expressly provides for adequate protection liens and proceeds liens to maintain the value of the prepetition secured creditor's property interest in the DIP's assets. Although cross-collateralization has been the subject of substantial debate in both the courts and scholarly journals for several years, [FN81] this distinction has been largely ignored. [FN82]

*185 Conceptually, if a prepetition creditor is fully secured or oversecured, adequate protection liens and proceeds liens should fully protect the creditor's claim. [FN83] Only an undersecured creditor would benefit from a lien securing the unsecured portion of its claim. Thus, the term “cross-collateralization” should be used only in reference to those liens not expressly provided for under the Code; i.e., postpetition liens granted to secure the otherwise unsecured portion of a secured creditor's prepetition claim. A careful reading of the rationale of *Saybrook* and the other cases discussed in this article suggests that, in fact, the controversy in those cases focused on the grant of such postpetition liens in Chapter 11 estate assets to secure the unsecured portion of a creditor's prepetition claims.

The Texlon Case

Facts, Lower Court Holdings, and Issues Presented

Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon), [FN84] a case decided under the former Bankruptcy Act, marks the beginning of the cross-collateralization debate. In *Texlon*, the court defined cross-collateralization as follows:

What this term means is that in return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the 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. [FN85]

*186 Although this broad definition could be construed to encompass all postpetition liens granted in favor of the prepetition creditor, the court's reasoning (discussed later) suggests that the true focus of the court's concern is on postpetition liens that secure the unsecured portion of the creditor's prepetition claim. [FN86]

In *Texlon*, the bankruptcy court had entered a financing order, on an ex parte basis, on the day Texlon filed its petition for an arrangement under Chapter XI of the former Bankruptcy Act. [FN87] The financing order authorized Texlon to enter into account factoring agreements with Manufacturers Hanover Commercial Corporation (MHCC), borrow up to an additional \$100,000 (evidenced by certificates of indebtedness issued pursuant to Section 344 of the former Bankruptcy Act), [FN88] and grant MHCC a security interest in all of Texlon's inventory and equipment and accounts receivable to secure MHCC's postpetition claims (under the factoring agreements and certificate of indebtedness) and MHCC's prepetition claims. [FN89] No appeal was taken from the financing order. [FN90]

Two and one half months later, after Texlon had been adjudicated a bankrupt, [FN91] a trustee had been appointed, [FN92] and MHCC had loaned *187 \$100,000 on the certificate of indebtedness and \$567,000 in factoring advances, the trustee moved to modify the financing order to permit the pro rata distribution to creditors of all excess funds after the payment of MHCC's postpetition claims. [FN93] At the time, it appeared that the proceeds of liquidation of Texlon's assets would be sufficient to repay MHCC's postpetition claims in full but not to repay MHCC's prepetition claims in full, and that, if all liquidation proceeds were applied solely to MHCC's claims, there would be no dividend for other creditors. [FN94]

Nearly three years after the trustee's motion was filed, the bankruptcy judge denied the motion on the ground that MHCC had relied on the financing order in making the new advances. [FN95] In dicta, however, the court strongly suggested that cross-collateralization provisions should be prohibited in the future because such provisions (1) accord prepetition claims priority over postpetition claims and (2) prefer one creditor's prepetition claims. [FN96] The district court reversed, reasoning that cross-collateralization *188 was not appropriate and that MHCC had not relied on the order to its detriment because it would be repaid for its postpetition advances. [FN97]

On appeal, the U.S. Court of Appeals for the Second Circuit framed the issues as “whether the bankruptcy court properly authorized such ‘cross-collateralization’ in this case, and, if not, whether the trustee's challenge came too late.” [FN98]

Cross-Collateralization

On the first issue, the court reasoned, in dicta, that cross-collateralization accorded the prepetition creditor a “post-adjudication preference” over other similarly situated creditors by effecting a transfer that would have constituted a voidable preference if it had occurred prior to the petition date. [FN99] The preferential nature of

the transaction violated the Bankruptcy Act's equality principle. [FN100] The court rejected MHCC's arguments that the Bankruptcy Act's provisions for the issuance of secured certificates of indebtedness or the bankruptcy court's broad equitable powers permitted the bankruptcy court to treat MHCC's prepetition claims more favorably than other prepetition claims of the same class. [FN101]

Nevertheless, the court expressly declined to hold that there were no "conceivable circumstances" in which cross-collateralization would be authorized. [FN102] Instead, the court held [FN103] merely that:

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

*189 A hearing might determine that other sources of financing are available; that other creditors would like to share in the financing if similarly favorable terms are accorded them; or that the creditors do not want the business continued at the price of preferring a particular lender. [FN104]

Several courts have read this narrowly crafted holding of *Texlon* as permitting cross-collateralization pursuant to financing orders entered after notice and a hearing. [FN105]

Timeliness of the Challenge

The second issue presented in *Texlon* was the timeliness of the trustee's motion for relief from the financing order. MHCC argued that the order was final and no longer subject to challenge because no timely appeal had been filed. [FN106] The trustee argued that the court could grant relief from the order as "void" under [Federal Rule of Civil Procedure 60\(b\)\(4\)](#) or as a "mistake" under [Federal Rule of Civil Procedure 60\(b\)\(1\)](#). [FN107] The Second Circuit rejected each of these arguments. Nevertheless, the court held that the trustee could challenge the financing order under the judicial "administrative order" doctrine. This rule, embodied in *Wayne United Gas Co. v. Owens-Illinois Glass Co.*, [FN108] provides that:

*190 a district court sitting in bankruptcy could in its discretion rehear a cause even after the expiration of the period allowed for appeal "if no intervening rights will be prejudiced by its action" and that if the court rehears the petition "upon the merits," the time to appeal would run from its grant or denial. [FN109]

Reasoning that MHCC would suffer no actual loss as long as its postpetition advances and related interest, commissions, and expenses were repaid, the *Texlon* court concluded that no intervening rights would be prejudiced. [FN110]

Texlon's Legacy

Having thus concluded that cross-collateralization was not permissible without notice and a hearing and that the trustee's challenge was not untimely, the court affirmed the district court's approval of the trustee's motion to modify the financing order. Recall that the *Texlon* trustee sought to distribute to creditors on a pro rata basis *all* excess liquidation proceeds after payment of MHCC's postpetition claim, without regard to the fact that at least some portion of MHCC's prepetition claim presumably was secured. In affirming the district court's order, the Second Circuit sanctioned this result without any reference to or protection of MHCC's prepetition secured claim. [FN111]

Several early decisions read *Texlon* as permitting cross-collateralization if all parties in interest had received adequate notice and an opportunity to be heard. [FN112] Other courts have approved cross-collateralization clauses only after articulating and applying equitable tests that rely heavily on the *191 perceived need to induce lenders to provide funding to DIPs in order to foster the Code's goal of debtor rehabilitation. [FN113] Still other courts, generally citing the absence of any express authority for cross-collateralization under the Code and reiterating *Texlon*'s concerns about the inequity of cross-collateralization, have held that cross-collateralization may never be approved under the Code. [FN114] *Saybrook* falls squarely in this last group.

Saybrook

Facts and Lower Court Holdings

On December 22, 1988, Saybrook Manufacturing Company and three of its affiliates (collectively, Saybrook) filed voluntary Chapter 11 cases, which were consolidated the next day. [FN115] At the time of the filing, Saybrook owed Manufacturers Hanover Trust Company and Manufacturers Hanover Bank (together, MH) approximately \$34 million secured by collateral worth less than \$10 million. [FN116] On the day after the case was *192 filed, Saybrook filed a motion to use MH's cash collateral and incur secured debt. The court entered an emergency order granting the motion on that same day. Under the emergency order, MH loaned Saybrook an additional \$3 million [FN117] and received a continuing and additional security interest in all of Saybrook's assets, including the assets subject to MH's existing security interests, all unencumbered assets (i.e., inventory valued at approximately \$2 million) and all assets acquired and generated postpetition, to secure both the postpetition new loan and the existing prepetition claim.

Following a final hearing on the motion, [FN118] the bankruptcy court overruled the objections raised by two unsecured creditors (the Shapiros) to the provisions of the order granting liens in postpetition assets to secure MH's prepetition claims. [FN119] The Shapiros appealed to the district court and moved for a stay of the financing order pending appeal. Both the bankruptcy court and the district court denied the Shapiros' request for a stay pending appeal. [FN120]

Addressing the merits of the appeal, the district court focused primarily on the interpretation of Section 364(e). [FN121] The court framed the issues as follows: "1. Is Cross-Collateralization Protected by § 364(e)?" and "2. Did MH Exercise Good Faith?" [FN122] On the first issue, the district court concluded that Section 364(e) protects a financing order providing for cross-collateralization from reversal or modification on appeal if the order has not been stayed and the lender has acted in good faith. [FN123] On the second issue, the court found that the existence of reasonable arguments supporting*193 cross-collateralization and case law permitting cross-collateralization insulated MH from attack on bad faith grounds. [FN124]

Eleventh Circuit Holding and Rationale

The Eleventh Circuit approached the issues differently, asking first:

"[w]hether the appeal ... [is] moot under section 364(e) of the Bankruptcy Code because the Shapiros failed to obtain a stay of the bankruptcy court's financing order," and second: "[w]hether cross-collateralization is authorized under the Bankruptcy Code." [FN125]

Mootness. On the first issue, the Eleventh Circuit reasoned that, even if a financing order has not been stayed pending appeal, the liens and priorities granted under the order will be protected from reversal or modification on appeal under [Section 364\(e\)](#) only if they were “authorized” under [Section 364](#). [\[FN126\]](#) To hold otherwise, the court reasoned, would be to “put the cart before the horse.” [\[FN127\]](#) In support of this approach, the court noted that “[b]y its own terms, [section 364\(e\)](#) is only applicable if the challenged lien or priority was authorized under [section 364](#).” [\[FN128\]](#)

Reasoning that the provisions of Subsections 364(c) and 364(d) authorize the granting of liens and specialized priorities only with respect to postpetition extensions of credit, [\[FN129\]](#) the court concluded that “*Texlon-type*” cross-collateralization of prepetition claims is not “authorized” by [Section 364](#) of the Code. [\[FN130\]](#) Thus, the Eleventh Circuit declined to dismiss the appeal as moot, notwithstanding the Shapiros' failure to obtain a stay. [\[FN131\]](#)

***194 Cross-Collateralization.** Turning to the merits of the appeal, the court first noted that no provision of the Code expressly authorizes cross-collateralization. [\[FN132\]](#) In the absence of clear statutory direction, the court considered whether the bankruptcy court could employ its equitable powers to approve cross-collateralization as a means of implementing the policies and provisions of the Code. [\[FN133\]](#) The court weighed the secured creditor's argument that cross-collateralization furthers the policy of rehabilitation of debtors by inducing lenders to provide financing to DIPs against the unsecured creditors' argument that cross-collateralization violates the policy of ensuring equitable distribution of assets among similarly situated creditors.

Cross-collateralization does violate the policy of equitable distribution because it grants the prepetition unsecured claim of one creditor collateral security not granted to the prepetition unsecured claims of other creditors. [\[FN134\]](#) Reasoning that the Code's “primary purpose” of fostering rehabilitation does not justify means that are directly contrary to the Code's equality principle and priority scheme, the Eleventh Circuit concluded that cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable powers. [\[FN135\]](#) Accordingly, the court reversed and remanded. [\[FN136\]](#)

***195 The Case Against Cross-Collateralization**

The Eleventh Circuit's opinion in *Saybrook* contains a concise summary of the statutory and policy arguments against cross-collateralization. [\[FN137\]](#)

The Statutory Language

The statutory language argument is simple and straightforward. In *Saybrook*, the Eleventh Circuit concluded that the authority conferred on courts by [Section 364](#) was limited to postpetition extensions of credit. [\[FN138\]](#) Subsections 364(c) and 364(d) provide that a court “*may authorize the obtaining of credit or the incurring of debt*”: (1) “with priority over any or all administrative expenses”; [\[FN139\]](#) (2) “secured by a lien on property of the estate that is not otherwise subject to a lien”; [\[FN140\]](#) (3) “secured by a junior lien on property of the estate that is subject to a lien”; [\[FN141\]](#) or (4) “secured by a senior or equal lien on property of the estate that is subject to a lien.” [\[FN142\]](#) The *Saybrook* court determined that these provisions are prospective in their application and provide no authority for the grant of liens or specialized priorities in respect of credit *obtained* or debt *incurred* prepetition. [\[FN143\]](#) This same reasoning had been applied earlier by two bankruptcy courts, cited in

Saybrook, that had also concluded that cross-collateralization is impermissible. [FN144]

*196 *Saybrook* further concluded that no other provision of the Code expressly authorizes cross-collateralization. [FN145]

A related argument, not expressly mentioned in *Saybrook* but developed by Tabb, suggests that cross-collateralization not only is not permitted by Section 364 but actually is prohibited by Section 364. Tabb reasons that (1) Section 364 contains the exclusive list of rights, benefits, liens, and priorities that may be granted to induce postpetition financing; (2) Section 364 does not provide for the granting of cross-collateralization liens to secure existing prepetition debt; and (3) therefore, cross-collateralization is not a permissible means of inducing postpetition lending. [FN146] The second and third elements of this argument flow from the first element. The first element is drawn from the legislative history of Section 364, which states that Section 364 “governs all obtaining of credit and incurring of debt by the estate.” [FN147] It logically follows that no other provision of the Code expressly covers postpetition credit. [FN148] Tabb reasons that it also logically follows that only those rights and protections expressly itemized in Section 364 may be granted by the court in respect of postpetition credit. [FN149] Thus, although no provision of the Code expressly*197 prohibits cross-collateralization, Tabb concludes that a prohibition may be inferred from the legislative history of Section 364.

Bankruptcy Code Policies

In the absence of any express reference to cross-collateralization under the Code, *Saybrook* and other courts have considered whether the bankruptcy courts may employ their general equitable powers to approve cross-collateralization.

It is axiomatic that the bankruptcy court is a court of equity. [FN150] The general equitable powers permit a bankruptcy court to “issue any order, process or judgment that is necessary or appropriate to carry out,” but not to contravene, the general policies and specific provisions of the Code. [FN151] *198 The bankruptcy court's equitable powers are employed to supplement and implement the general policies and provisions of the Code. [FN152] In determining whether a particular remedy not expressly provided under the Code carries out or contravenes the provisions of the Code, the courts look to the fundamental policies underlying the Code, i.e., rehabilitation and equality. [FN153] Bankruptcy courts' equitable powers do not permit bankruptcy courts to enter orders that violate these policies. [FN154]

The courts and commentators disagree whether the bankruptcy court's general equitable powers may be employed to authorize cross-collateralization.*199 [FN155] *Saybrook* held that they may not. Specifically, *Saybrook* held that cross-collateralization is beyond the bankruptcy court's equitable powers because it violates the Code's principle of equitable distribution among similarly situated creditors. [FN156] The court based this conclusion largely on an examination of the Code's priority scheme and an analogy to the Code's preferential transfer recovery provisions, each of which implement the equality principle. [FN157]

The Bankruptcy Code's Priority Scheme. Section 507(a) of the Code establishes the priority and order of distribution of specified expenses and claims that are accorded priority over general unsecured claims. [FN158] *Saybrook* reasoned that “[s]ection 507 of the Bankruptcy Code fixes the priority order of claims and expenses against the bankruptcy estate. Creditors within a given class are to be treated equally, and the bankruptcy courts may not create their own rules of superiority within a single class. Cross-collateralization, however, does exactly that.” [FN159]

Priority claims are entitled to be paid in full before any distribution is made on other unsecured claims in either a Chapter 7 liquidation case or a Chapter 11 reorganization case. In a Chapter 7 case, Section 726 establishes the order in which property of the estate is to be distributed among classes of unsecured creditors. Payment is to be made pro rata among claims in each class. [FN160] Secured claims, however, are excluded from this *200 distribution scheme. Property subject to a lien, or the proceeds of such property, must be distributed to the secured creditor. [FN161] Any excess equity in lien property after satisfaction of all liens will be available for distribution to priority and general unsecured claims, as outlined previously. If the property's value is insufficient to pay a secured creditor's claim in full, the creditor's unsecured deficiency claim will share pro rata in the distribution among unsecured claims.

Chapter 11 incorporates the distribution principles of Chapter 7 into the requirements for confirmation of a plan of reorganization. [FN162] A plan may not be confirmed unless it satisfies the “best interests” test, which requires that each holder of an impaired [FN163] claim or interest either (1) has voted to accept the plan or (2) will receive or retain under the plan property having a value that is not less than the amount the holder would have received or retained if the DIP had been liquidated under Chapter 7 as of the effective date of the plan. [FN164] Thus, a secured creditor is entitled to receive at least as much as it would have received from the disposition of its collateral, and an unsecured creditor is entitled to receive at least as much as it would have received from the pro rata distribution of the estate's assets. Although Chapter 11 permits the holder of a claim voluntarily to accept less than it would be entitled to receive under Chapter 7 by voting in favor of a plan that offers it less beneficial treatment, the “best interests” *201 requirement prohibits the majority of creditors in any given class from binding the minority to such treatment even if the class accepts the plan by the requisite majorities. [FN165]

If a class of creditors votes to reject a plan, the plan may be confirmed only if it meets the “cramdown” requirements with respect to the rejecting class (in addition to satisfying the best interests test and the other confirmation requirements). [FN166] Cramdown is permissible only if the plan does not discriminate unfairly [FN167] and is fair and equitable with respect to the dissenting class. [FN168] A comparison of the “fair and equitable” element as applied to secured claims and unsecured claims further highlights the advantages attained by a prepetition undersecured creditor that obtains collateral for its unsecured deficiency claim through cross-collateralization. The fair and equitable test is satisfied with respect to a class of secured claims only if the creditor retains its liens in its collateral or the proceeds thereof and receives either deferred cash payments with a present value equal to *202 the value of the lien or the “indubitable equivalent.” [FN169] For example, the value of the lien of a creditor holding a \$10 million prepetition claim secured by collateral valued at \$5 million would be \$5 million. If, as part of a financing agreement, this creditor is granted an additional \$5 million worth of collateral to secure its prepetition claim, the value of the lien for purposes of the fair and equitable test would be \$10 million. In contrast, a class of unsecured claims is treated fairly and equitably if each creditor receives property equal to the allowed amount of its claim *or* no junior class of claims or interests receives any distribution. [FN170] Thus, the fair and equitable test may be satisfied even if unsecured creditors receive no distribution, as long as no junior class (e.g., equity holders) receives any distribution.

These priority and distribution rules reflect that, notwithstanding *Saybrook's* reasoning, an undersecured creditor that is the beneficiary of cross-collateralization does not actually obtain a “priority” over general unsecured creditors within the meaning of Section 507(a). Rather, by receiving a lien on estate assets, the creditor is entitled to retain the value of those assets or receive the proceeds of the liquidation of those assets in payment of its claim before any proceeds are distributed in payment of either priority claims or general unsecured claims. Absent the effects of cross-collateralization, those assets would have been available for pro rata distribution on

all unsecured claims, including the unsecured portion of the prepetition undersecured creditor's claim. The effect is that the prepetition unsecured claim of one creditor is entitled to be paid before the priority claims or prepetition unsecured claims of other creditors. While this may not technically violate the Code's priority scheme, it clearly violates the Code's equality principle. [FN171]

***203 Voidable Preferences.** *Saybrook* and other courts opposing cross-collateralization also have analogized cross-collateralization to the grant of a preference voidable under the Code. [FN172] Quoting the Second Circuit's comment in *Texlon*, *Saybrook* noted that "if cross-collateralization were initiated by the bankrupt while insolvent and shortly before filing a petition, the arrangement 'would have constituted a voidable preference.'" [FN173]

The Code authorizes the DIP to avoid and recover as "preferences" certain prepetition payments and transfers that have the effect of improving the position of one unsecured claim at the expense of other unsecured claims. These preferential transfer recovery provisions further the Code's policy of ensuring equality of distribution among similarly situated creditors because voided transfers are available for distribution to all creditors in accordance with the Code's priority and distribution scheme. The transfer that occurs as a result of cross-collateralization, i.e., the transfer of a security interest in property of the DIP's Chapter 11 estate to the prepetition undersecured creditor, technically is not a preferential transfer because it occurs postpetition. [FN174] Nevertheless, the inequitable effect of preferring one creditor over other similarly situated creditors is the same. [FN175]

Inequality Generally. The inequality that may result from cross-collateralization is particularly offensive where there is a significant imbalance between the new money committed and the benefit received by the prepetition secured creditor. In *Saybrook*, for example, the financing order granted MH postpetition liens to secure MH's \$24 million prepetition unsecured*204 deficiency claim in exchange for a \$3 million new postpetition loan. [FN176]

In *In re Monach*, [FN177] the DIP owed the prepetition secured creditor approximately \$500,000. The secured creditor agreed to advance \$40,000 in new postpetition financing. In exchange, the creditor's prepetition and postpetition claims were secured by all of the estate's assets, including more than \$100,000 worth of assets not subject to the creditor's prepetition security interest, and were accorded superpriority status over all administrative claims. [FN178] Four months later, the case was converted to a case under Chapter 7. [FN179] On the Chapter 7 trustee's motion for reconsideration, [FN180] the bankruptcy court vacated the financing order. [FN181] The court did not quantify the advantage that the secured creditor had obtained over other unsecured creditors, but it did conclude that "the security interest and the priority received by [the secured creditor] were in excess of the \$40,000 in value it gave." [FN182]

These inequities bolstered *Saybrook* and *Monach* courts' conclusion that the Code's policy of fostering rehabilitation of debtors does not justify the use of the bankruptcy court's general equitable powers to sanction a practice that is directly contrary to the Code's policy of ensuring equitable distribution among creditors. [FN183]

The Case in Favor of Cross-Collateralization

Courts that have approved cross-collateralization clauses have relied primarily on the Code's policy favoring rehabilitation of debtors and the lack of any express prohibition of cross-collateralization under the Code. [FN184]

205 *The Statutory Language

At least one bankruptcy court has attempted to draw support for cross-collateralization from the Code's statutory language as well as its policies. In *In re Roblin Industries, Inc.*, [FN185] Chemical Bank (Chemical) and Chase Manhattan Bank (Chase) held prepetition claims in the amount of approximately \$24 million for joint loans made to Roblin. These claims were secured by liens on all of Roblin's assets. [FN186] Roblin entered into a stipulation under which Chemical and Marine Midland Bank agreed to loan Roblin up to \$120 million in post-petition financing secured by all of Roblin's assets. The stipulation and order further proposed that adequate protection and cross-collateralization liens be granted to secure the lenders' prepetition claims. [FN187] The indenture trustee (U.S. Trust) for certain subordinated debentures objected to several provisions of the proposed order, including the cross-collateralization provision. [FN188] U.S. Trust did not challenge the legality of cross-collateralization per se, but argued that cross-collateralization was inappropriate in the case at bar because it would not be in the best interests of the creditors. [FN189] Focusing first on policy considerations, the court disagreed, noting that:

The Banks and debtor "believe" the pre-petition obligations are oversecured. U.S. Trust claims that in reality they are undersecured. If in fact they are undersecured, absent financing the debtor would in all likelihood shut down, liquidation would follow, and unsecured creditors would receive no distribution from the debtor's estate An ongoing operation which maintains the value of plant and equipment at a level in excess of liquidation is in the best interest not *206 only of the Banks but of all creditors. The provisions for cross-collateralization to permit that operation are not contrary to the spirit or intent of the Code. [FN190]

Roblin then bolstered this conclusion by considering the statutory predicate for cross-collateralization, [FN191] reasoning that:

Specific provisions of the Code provide for each facet of the cross-collateralization issue. Post-petition advances may be secured not only by post-petition assets but by pre-petition assets as well as by a superpriority grant against otherwise unencumbered assets. Secured parties can be given a security position on post-petition assets as adequate protection for the use of collateral which secures pre-petition obligations. [citations omitted] The harm to be perceived [from cross-collateralization] arises from the concern that the reorganization opportunity provided by the Code is not intended solely for the benefit of pre-petition secured lenders but for all creditors. If the effort is successful and a plan of reorganization is confirmed, no harm should result. If it fails, the result to be avoided is an improvement in the Banks' position. It creates an issue only if the reorganization effort fails. It will not arise if the effort is successful. It is an issue which is needless to attempt to resolve at this juncture Records may be maintained with respect to the inventory used and accounts collected post-petition. Such records and competent testimony with respect to the value of other collateral will establish the extent of the Banks' damages, if any, suffered during the course of the reorganization effort should it fail. There is no useful purpose to be served by a present adjudication of the over/undersecured position of the Banks' pre-petition loans at this time. To the extent indicated, the lien pursuant to section 363(e) [which requires adequate protection of secured claims] would be appropriate and in accord with the substantive provisions of section 361. [FN192]

The *Roblin* court's initial comments and reasoning (in the first passage quoted) seem to suggest that cross-collateralization is permissible if it is in the best interests of creditors, [FN193] even if it provides the lender with a windfall by collateralizing the unsecured portion of its prepetition claim. The court's further explanation (in the second passage) suggests, however, that collateralization of a prepetition claim may be appropriate to provide adequate protection of the creditor's interest in its prepetition collateral, but perhaps not to permit the

creditor to improve its position by collateralizing *207 an unsecured deficiency claim. Although the rationale is not entirely clear, *Roblin* seems to imply that the court should be permitted to determine in retrospect whether the liens granted to the prepetition lender had the effect of giving the lender a windfall relative to other unsecured creditors or merely of providing adequate protection. [FN194] In any event, because *Roblin* refused to approve the financing order on other grounds, its entire discussion of cross-collateralization would appear to be dictum. [FN195]

At least one commentator, Jeff Bohm, has also attempted to glean support for cross-collateralization from the language of the Bankruptcy Code. [FN196] Bohm acknowledges that the Code does not expressly provide for cross-collateralization. Nevertheless, he suggests that, because Congress accorded bankruptcy courts the extraordinary power to grant priming liens under Section 364(d), Congress likely also would have permitted the “less harmful” power to grant cross-collateralization liens if the issue had been clearly presented to Congress. [FN197] Bohm argues, in essence, that inducing a new loan by granting the lender a postpetition lien that primes prepetition *unsecured* claims (i.e., cross-collateralization) is less onerous than inducing a new loan by granting the new lender a postpetition lien that primes prepetition *secured* claims (i.e., a Section 364(d) priming lien). [FN198]

This argument fails to recognize, however, that (1) priming liens granted under Section 364(d) secure only the new postpetition loans without affecting the rights and priorities between prepetition creditors (and without violating the policy of equality of distribution among similarly situated prepetition creditors) and (2) priming liens are allowed only if the court finds that the property interests of the prepetition secured creditor whose lien is primed are accorded adequate protection. [FN199] Moreover, the benefits of a new DIP loan secured by a priming lien will redound to the benefit of the estate and its unsecured creditors so long as the value preserved or generated by the new loan exceeds the amount of the loan and related expenses. [FN200]

*208 Conversely, cross-collateralization liens secure the unsecured portion [FN201] of an existing prepetition claim, thereby altering the respective rights and priorities between prepetition creditors (and violating the policy of equality of distribution among similarly situated prepetition creditors). The prepetition unsecured creditors who are not the beneficiaries of cross-collateralization are offered the mere hope that the new loan induced by cross-collateralization will create sufficient value to increase their dividend. These creditors will receive an increased dividend only if the value created or preserved by the postpetition loan exceeds the amount of the new loan and related expenses plus the value transferred to the lender to secure its prepetition unsecured deficiency claim. [FN202] Thus, Bohm's statutory analysis provides little support for cross-collateralization. [FN203]

*209 Moreover, in conducting their statutory analysis, neither Bohm nor *Roblin* directly addressed the statutory plain language argument, advanced by *Saybrook* and other courts, that Section 364 permits the grant of postpetition liens and priorities only in respect of credit “obtained” or debt “incurred” postpetition. [FN204]

Bankruptcy Code Policies

Most courts and commentators favoring cross-collateralization rely heavily on the Code's fundamental policy of facilitating the rehabilitation of financially distressed businesses. They reason that the bankruptcy court's general equitable powers are designed to permit the bankruptcy courts to fashion equitable solutions to foster the rehabilitation of debtors. [FN205] They conclude that, in the absence of any express prohibition of cross-collateralization under the Code, the courts may employ their equitable powers to grant cross-collateralization liens in appropriate cases. [FN206] *Texlon* laid the foundation for this reasoning by implying, in

dicta, that cross-collateralization might be appropriate in certain circumstances to permit the debtor to reorganize. [FN207]

Many courts have applied the test established in *In re Vanguard Diversified, Inc.* [FN208] to determine whether the equities of a particular case justify cross-collateralization. Drawing on factors articulated in *Texlon* and in *210 an early law review article analyzing *Texlon, Vanguard* posited that cross-collateralization is permissible, but only if the DIP demonstrates that: “(1) Absent the proposed financing, its business operations will not survive ...; (2) It is unable to obtain alternative financing on acceptable terms ...; (3) The proposed lender will not accede to less preferential terms; and (4) The proposed financing is in the best interests of the general creditor body.” [FN209] Applying these factors, the *Vanguard* court approved a financing order that granted the lender a lien on virtually all of Vanguard's prepetition and post-petition assets to secure payment of all of the lender's prepetition and post-petition claims. [FN210] Testimony demonstrated that Vanguard had no cash available to pay salaries and other operating expenses absent the postpetition financing, that no other sources of financing were available, and that the lender would not provide financing without the benefits of cross-collateralization. In determining that cross-collateralization was in the best interest of creditors, the court relied heavily on calculations suggesting that the general unsecured creditors likely would receive nothing if Vanguard were liquidated, but might receive some recovery if Vanguard continued operating. No creditors objected to the proposed financing. [FN211]

The court in *Roblin* [FN212] applied the *Vanguard* test. Although the court declined to approve the financing order on other grounds, it found that the *Vanguard* test was satisfied with respect to the cross-collateralization clause. [FN213] The *Antico* [FN214] court also applied the *Vanguard* test in approving a post-petition financing arrangement, noting that:

without the proposed financing ... the debtor-in-possession would soon be without funds, and would be forced to shut down ... [would] be unable to purchase inventory and to pay the salaries of its employees ... attempts to secure other means of financing were unsuccessful ... [the creditor] would not finance the DIP's operation unless it received the protection afforded by cross-*211 collateralization ... [and] in the absence of any opposition from the creditors, ... the proposed financing [is in the best interests of the creditors]. [FN215]

The *Vanguard* line of cases fashions a test that relies heavily on the perceived necessity of approving a practice that violates the equality principle in order to prevent the debtor's immediate liquidation. Thus, the district court in *Saybrook* noted that:

A general rule distilled from the weight of authority would be that while cross-collateralization is a disfavored method of financing to be used as a last resort, and may not be used at all without notice and hearing, it is nonetheless a valid tool in a bankruptcy court's arsenal of means to keep a debtor alive, and so falls within the protection of § 364(e). [FN216]

Courts that adopt this reasoning analogize to other situations in which courts have engaged in similar “necessity” analyses to permit actions and payments that may violate the equality principle. For example, in *Adams Apple*, the U.S. Court of Appeals for the Ninth Circuit noted that:

Cases have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as (i) pre-petition wages to key employees; (ii) hospital malpractice premiums incurred prior to filing; (iii) debts to providers of unique and irreplaceable supplies; and (iv) peripheral benefits under labor contracts. [citations omitted] In addition, Congress provided in section 364(d) that pre-petition

debts, even secured interests, may be subordinated by post-petition obligations. Although this more traditional application of [section 364\(d\)](#) does not involve disparate treatment of creditors, it illustrates a Congressional willingness to subordinate the interests of pre-petition creditors to the goal of rehabilitation.

Cross-collateralization clauses may provide the only means for saving a failing company. As noted above, 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. [\[FN217\]](#)

Adams Apple specifically reserved the question of whether cross-collateralization is illegal per se. [\[FN218\]](#) Nevertheless, in response to the argument*212 that “cross-collateralization ... violates a fundamental tenet of bankruptcy law that like creditors must be treated alike,” the court noted that the equality principle is in “conflict with another ‘fundamental tenet’—rehabilitation of debtors, which may supersede the policy of equal treatment.” [\[FN219\]](#)

Similarly, Bohm draws an analogy to the “necessity of payment” doctrine to support cross-collateralization. [\[FN220\]](#) The necessity-of-payment doctrine is a judicially created rule under which some courts have permitted the postpetition payment of certain prepetition claims, where the DIP's continued operations were dependent on the receipt of goods or services from the preferred claimant and the claimant refused to supply further goods or services absent payment of its prepetition claims. [\[FN221\]](#) Originally, the necessity doctrine was limited to railroad cases, and its justification rested heavily on the public interest in preserving the assets of entities that served the public. Although the doctrine has since been expanded to permit the payment of certain prepetition priority and nonpriority claims, [\[FN222\]](#) it has been widely criticized. [\[FN223\]](#) Tabb succinctly challenged its use to support cross-collateralization:

*213 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 pre-petition debt, despite the violence this does to established principles of bankruptcy law such as equality of distribution. [footnote omitted] This extortion premise similarly underlies cross-collateralization. [\[FN224\]](#)

The authors submit that the courts should not sanction any “extortion exceptions” under the Code.

Summary

The Code does not expressly authorize or prohibit the practice of cross-collateralization. In the absence of unequivocal statutory language, the courts have sought direction from the fundamental policies underlying the Code; i.e., rehabilitation of debtors and equitable distribution among creditors.

The courts and commentators seem to agree that cross-collateralization is inconsistent with the policy of equitable distribution because it permits the unsecured portion of a secured creditor's prepetition claim to be treated better than other general unsecured prepetition claims with which it would have shared pro rata distribution absent the effects of cross-collateralization. Several courts, including *Saybrook*, have concluded that this direct violation of the equality principle renders cross-collateralization impermissible under the Code. [\[FN225\]](#)

Other courts have concluded that the policy of fostering the rehabilitation of debtors may override the policy of equitable distribution and warrant the use of cross-collateralization in appropriate circumstances to induce the prepetition creditor to provide new postpetition financing without which the DIP could not remain in operation.

[FN226]

Some may argue that the policy debate is a draw. One line of reasoning seems to favor the rehabilitation principle in derogation of the equality principle, while the other line of reasoning seems to favor the equality principle in derogation of the rehabilitation principle. On closer inspection, however, this conclusion is overly simplistic.

Permitting cross-collateralization clearly does advance rehabilitation in direct and unavoidable violation of the equality principle. There is no scenario under which equality may be preserved if one prepetition creditor is *214 granted liens to secure the unsecured portion of its prepetition claim. Although some courts have sanctioned this inequity in order to induce loans vital to the DIP's survival, it may be possible to induce such loans by adjusting the price of the financing without producing the inequity.

In contrast, prohibiting cross-collateralization does not directly violate either of the Code's principal policies. The prohibition preserves equality by ensuring that one prepetition unsecured claim is not accorded preferential treatment vis-à-vis other prepetition unsecured claims. Conversely, although prohibiting cross-collateralization may make rehabilitation more uncertain for some DIPs, it does not unavoidably prevent DIPs' survival and reorganization. In many cases, other financing may be available, [FN227] the prepetition lender may agree to advance the new postpetition credit even in the absence of cross-collateralization, [FN228] or the DIP may be able to continue operating (although not necessarily at the level it had hoped) at least until it is able to obtain alternate financing on less onerous terms. [FN229] For so long as some courts permit cross-collateralization, it will be virtually impossible to predict whether the dire consequences of liquidation actually would occur if cross-collateralization were prohibited. [FN230] The *Vanguard* test invites and, in fact requires, a representation by the prepetition creditor that it will not advance new funds absent the preferential benefits of cross-collateralization. This places the court in the difficult position of attempting to determine whether the creditor's position truly is inflexible. It may be that the creditor is bluffing. It is also possible that a creditor who has no intention of providing financing absent cross-collateralization may have a change of heart if the court refuses to authorize cross-collateralization. A prepetition partially secured creditor has significant incentives to permit the use of its cash collateral and to provide DIP financing even in the absence of the windfall "bonus" accorded by cross-collateralization. [FN231] In view of these considerations, and in the absence of empirical data, it is speculative at best to conclude that the prohibition of cross-collateralization will result in the liquidation of DIPs that could have survived if cross-collateralization were permitted. Moreover, even if cross-*215 collateralization enables a DIP to survive, it is questionable whether the DIP's rehabilitation is consistent with the purposes of the Code if the cost of rehabilitation is the grant of cross-collateralization liens that result in the general unsecured creditors receiving less than they would have received if the DIP had been liquidated. [FN232]

Ultimately, the question is whether a practice that clearly violates the equality principle embodied in the Code should be sanctioned in order to permit a DIP to reorganize under Chapter 11. The *Saybrook* ruling suggests, correctly in the authors' view, that a court may not advance one of the "twin pillars," i.e., the rehabilitation policy, in direct violation of the other, i.e., the equality policy. Accordingly, the bankruptcy court's broad equitable powers should not be used to permit cross-collateralization under the Code. [FN233]

Appeal of or Collateral Attack on an Order Authorizing Cross-Collateralization

Mootness on Appeal

Saybrook's conclusion that cross-collateralization is not authorized under the Code raises a second issue that may have far reaching precedential effects. The issue is whether a cross-collateralization lien granted under a financing order may be affected by reversal or modification on appeal if the order has not been stayed pending appeal. According to the Ninth Circuit, in *Adams Apple*, [FN234] and the Sixth Circuit, in *Ellingsen*, [FN235] the answer should be no. [FN236] Each of these courts dismissed as moot an appeal from a financing order containing a cross-collateralization clause, [FN237] where the *216 order had not been stayed pending appeal. The Eleventh Circuit, in *Saybrook*, disagreed. [FN238]

Scope of Section 364(e)

In *Saybrook*, the Eleventh Circuit ruled that Section 364(e) does not protect a financing order providing for cross-collateralization from reversal or modification on appeal, even in the absence of a stay pending appeal. [FN239] *Saybrook* reasoned that the protections of Section 364(e) apply only to liens and priorities “authorized” under Section 364. Cross-collateralization is not “authorized” under Section 364 because Section 364 only authorizes the granting of liens and priorities in respect of postpetition debt and credit. [FN240] This statutory analysis is bolstered by the recognition that, as a practical matter, parties should not be permitted to obtain the special protections of Section 364(e) merely by inserting into a financing order terms unrelated to the extension of new credit under Section 364. [FN241] Thus, Section 364(e) should protect only those provisions of the order that relate to the protection of postpetition credit extended under Section 364, [FN242] as distinguished from those provisions that relate to the protection of the lender's prepetition claims. [FN243]

*217 This straightforward reasoning is likely to be challenged, however, by those courts and commentators that have argued that the failure to apply Section 364(e) to all provisions of a financing order may impair a DIP's ability to obtain financing. This argument reasons that few lenders would be willing to provide financing to a DIP absent assurance that the entire “package” of liens, priorities, and other rights for which the lender bargained will be protected from reversal or modification on appeal after the lender has advanced new funds. [FN244]

In *Ellingsen*, for example, the court responded to unsecured creditors' objections that “using section 364(e)'s language to shield the order in controversy from scrutiny ... is unfair to unsecured creditors and allows secured creditors to abuse the system” [FN245] by focusing on the perceived need to induce lenders to extend new credit to the DIP:

[t]here are countervailing strong policy reasons to encourage creditors to extend additional post-petition credit to debtors. Chapter 11 envisions the continued operation of a debtor's business, but the need for fresh capital and difficulties in obtaining the capital and wherewithal to run a business are obvious. Lenders and suppliers are understandably reluctant to do business with a debtor who is in bankruptcy and who may have few, if any, unencumbered assets to offer as collateral. Section 364 is designed to encourage post-petition financing by authorizing security in the debtor's assets and giving the lender priority over administrative costs. It provides for approving such loans on an expedited basis after notice and a hearing. Subsection (e), in turn, protects the authorization for priority or a lien from reversal or modification on appeal, as long as the order has not been stayed pending appeal and the creditor extended credit in good faith. This good faith requirement allays creditors' concerns about abuse of the process. [FN246]

*218 The *Adams Apple* court echoed the policy enunciated in *Ellingsen*, and added:

Although limiting application of section 364(e) to cross-collateralization situations in which, unlike

here, a lender's post-petition funds are unpaid would protect lenders from the risk of loss associated in particular with investing in bankrupt companies, the limitation fails to take account of lenders' reliance on the possibility of profit. Without such an opportunity, lenders may choose to invest in other enterprises. Congressional intent of fostering private investment in failing companies by promoting reliance on a bankruptcy court's authorization would be defeated. [FN247]

Similarly, in *Revco*, certain preferred stockholders challenged the provision of a financing order that authorized periodic interest payments on the prepetition claims of the secured creditors who were also providing the postpetition financing. [FN248] The district court dismissed the appeal as moot under Section 364(e) because the stockholders had not obtained a stay. The Sixth Circuit agreed that the interest payments were part of the package approved by the bankruptcy court and were not subject to reversal or modification on appeal in the absence of a stay pending appeal. [FN249]

Courts subscribing to the package theory view every term of a financing order as integrally related to every other term and conclude that the entire order must be protected from challenge on appeal unless the order has been stayed pending appeal. [FN250] The argument that a DIP financing arrangement should be viewed as a “package,” protected in its entirety by Section 364(e), was rejected by *Saybrook* and has been criticized by at least one commentator. [FN251] The package theory is flawed for two principal reasons.

First, it fails to acknowledge that the express language of Section 364 applies only to postpetition extensions of credit. Proponents of the package *219 theory would expand Section 364(e) well beyond its intended scope by applying Section 364(e) to protect every term of a financing order, without regard to whether the term relates to postpetition credit, prepetition claims, or other unrelated matters.

Second, the legitimate concern that lenders should be able to rely on the term of a financing order is not seriously threatened by the failure to extend the protections of Section 364(e) to those terms of a financing order that are beyond the scope and authorization of Section 364. Tabb argues that a court could sever the illegal clause; e.g., the cross-collateralization provision, [FN252] without prejudicing the lender because the lender would retain the benefits of the legal terms of financing order relating directly to the postpetition advance of new money. [FN253] Severance is not a commonly applied remedy. A trial court generally will approve or reject a proposed order in its entirety, rather than rewriting it if certain of its terms are unacceptable. [FN254] Appellate courts have similarly been reluctant to sever possibly illegal provisions from financing orders. [FN255] Nevertheless, refusal to apply Section 364(e) to protect terms of a financing order that are not authorized under Section 364 does not involve the type of “severance” that threatens lenders' legitimate reliance on a financing order. It does not invite a court to rewrite a financing order. Rather, it merely permits the court to conduct a substantive review of those terms that do not relate to the postpetition credit. Thus, an appellate court could, and in the authors' view should, conclude that those provisions of a financing order that apply to the new postpetition financing are immune from modification or reversal on appeal in the absence of a stay pending appeal, whereas those provisions that do not apply to the new postpetition financing are beyond the scope of Section 364 and are subject to reversal or modification on appeal, even in the absence of a stay. [FN256]

220 *The Extension of Credit in Good Faith

Liens and priorities granted to a lender that did not extend credit in “good faith” are subject to reversal or modification on appeal, even if the extension of credit and the grant of such liens and priorities was not stayed pending appeal. [FN257] The good faith element of Section 364(e) provides objecting creditors with an addi-

tional basis for challenging a financing order, even if the creditors were unable to obtain a stay pending appeal.

Nevertheless, the good faith element should not be viewed as a panacea to remedy inequities caused by cross-collateralization and similar clauses. The difficulties inherent in challenging a lender's good faith based solely on the fact that the lender demanded and obtained cross-collateralization or similar preferential provisions in a financing order reaffirm the conclusion reached previously that [Section 364\(e\)](#) should be construed only to protect those provisions of a financing order that bear directly on the new credit advanced by the lender. [\[FN258\]](#)

The leading case interpreting “good faith” in the context of a financing order under [Section 364\(e\)](#) is *In re EDC Holding Co.* [\[FN259\]](#) In *EDC*, the DIP's prepetition secured creditor agreed to advance postpetition loans under a financing order that incorporated the settlement of a lawsuit brought by the DIP's union against the DIP and the secured creditor. The settlement contemplated that the DIP would use the proceeds of the loan to settle the claims of the DIP's union employees and to reimburse the union for attorney fees and other legal expenses incurred in the suit. The lender's entire claim arising from the postpetition loan was accorded the priority applicable to wage claims. [\[FN260\]](#) The official creditors' committee objected on the *221 ground that the payment of the union's attorneys' fees was impermissible under the Code and that the grant of a priority for repayment of the advances used to pay such fees was improper. The bankruptcy court approved the agreement over the committee's objection. The committee appealed, but did not obtain a stay. In the absence of a stay, the district court dismissed the appeal as moot. [\[FN261\]](#)

On appeal, the U.S. Court of Appeals for the Seventh Circuit applied [Section 364\(e\)](#), such that the terms of the financing order could not be affected by any reversal or modification on appeal unless the lender had acted in bad faith. [\[FN262\]](#) The court first noted that “the mere fact that [the lender] knew the Committee objected to its receiving a special priority with regard to that portion of the loan that was to pay the union's legal expenses does not show bad faith.” [\[FN263\]](#) The lender argued that good faith required only that the lender had not affirmatively misrepresented the terms of the transaction to the bankruptcy court. The Seventh Circuit disagreed, reasoning that, even in the absence of an express good faith provision, parties are always prohibited from making misrepresentations to or committing fraud upon a court. Specifically, the court cautioned that:

the statute was intended to protect not the lender who seeks to take advantage of a lapse in oversight by the bankruptcy judge but the lender who believes his priority is valid but cannot be certain that it is, because of objections that might be upheld on appeal. 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. [\[FN264\]](#)

Applying this test, the Seventh Circuit concluded that the lender had acted in bad faith by requiring priority payment for loans that the lender knew the DIP intended to use for an improper purpose. [\[FN265\]](#)

In *EDC*, the improper term in the financing order related directly to the purpose for which the funds were advanced. Thus, the lender's knowledge *222 of the impropriety of the intended use of the funds led directly to the conclusion that the lender had not, in the language of [Section 364\(e\)](#), “extended such credit in good faith.” [\[FN266\]](#) The application of the good faith element to financing orders containing cross-collateralization provisions is not so straightforward. [\[FN267\]](#)

First, the purpose for which the funds are to be used generally is not illegal. Rather, the issue is whether the preferential consideration (i.e., the cross-collateralization clause) received in exchange for the advance of new

funds is illegal under the Code. Thus, the direct nexus that existed in *EDC* between the credit extended and the illegal purpose does not exist. Moreover, even if a court agrees with *Saybrook* that cross-collateralization is not authorized under the Code and should be prohibited, this conclusion does not necessarily lead to a finding of bad faith on the part of the lender. The determination of a party's good faith is necessarily subjective. [FN268] The court in *EDC* concluded that the lender had extended credit in bad faith because the lender subjectively knew that the purpose for which the funds were to be advanced was improper. [FN269] Given the number of courts that have approved the use of cross-collateralization, it would be difficult for a court to conclude that a lender knew with any degree of certainty that cross-collateralization was illegal. The district court in *Saybrook*, for example, concluded that the existence of legitimate arguments in favor of cross-collateralization and the fact that other courts had approved cross-collateralization insulated the lender from a finding of bad faith. [FN270] Other courts have applied similar reasoning. [FN271]

*223 In summary, the good faith element of Section 364(e) offers little basis on which courts might be likely to reverse or modify a financing order that provides for cross-collateralization. Moreover, even if a court does find that a lender has extended credit in bad faith, it is unclear what relief will be granted. Logically, it could be argued that a bad faith determination taints the entire order, such that the court should simply reverse and remand without assuring the lender that any terms of the order will be upheld. [FN272] Stated conversely, the language of Section 364(e) suggests that the protections of Section 364(e) simply do not apply at all to a financing order if the lender extended credit in bad faith. Thus, every provision of the order may be subject to substantive review, modification, or reversal on appeal, even in the absence of a stay pending appeal. In contrast, a finding that Section 364(e) applies only to those provisions of a financing order that relate directly to the postpetition debt does not carry the negative connotations of a bad faith finding and should not subject the entire order to substantive review in the absence of a stay pending appeal. A court that declines to apply Section 364(e) to those provisions that relate to the lender's prepetition claims should nevertheless uphold the application of Section 364(e) to the terms of the order that relate directly to the postpetition advances.

Collateral Attack

If no appeal has been filed within the time permitted for appeal, it may be presumed that principles of finality, *res judicata*, [FN273] and collateral estoppel *224 bar any challenge to the provisions of a financing order, even if the order provides for cross-collateralization or other "illegal" matters. [FN274] Nevertheless, *Saybrook*'s holding that cross-collateralization is not authorized by the Code raises the spectre of direct and collateral attacks on orders from which no appeal has been taken.

Creditors or a trustee [FN275] might attempt to challenge a cross-collateralization provision on illegality grounds either directly by a motion for reconsideration or for relief from judgment, or indirectly in proceedings relating to the enforcement of the liens, priorities, and other rights granted to the lender under the financing order (e.g., allocation of the proceeds of asset sales, the lender's attempt to enforce its rights against the collateral on default, or the plan confirmation process, including the classification and treatment of the lender's claims).

Res Judicata

In *Monach* [FN276] and *Texlon*, [FN277] the courts permitted challenges to financing orders containing cross-collateralization provisions even though the objecting parties had failed to file appeals.

In *Monach*, [FN278] the Chapter 7 trustee prosecuted a motion for reconsideration of a financing order containing a cross-collateralization provision. The court granted the motion for reconsideration and vacated the financing order, holding that the failure to file an appeal did not bar reconsideration because the order had been entered without the requisite notice. [FN279] Similarly, in *Texlon*, [FN280] the trustee sought to modify a financing order *225 containing a cross-collateralization provision. Although neither the trustee nor any other party in interest had filed an appeal from the financing order, the court held that the trustee was not precluded from challenging an order that had been entered on an ex parte basis prior to the appointment of the trustee and prior to the first meeting of creditors. [FN281]

The application of *Monach* and *Texlon* should be limited because each court relied heavily on due process considerations. [FN282] The more troubling question arises when a court is asked to reconsider or vacate a financing order entered after notice and an opportunity for hearing. In such cases, if no appeal has been filed, res judicata should bar any challenge to the order. Illegality should not alter this conclusion.

An analogy may be drawn to the decisions of the Seventh Circuit in *Union Carbide Corp. v. Newboles*, [FN283] and of the Fifth Circuit in *Republic Supply Co. v. Shoaf*. [FN284] These decisions address res judicata in the context of Section 524(e) of the Code, which provides, in part, that the “discharge of a debt of the debtor does not affect the liability of any other entity on ... such debt.” [FN285] In *Newboles*, the court severed and refused to enforce a provision in a confirmed plan of reorganization purporting to discharge claims against nondebtor guarantors, notwithstanding that the objecting creditors that asserted the guaranteed claims had voted in favor of the plan. [FN286] In contrast, the court in *Republic Supply* held that the release of a creditor's claim against the nondebtor guarantor under a confirmed plan was res judicata where the creditor had neither objected to confirmation of the plan nor appealed the confirmation order. The *Republic Supply* court, in a footnote, concluded that its decision was not in conflict with the *Newboles* decision because *Newboles* did not consider whether the confirmation order was res judicata, and the court in *Republic Supply* did not dispute that the bankruptcy court had no authority to release the guarantors. [FN287] The crucial distinction is that the objecting creditors in *Newboles* *226 preserved their rights by filing an appeal. [FN288] The creditor in *Republic Supply* did not.

In other circumstances, courts have also declined to permit parties who sat on their rights to use “illegality” as the basis for an untimely assertion of those rights. For example, the Supreme Court recently rejected a late objection to a debtor's claim of exemptions. [FN289] In *Taylor v. Freeland & Kronz*, [FN290] the Court considered whether “the trustee [could] contest the validity of an exemption after the 30-day period if the debtor had no colorable basis for claiming the exemption.” [FN291] The Court rejected the trustee's challenge, reasoning that:

The parties agree that [debtor] did not have a right to exempt more than a small portion of these proceeds either under state law or under the federal exemptions specified in § 522(d). [Debtor] in fact claimed the full amount as exempt. [Trustee], as a result, apparently could have made a valid objection under § 522(1) and Rule 4003 if he had acted promptly. We hold, however, that his failure to do so prevents him from challenging the validity of the exemption now. [FN292]

Similarly, “illegality” should not be available as a basis to overturn a final financing order from which no appeal has been taken. Res judicata and finality principles should bar any such challenge. [FN293]

Collateral Estoppel

Collateral estoppel, also known as issue preclusion, “bars the relitigation of all issues that were litigated in a prior proceeding, even if the second proceeding*227 is an action on a claim different from the one asserted in the first action.” [FN294] Under this doctrine, any issues litigated in the context of a financing hearing should be immune from collateral challenge. [FN295]

Among the issues actually and necessarily determined in the context of a financing hearing are the rights, claims, liens, and priorities granted to the lender. An order providing for cross-collateralization accords the lender all of the rights of a secured creditor with respect to the liens granted and the claims secured by the order, including enforcement rights (e.g., to foreclose in the event of a default) and the right to have its claim classified and treated as a secured claim under any plan of reorganization. Thus, any proceeding challenging the lender's enforcement action or the classification and treatment of the lender's claim as a secured claim under a plan solely on the basis that the postpetition collateralization of the prepetition claim was improper would be a direct challenge to issues resolved under the financing*228 order. The doctrine of collateral estoppel should bar any such challenge. [FN296]

Federal Rule Of Civil Procedure 60(b)

Even if no successful appeal has been taken from a financing order, a creditor or the DIP could attempt to challenge the cross-collateralization provision of the order by seeking relief from the order pursuant to **Federal Rule of Civil Procedure 60(b)**. **Rule 60(b)** (made applicable in bankruptcy cases pursuant to Bankruptcy Rule 9024, with certain limitations) provides for relief from a final judgment or order for mistake, inadvertence, surprise, excusable neglect, newly discovered evidence, fraud, voidness, satisfaction of judgment, or any other reason justifying relief. [FN297] **Rule 60(b)** is designed to be of limited application. [FN298]

The leading case considering the applicability of **Rule 60(b)** to a challenge to a final postpetition financing order is the Second Circuit's decision in *Texlon*. [FN299] In *Texlon*, the court reconsidered a final financing order under the “administrative order” doctrine after rejecting arguments that **Rule 60(b)(1)** or **Rule 60(b)(4)** provided a basis for review. [FN300] The court declined to overturn the final order under **Rule 60(b)(1)** on ground of mistake, reasoning that mistake does not include judicial error except in highly unusual circumstances not present in the *Texlon* case. [FN301] The court also rejected the **Rule 60(b)(4)** challenge, reasoning that: “[a] judgment is not void merely because it is erroneous. It is void only if the court that rendered it lacked jurisdiction of the subject matter, of the parties, or if it acted in a manner inconsistent with due process of law.” [FN302]

*229 The catch-all “for any reason justifying relief” of **Rule 60(b)(6)** allows relief only in extraordinary circumstances, such as where the movant received no notice, or inadequate notice, of the hearing on or entry of an order. [FN303] Similarly, Subsections 60(b)(2), authorizing relief where new evidence has been discovered, 60(b)(3), authorizing relief on grounds of fraud or misconduct, and 60(b)(5), authorizing relief where the judgment has been satisfied or discharged or the judgment has been reversed or otherwise vacated, are not intended as a substitute for appeal and are generally inapplicable where the only basis for the challenge to a financing order is that the court made an error of law. [FN304]

Also, because an agreed financing order is a consent decree, it is a contract. As such, its binding effect arises from the parties' agreement as well as the decree of the court. [FN305] The standards for challenging a consent decree under **Rule 60(b)** are even more stringent than the standards for challenging other orders. The DIP, as a party to a consent decree, should be required to demonstrate either fraud, mutual mistake of fact, or an unfore-

seen change in circumstances in order to obtain relief from the terms of a financing order. [FN306] None of these bases should apply where the only challenge asserted is that the cross-collateralization term is not authorized by the Code. Because the DIP acts on behalf of the estate, it also could be argued that creditors of the estate should be bound by the same strict limits as are applicable to the DIP's ability to challenge a financing order. [FN307]

Thus, whether the general standards or the consent decree standards are applied, Rule 60(b) should not provide creditors with a basis to challenge a financing order from which no appeal was taken except in very limited circumstances.

***230 Summary**

Without an exhaustive empirical survey, it is impossible to determine the number of pending cases in which financing orders authorizing cross-collateralization may have been entered. Given the increasingly common use of the practice in recent years, there presumably are many. Although *Saybrook's* ruling that cross-collateralization is not “authorized” under the Code may encourage creditors, DIPs, or trustees in such cases to mount direct or indirect collateral attacks on such orders, such challenges should be prohibited under the principles of res judicata and collateral estoppel. [FN308]

Postpetition Financing After *Saybrook*

***Texlon-Type* Cross-Collateralization**

It is unclear from the discussion in *Saybrook* whether the court's prohibition of “*Texlon-type*” cross-collateralization permits any type of cross-collateralization. [FN309] *Saybrook* defined “*Texlon-type*” cross-collateralization as the pledge of assets generated postpetition [FN310] to secure prepetition debt. [FN311] This broad language could suggest that no postpetition liens may be granted for any reason with respect to the prepetition debt. *Saybrook's* reasoning suggests, however, that the decision should be read merely to prohibit the grant of postpetition liens to secure the unsecured portion of a prepetition claim. [FN312] To the extent that the term “cross-collateralization” has been applied loosely by courts or commentators to include the grant of postpetition adequate protection liens or proceeds liens or the grant *231 of liens in “prepetition” assets to secure postpetition debt, such “cross-collateralization” is not prohibited by *Saybrook*. [FN313]

Conversely, all “true” cross-collateralization, i.e., all liens granted postpetition for purposes other than adequate protection, proceeds liens or to secure postpetition credit, should be prohibited under the Code.

Will Other Courts Follow or Expand *Saybrook*?

Although *Saybrook* appears to be a well-reasoned and correct interpretation of the Code, it is difficult to predict whether other circuit courts (let alone lower courts in other circuits) might adopt *Saybrook's* reasoning. Even on issues of apparently clear statutory language under the Code, the circuit courts often split. [FN314]

Of equal interest is the extent to which courts may expand *Saybrook* either to disallow other common provisions of financing orders as not being “authorized” under the Code, or to permit review of such provisions on

appeal as not being protected by [Section 364\(e\)](#).

Provisions Relating to Prepetition Claims

The most obvious challenges may be to other provisions designed to protect the lender's prepetition claim rather than the postpetition loans, such as clauses granting cross-prioritization; [\[FN315\]](#) fixing the amount of the *232 prepetition claim; [\[FN316\]](#) determining the validity, perfection, priority, and nonavoidability of the prepetition liens; [\[FN317\]](#) or prohibiting Section 506(c) charges against the lender's collateral for costs incurred by the estate in preserving or disposing of the collateral. [\[FN318\]](#) In considering the propriety of such provisions, the same two questions that were raised by *Saybrook* should be posed: (1) "Is the provision protected by [section 364\(e\)](#)?", and (2) "Is the provision authorized under the Bankruptcy Code?"

Saybrook's reasoning suggests, correctly in the authors' view, that provisions relating to the protection of the lender's prepetition claims should not fall within the protection of [Section 364\(e\)](#) merely because they are incorporated in a financing order. [\[FN319\]](#) [Section 364\(e\)](#) is intended only to protect those terms of a financing order that relate to credit obtained or debt incurred postpetition, as provided by [Section 364](#).

Whether provisions relating to the lender's prepetition claims are permissible under the Code is a more complex question. Although a detailed analysis of this question with respect to every possible term of a financing order is beyond the scope of this article, some generalizations may be drawn from the conclusions reached in this article. First, cross-prioritization clauses probably are illegal for the same reasons that led *Saybrook* to conclude that cross-collateralization clauses are illegal; i.e., cross-prioritization accords priority (as distinguished from security, in the case of cross-collateralization) to the lender's otherwise unsecured, nonpriority, prepetition claim in violation of the Code's equality principle *233 and in a manner inconsistent with the Code's scheme for protecting the legitimate property interests of prepetition secured creditors.

Second, clauses purporting to prohibit any Section 506(c) claims against the prepetition secured creditor or its collateral likewise are probably impermissible. Section 506(c) is expressly designed to permit the estate to recover from the proceeds of the secured creditor's collateral the costs incurred by the estate in preserving the value of or disposing of the collateral for the benefit of the secured creditor. [\[FN320\]](#) If such costs are not recovered from the secured creditor's collateral, they will be borne by the estate, to the detriment of unsecured creditors. Thus, prohibiting the estate from charging such costs against the creditor's collateral directly violates not only Section 506(c) but also the equality principle, because it shifts an expense from the secured creditor to the unsecured creditors.

Finally, clauses determining the amount, validity, perfection, priority, and lack of defenses to a secured creditor's claims and liens probably are permissible in appropriate circumstances. The Code expressly provides mechanisms for the determination and allowance of secured claims and the determination of liens. [\[FN321\]](#) The nonavoidability of liens may be determined by the presentation of testimony and evidence reflecting that a reasonable investigation demonstrated the absence of any preference, fraudulent conveyance, or other challenges to the secured creditor's claims and liens. If the proper documentation is filed and presented to the court and the correct procedures are followed, including adequate notice to all parties entitled to notice, the hearing to determine and allow a secured creditor's claims and to determine the validity, perfection, and priority of its liens may be held in conjunction with the financing hearing. Conceivably, the court's findings and conclusions could be incorporated as part of the financing order, although, as noted previously, they should not be accorded the protections of [Section 364\(e\)](#). [\[FN322\]](#) The determination and allowance of a secured creditor's claims and liens

should not, however, be incorporated as a clause of a financing order absent compliance with the substantive provisions, rules, and procedures required under the Code to permit the court to make the appropriate findings of fact and conclusions of law.

Postpetition “Fraudulent Transfers”

Other potentially vulnerable provisions could include the use of upstream and cross-stream guaranties in loans made to one or more of a group of affiliated*234 DIPs. [FN323] In some instances, the loan proceeds never inure to the benefit of the guarantors. Nevertheless, each member of the group may be asked to guarantee the loan and pledge assets to secure repayment of the loan. Prepetition upstream and cross-stream guaranties are subject to attack as fraudulent transfers under the Code if the debtor issuing the guaranty did not receive reasonably equivalent value in exchange for the obligation incurred or property transferred and either (1) was insolvent on the date the obligation was incurred or became insolvent as a result of the obligation; (2) had unreasonably small capital to operate its business; or (3) intended or believed it would incur debts beyond its ability to pay. [FN324] Fraudulent transfer recovery provisions are designed to reverse the effects of transactions that intentionally or improvidently left the DIP with insufficient assets to pay its debts. The Code's goals of maximizing value and equitably distributing assets would seem to heighten the requirement that the DIP not convey assets or incur debts for less than reasonably equivalent value in the course of a bankruptcy case. *Saybrook's* reasoning, particularly its analogy to the Code's preference recovery provisions, also suggests that upstream and cross-stream guaranties should be prohibited as violations of the equality principle to the extent that the DIP/guarantor receives less than reasonably equivalent value in exchange for the obligation incurred or the assets pledged. A “postpetition fraudulent conveyance” would appear to be even more egregious than a “postpetition preference” because, to the extent that the value of the assets transferred or the amount of the obligation incurred exceeds the consideration received by the DIP, the fraudulent conveyance transferee/obligee receives a “gift” to the detriment of all creditors. In contrast, the recipient of preference receives payment on a legitimate claim for which it gave consideration; the impropriety lies merely in the fact that the payment allows it to receive more than similarly situated creditors.

*235 Whether the lender is entitled to the benefits of [Section 364\(e\)](#) of the Code with respect to an order authorizing such guaranties that has not been stayed pending appeal may be a more difficult question. Unlike a cross-collateralization provision, which relates to a prepetition claim, the guaranty relates to postpetition credit. Thus, it arguably is granted under [Section 364](#) and is protected by [section 364\(e\)](#). Two arguments could be made, however, to permit a substantive challenge on appeal, even in the absence of a stay pending appeal. First, although the guaranty and pledge of assets relates to debt incurred or credit obtained postpetition, it does not relate to debt incurred or credit obtained *by the DIP making the guaranty or pledging assets to secure the guaranty* except to the extent, if at all, that that particular DIP received the direct proceeds or indirect benefits of the loan. [FN325] Thus, the guaranty obligation may be beyond the scope of [Section 364](#) and, as a result, beyond the protections of [Section 364\(e\)](#). Second, even if the guaranty is protected by [Section 364\(e\)](#), the lender's good faith may be challenged on grounds analogous to those employed by the court in *EDC*. [FN326] In essence, it could be argued that the lender acted in bad faith by demanding terms that it knew to be impermissible under the Code. Unlike *EDC*, however, the improper term (the upstream or cross-stream guaranty) relates to the protections accorded to the lender, rather than to any improper purpose of the loan itself. Also, a lender could attempt to rebut the argument that it knew that the term was improper by presenting evidence of other cases in which similar guaranties were permitted. Thus, the good faith challenge may face some of the same obstacles that make it difficult to mount a successful good faith challenge to an order providing for cross-collateralization. [FN327]

Provisions Relating Directly to the Postpetition Financing

Finally, financing orders frequently contain terms that are not expressly itemized in [Section 364](#) but that relate directly to the new postpetition loans advanced under the order. Such terms may include interest rate and payment provisions, covenants, events of default, and remedies. Such provisions should not be prohibited merely because they are not expressly listed in [Section 364](#). In drafting [Section 364](#), Congress could not have itemized every possible provision of a loan agreement or financing order. To the extent that such provisions are of a type commonly included in loan agreements and such provisions do not violate a specific provision or general policy of the Code, they should be permissible.

***236** Similarly, a term that relates directly to the postpetition new loans should be within the scope of the protections of [Section 364\(e\)](#), unless the term is deemed to be an illegal violation of the Code or other applicable law. [\[FN328\]](#)

Saybrook's Impact on DIP Financing

Saybrook ushers in a changed scenario for lenders, DIPs, creditors, and courts considering the terms of postpetition financing orders. Cross-collateralization is no longer a permissible means of inducing a prepetition creditor to advance new loans to a DIP (at least in the Eleventh Circuit) and the mootness doctrine of [Section 364\(e\)](#) can no longer be relied on to foreclose appellate review of cross-collateralization provisions (or, perhaps, other financing terms that relate to prepetition claims).

Ultimately, the question is whether this changed scenario will alter or impair DIPs' ability to obtain crucial financing. The answer to this question requires a consideration of (1) whether prepetition secured creditors will decline to permit the use of cash collateral or to advance new loans in the absence of cross-collateralization; (2) whether new lenders or prepetition secured creditors providing new financing will be reluctant to advance new funds before all appeals have been resolved; and (3) whether new terms that lenders may request in exchange for the loss of cross-collateralization will adversely affect DIPs' ability to obtain financing on acceptable terms. Although the answers to these questions are necessarily speculative, some general conclusions may be drawn if one considers the risks and incentives inherent in any financing controversy and assumes that lenders, DIPs, and other parties in interest will act in their own economic best interests. [\[FN329\]](#)

Risks and Incentives for the Secured Creditor

A borrower's decision to file a Chapter 11 case often forces the prepetition secured creditor to choose between (1) stemming its losses by pressing for liquidation and (2) seeking to maximize recovery on its prepetition claims ***237** by permitting the continued use of the creditor's collateral, and possibly advancing new loans to the DIP, in an effort to keep the DIP operating. [\[FN330\]](#) Advancing new loans and permitting the DIP's use of the creditor's cash collateral may place at risk the proverbial good money after bad, merely exacerbating the creditor's losses. On the other hand, the creditor's refusal to consent to the use of cash collateral or the advance of new DIP loans raises the uncertainty of a contested adequate protection hearing, [\[FN331\]](#) the possibility of a priming lien, [\[FN332\]](#) the risk that a new lender will displace a profitable relationship, [\[FN333\]](#) the potential for owner/operator, control or other lender liability if the secured creditor controls the liquidation or operates the business as a secured creditor in possession pending sale, [\[FN334\]](#) and the risk that, on liquidation or foreclosure, the secured creditor may receive ***238** less than it would have received if the business had been operated and

the secured creditor had been paid from cash flows or from a sale of the DIP as a going concern. These same risks may face the prepetition secured creditor if the court declines to approve a proposed cash collateral or financing order and the secured creditor is forced to decide, often literally on the steps or in the halls of the courthouse, whether it will accede to less favorable terms. [FN335]

Thus, prepetition secured creditors have significant incentives to permit the use of their cash collateral and to advance new DIP financing even in the absence of such a “windfall” as cross-collateralization. A reasonable, sophisticated and well-advised lender can be expected to recognize these risks and incentives and take them into account in determining whether its economic interests are best served by cooperation or intransigence. Although there may be cases in which the prohibition of cross-collateralization as a financing incentive will tip the economic scales in favor of liquidation, the authors are not convinced that the prohibition will have the dire consequences of significantly increasing the number of DIPs who are unable to obtain financing. Moreover, liquidation may not necessarily be an undesirable result. There may be cases in which unsecured creditors will receive a greater dividend on liquidation, (by virtue of the proceeds of unencumbered property being shared pro rata among all unsecured claims including the unsecured portion of the prepetition secured creditor's claim) than they would have received if the DIP had continued to operate under circumstances in which the value of all unencumbered property was transferred to the prepetition undersecured creditor by virtue of cross-collateralization. [FN336]

Risks and Incentives for the New Lender

For the new postpetition lender, the principal risk of the court's refusal to approve a financing agreement is that the lender will be faced with the choice of modifying its agreement or walking away. If the lender declines to *239 modify the terms of its proposed financing, the lender may face the loss of a lucrative present and future customer. [FN337]

The risk of an appeal should not be sufficient to cause new lenders to refuse to advance funds pending an appeal under a financing order that has not been stayed pending appeal. To the extent that the terms of the order relate directly to the postpetition loans, they should fall within the protection of Section 364(e) and should not be affected by any reversal or modification on appeal, provided that the order has not been stayed and the lender has acted in good faith. [FN338]

Risks for the DIP

For the DIP, the most fundamental risk of failed financing negotiations or a contested financing hearing is that the DIP may be forced to terminate operations, and possibly to liquidate, if it is unable to obtain prompt access to critical funds.

The DIP's efforts to obtain essential financing may be frustrated in a variety of circumstances, including where (1) the DIP cannot reach acceptable terms with its secured creditors to use their cash collateral or with a proposed DIP lender to obtain new financing; [FN339] (2) the DIP cannot prove that a prepetition secured creditor's [FN340] interest in the DIP's property will be adequately protected, as is required to permit the DIP to use the creditor's cash collateral without the creditor's consent [FN341] or to impose a *240 priming lien; [FN342] (3) the court, sua sponte or at the urging of creditors, declines to approve a cash collateral or postpetition financing arrangement on the terms to which the DIP and the prepetition creditor or postpetition lender have agreed;

(4) the order authorizing the DIP to use cash collateral is appealed; [FN343] or (5) the order authorizing the DIP to obtain postpetition credit is stayed pending an appeal.

Conversely, the lack of flexibility imposed on a DIP that agrees to financing arrangements that narrowly limit the DIP's operations and use of cash or the terms of any plan of reorganization, [FN344] could impair the DIP's ability to reorganize successfully and increase the potential that the DIP will default. [FN345] The risk of liquidation increases if, on default under the terms of cash collateral or postpetition financing agreements, the DIP is subjected to self-executing "drop dead" clauses granting the lenders the right to foreclose on the DIP's assets without further order or substantive involvement of the bankruptcy court. [FN346] Thus, the DIP must balance the need to obtain operating financing against the risk that agreeing to overly restrictive or expensive terms ultimately will contribute to the possibility of liquidation.

A DIP's ability to obtain financing and the terms available may well turn on the prospective lenders' recognition of the risks and rewards of providing financing. The increasing frequency with which lenders have been forced to address their borrowers' Chapter 11 cases has significantly increased many lenders' understanding of Chapter 11 and of the risks and benefits of permitting borrowers to use the lenders' cash collateral and of advancing DIP financing. Several lenders have actually created facilities for the sole purpose of providing DIP financing loans. [FN347] As a result, cash *241 collateral and DIP financing orders and agreements have become increasingly standard as well as increasingly lengthy and complex with highly sophisticated cost and fee structures. [FN348] Although lenders may attempt to formulate new financing incentives, costs and fees to replace the benefits lost through the prohibition of cross-collateralization, the authors suspect that any new costs that lenders may devise likely would be requested as additional terms whether or not cross-collateralization were permitted. Thus, it would be difficult at best to conclude that the costs of DIP financing might increase as a direct result of the prohibition on cross-collateralization.

Conclusions and Recommendations

Based on an analysis of the fundamental policies of debtor rehabilitation and creditor equality underlying the Code and of the specific provisions of the Code governing the protection of secured creditors and the obtaining of postpetition credit, the authors conclude that cross-collateralization should be prohibited as a means of inducing postpetition credit under the Code. Similarly, other provisions that accord priority, security, or other preferential treatment to the unsecured portion of a secured creditor's prepetition claim should be prohibited as violations of the equality principle and of the Code's scheme for protecting secured creditors and for inducing postpetition credit.

Even if some courts continue to allow cross-collateralization and to accord it the protections of [Section 364\(e\)](#), prepetition lenders are not well served by continuing the practice of seeking preferential treatment (through cross-collateralization or other means) for their prepetition claims in exchange for providing new financing. All of the policy arguments cited by those supporting the practice of granting preferential treatment to the prepetition secured creditor focus on creating incentives for the *postpetition* advance, without regard to whether the new money is advanced by a new lender or a prepetition lender. The prepetition creditor that is providing postpetition financing is better served by foregoing the demand for cross-collateralization (and the risk that it will be denied, reversed on appeal, or subjected to collateral attack) and, instead, (1) obtaining proceeds liens and adequate protection liens or other protections to preserve the value of the secured portion of the creditor's prepetition claim and (2) requiring such terms as the lender deems appropriate and necessary*242 as the cost of

and to protect and ensure the repayment of the advance of postpetition financing. [FN349] Orders providing for the DIP's use of the creditor's cash and other collateral should clearly delineate the nature and extent to which the creditor is granted adequate protection liens and proceeds liens, regardless of whether the creditor advances postpetition financing. Lenders and DIPs should also carefully craft financing orders to delineate clearly the nature and extent to which fees, costs, liens, priorities, and other incentives relate to the new loans, rather than to the lender's prepetition claims. By so doing, the lender, the DIP, and the other creditors will be able to determine, in the proper context of quantifying what price they are willing to pay to obtain the new financing, whether the terms required are acceptable. Similarly, the court may focus directly on the cost of the new financing without the uncertainties associated with an attempt to quantify the cost of cross-collateralization (e.g., valuation of the creditor's prepetition secured claim and estimation of the value of the additional collateral being pledged).

Moreover, even if the cost of the new financing is steep, where the terms (e.g., interest rate, fees, and the like) relate directly to the new financing, it would be difficult to argue that an order authorizing the new credit is not protected from reversal on appeal by the mootness doctrine of [Section 364\(e\)](#) where no stay pending appeal has been obtained. [FN350] If financing orders are challenged on appeal, parties should urge the courts to apply [Section 364\(e\)](#) strictly to insulate those provisions that relate directly to the postpetition debt from reversal or modification, absent a stay pending appeal. Provisions included in financing orders that do not bear directly on the postpetition loans should not, however, enjoy the protections of [Section 364\(e\)](#). Parties should not be permitted to extend the special protections accorded to postpetition credit under [Section 364](#) to terms that do not relate to the postpetition credit simply by inserting such terms in a postpetition financing order.

*243 Nevertheless, if a financing order has been entered, no appeal has been taken, and the time for taking an appeal has expired, general principles of finality, res judicata and collateral estoppel should prohibit any direct or collateral attack on the terms of the order, even if such terms include cross-collateralization or other provisions prohibited under the Code.

Saybrook's holding that cross-collateralization is not a permissible means of obtaining financing under the Code may cause secured creditors to request alternative incentives to provide DIP financing. The nature and economic value of such alternatives will be limited only by the creativity of those developing them. Nevertheless, to the extent that new devices are deemed to prefer the prepetition secured creditor over other creditors unfairly, they may and should be subject to the same fate as cross-collateralization.

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[FN1]. Unless otherwise indicated, all section references in this article are to [Title 11 USC Sections 101-1330 \(1978\)](#), as amended (hereafter the Code). The Code is derived from The Bankruptcy Reform Act of 1978 ([Pub. L. No. 95-598, 92 Stat. 2549](#)) as amended by The Bankruptcy Amendments and Federal Judgeship Act of 1984 ([Pub. L. No. 98-353, 98 Stat. 333](#)), The Bankruptcy Judges, United States Trustees, and Family Farmer Bank-

ruptcy Act of 1986 ([Pub. L. No. 99-554, 100 Stat. 3114](#)), The Retiree Benefits Bankruptcy Protection Act of 1988, ([Pub. L. No. 100-334, 102 Stat. 610](#)), The Crime Control Act of 1991 ([Pub. L. No. 101-647, 104 Stat. 4789](#)), The Energy Policy Act of 1992 ([Pub. L. No. 102-486, 106 Stat. 2776](#)), and The Rail Safety Enforcement and Review Act of 1992 ([Pub. L. No. 102-365, 106 Stat. 972](#)). The Federal Rules of Bankruptcy Procedure shall be referred to as the Bankruptcy Rules. The former Bankruptcy Act of 1898 (ch. 541, 30 Stat. 544), as substantially amended by The Chandler Act of 1938 (ch. 575, 52 Stat. 840) (repealed 1979), which was repealed by the Bankruptcy Reform Act of 1978, shall be referred to as the Bankruptcy Act.

[FN2]. The Code provides five distinct chapters under which debtors may seek relief from creditors: Chapter 7 (liquidation of an individual, partnership, corporation, or other entity except a governmental unit, railroad, certain insurance companies, and certain financial institutions), Chapter 9 (adjustment of the debts of a municipality), Chapter 11 (reorganization of an individual, partnership, corporation, or other entity except a governmental unit, stockbroker, commodity broker, certain insurance companies, and certain financial institutions), Chapter 12 (adjustment of the debts of a family farmer with regular annual income), and Chapter 13 (adjustment of the debts of an individual with regular income). Eligibility requirements for relief under each such chapter are set forth in Section 109 of the Code. [11 USC § 109 \(1993\)](#). Except as expressly noted, the scope of this article is limited to Chapter 11 reorganization of business debtors, other than railroads. Chapter 11 contains special provisions governing railroad reorganization cases. See [11 USC §§ 1161-1174 \(1993\)](#).

[FN3]. See, e.g., [In re Ames Dep't Stores, Inc. 115 BR 34, 36 \(Bankr. SDNY 1990\)](#) (“most successful reorganizations require the debtor-in-possession to obtain new financing simultaneously with or soon after the commencement of the chapter 11 case”); B. Henoch, “[Postpetition Financing: Is There Life After Debt?](#)”, [8 Bankr. Dev. J. 575, 575-576 \(1991\)](#) (“without financing to keep the [DIP] in business, the company will ... fail quickly”); 2 L. King, *Collier on Bankruptcy*, ¶ 363.01, at 363-366 (15th ed. 1992) (hereafter *Collier*) (continued use of property and its proceeds may be vital to a successful rehabilitation); S. Stripp, “[Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11](#),” [21 Seton Hall L. Rev. 562, 563 \(1991\)](#) (“An order authorizing the debtor's use of cash collateral is often the most important order entered in a chapter 11 case.”); C. Tabb, “[A Critical Reappraisal of Cross-Collateralization in Bankruptcy](#),” [60 S. Cal. L. Rev. 109, 111 \(1986\)](#) (hereafter “*Critical Reappraisal*”) (without new financing during the case, successful reorganization probably would not be possible).

[FN4]. Anecdotal evidence reflects that few DIPs can operate without using cash collateral or obtaining post-petition financing. Empirical statistics are not readily available.

[FN5]. Under Chapter 11, the debtor is permitted to remain in possession of its assets and operate its business unless a trustee has been appointed. See [11 USC §§ 1101\(1\), 1107, 1108 \(1993\)](#). With certain exceptions and subject to such limitations as may be imposed by the Code or the bankruptcy court, the DIP has all of the rights and duties of a Chapter 11 trustee. [11 USC § 1107\(a\) \(1993\)](#). Unless otherwise indicated, the term “DIP” shall refer to the post-Chapter 11 filing entity; “debtor” shall refer to the pre-Chapter 11 filing entity (which latter entity, rather than the DIP, is the party entitled to file a plan of reorganization where no trustee has been appointed) and “trustee” shall refer to a trustee appointed or elected pursuant to Section 701, Section 702 or Section 1104 of the Code. See [11 USC §§ 701, 702, 1104, 1121\(a\) \(1993\)](#); see also [11 USC § 1106\(a\)\(5\) \(1993\)](#) (duty of Chapter 11 trustee, where appointed, to file plan).

[FN6]. “Cash collateral” is defined as
cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equival-

ents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title [11].

[11 USC § 363\(a\)](#) (1993).

[FN7]. See [11 USC § 363\(c\)\(2\)](#) (1993) (discussed *infra* note 33 and accompanying text).

[FN8]. See [11 USC § 364](#) (1993) (discussed *infra* notes 50-59 and accompanying text).

[FN9]. The provisions of the Code governing the use of cash collateral ([Section 363\(c\)](#)) and obtaining of postpetition credit ([Section 364](#)) apply to business and nonbusiness debtors under Chapters 7, 11, 12, and 13, and, with the exception of incurring unsecured postpetition debt in the ordinary course as an administrative expense ([Section 364\(a\)](#)), apply without regard to whether the business is authorized to be operated. See [11 USC §§ 103\(a\), 363, 364, 552, 721, 1108, 1161, 1203, 1204, 1304](#) (1993). Certain provisions of [Section 364](#) also apply in Chapter 9 municipality debt adjustment cases. See [11 USC § 901\(a\)](#) (1993).

[FN10]. [963 F2d 1490](#) (11th Cir. 1992).

[FN11]. The term “postpetition,” as used herein, shall refer to the period from and after the filing of a petition commencing a voluntary or involuntary case under Chapter 11. See [11 USC § 301](#) (commencement of a voluntary case), [11 USC § 303\(a\)](#) (permissible debtor in an involuntary case), [11 USC § 303\(b\)](#) (commencement of an involuntary case) (1993). The term “prepetition” shall refer to the period prior to the filing of any such petition. Note that, in an involuntary case, the debtor may continue to use, acquire, or dispose of property, including cash collateral, until the entry of an order for relief as if the involuntary case had not been commenced. [11 USC § 301\(f\)](#) (1993); see [11 USC § 301\(h\)](#) (1993) (entry of order for relief in an involuntary case).

[FN12]. [963 F2d at 1494-1496](#). See discussion *infra* notes 72-83 and accompanying text (suggesting a definition of “cross-collateralization”).

[FN13]. The debate concerning cross-collateralization is summarized *infra* notes 137-233 and accompanying text.

[FN14]. [963 F2d at 1496](#).

[FN15]. See discussion *infra* notes 225-233 and accompanying text.

[FN16]. See discussion *infra* notes 234-308 and accompanying text.

[FN17]. See generally [11 USC §§ 361, 362, 363, 364, 507\(b\), 552](#) (1993); D. Hillman & M. Caras, “[When the Bank Wants Its Borrower in Bankruptcy: Benefits of Bankruptcy for Lenders and Lender Liability Defendants](#),” [40 Me. L. Rev. 375](#) (1988); Stripp, *supra* note 3.

[FN18]. [Grogan v. Garner](#), [498 US 279](#) (1991), quoting [Local Loan Co. v. Hunt](#), [292 US 234, 244](#) (1934) (“a central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy ‘a new opportunity in life and with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt,’” but such “fresh start” is limited to the “honest but unfortunate debtor”); [Louisville Land Bank v. Radford](#), [295 US 555, 587-588](#) (1935) (“The ori-

ginal purpose of our bankruptcy act was the equal distribution of the debtor's property among his creditors The discharge of the debtor has come to be an object of no less concern than the distribution of his property.”); [Williams v. US Fidelity Co.](#), 236 US 549, 554-555 (1915) (“purpose of the Bankruptcy Act [is] to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh”); HR Rep. No. 595, 95th Cong., 1st Sess. 125 (1977) (“the purpose of straight bankruptcy ... is to obtain a fresh start, free from creditor harassment and free from the worries and pressures of too much debts”).

[FN19]. See, e.g., [Crocker Nat'l Bank v. American Mariner Indus. \(In re American Mariner Indus.\)](#), 734 F2d 426, 431 (9th Cir. 1984), quoting HR Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) (“the purposes of business reorganization [are] to initially relieve the debtor of its prepetition debts, to free cash flow to meet current operating expenses, and ultimately to permit the debtor to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders”).

[FN20]. The tension between these policies in the context of cross-collateralization is discussed *infra* notes 225-233 and accompanying text.

[FN21]. By virtue of Section 365(c)(2) of the Code, which prohibits a trustee from assuming or assigning an executory contract to make a loan or extend other debt financing or financial accommodations to the debtor, a lender has no obligation to continue to extend financing under a prepetition lending agreement subsequent to the petition date. 11 USC § 365(c)(2) (1993); see also 11 USC § 365(e)(2)(B) (1993); [Watts v. Pennsylvania Hous. Fin. Co.](#), 876 F2d 1090, 1095 (3d Cir. 1989) (prepetition lender may enforce clause in lending agreement permitting termination or modification of agreement on commencement of borrower's bankruptcy case). The courts have disagreed whether Section 365(c) absolutely prohibits assumption of a prepetition financing agreement even if the lender consents to the assumption or merely prohibits assumption of such an agreement absent the lender's consent. Compare [Transamerica Commercial Fin. Corp. v. Citibank \(In re Sun Runner Marine, Inc.\)](#), 945 F2d 1089 (9th Cir. 1991) (Section 365(c)(2) bars assumption of financial accommodation agreements even with all parties' consent) and [In re Placid Oil Co.](#), 72 BR 135, 139 (Bankr. ND Tex. 1987) (“prohibition against assumption of contracts for ‘financial accommodation’ ... is for the benefit of all claimants against the estate”) with [In re Prime, Inc.](#), 15 BR 216, 218 (Bankr. WD Mo. 1981) (Section 365(c)(2) does not bar assumption of a financial accommodation contract if all parties consent). Cf. [In re TS Indus., Inc.](#), 117 BR 682, 684-685 (Bankr. D. Utah 1990) (prepetition restructuring agreement that contemplates certain financial accommodations on the filing of an anticipated Chapter 11 case may be assumed and incorporated into plan of reorganization proposed by creditors over DIP's opposition); D. Pew, “The Need for Speed and Common Sense: Rewriting § 365(c)(2) to Recognize the Practice of Prepetition Agreements for § 364 Debtor-In-Possession Financing,” 140 U. Pa. L. Rev. 2471 (1992) (arguing that Section 365(c)(2) should be amended to permit assumption of prepetition restructuring agreements). Pew, *Prime*, and *TS Industries* fail to recognize that the assumption of a prepetition financial accommodation agreement (1) permits the DIP to obtain postpetition credit merely by satisfying the “business judgment” test applicable to the assumption of an executory contract rather than the more stringent requirements, discussed *infra* notes 50-59 and accompanying text, applicable to the incurrence of postpetition debt and (2) may require that the DIP cure prepetition monetary defaults that otherwise would be deferred and treated under a plan of reorganization. See [TS Indus.](#), 117 BR at 685 (courts apply business judgment test to determine whether to permit assumption or rejection of executory contract).

[FN22]. 11 USC § 101(37) (1993). A “security interest” is a specific type of lien, i.e., a “lien created by an agreement.” 11 USC § 101(51) (1993). State law (including real estate mortgage laws and the Uniform Commer-

cial Code) or other applicable nonbankruptcy law governs the determination of the extent to which a creditor holds a lien on property of the estate. See *Butner v. United States*, 440 US 48, 56 (1979) (state law defines the security interest). Such interests may, however, be subject to avoidance under the Code's avoidance and recovery powers. *Id.* at 54; see generally 11 USC §§ 544-549 (1993).

[FN23]. 11 USC § 506(a) (1993). Collateral valuation is inherent in the calculation of a secured claim. “Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.” 11 USC § 506(a) (1993). Bankruptcy valuation issues are analyzed in C. Fortgang & T. Mayer, “Valuation in Bankruptcy,” 32 UCLA L. Rev. 1061 (1985).

[FN24]. A claim is (1) unsecured if the holder has no lien interest in property of the estate to secure repayment of the claim; (2) undersecured if the value of the holder's lien interest in property of the estate to secure repayment of the claim is less than the amount of the claim; (3) fully secured if the value of the holder's lien interest in property of the estate to secure repayment approximately equals the amount of the claim; and (4) oversecured if the value of the holder's lien interest in property of the estate to secure repayment exceeds the amount of the claim. See 11 USC §§ 101(37) (1993) (defining lien), 506(a) (1993).

[FN25]. The former Bankruptcy Act employed the phrase “adequate protection” in the context of plan confirmation. If a class of creditors affected by a plan of reorganization (under Chapter X) or an arrangement, (under Chapter XII) did not accept the plan or arrangement, the Bankruptcy Act required that such creditors receive “adequate protection” for by such creditors of the value of their claims against property dealt with by the plan or arrangement. Bankruptcy Act §§ 216(7), 461(11) (1978). A similar requirement existed under an earlier version of the railroad reorganization provisions of the Bankruptcy Act. Bankruptcy Act §§ 77(e), 77(g) (1933); see *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry.*, 294 US 648, 663-666 n.4 (1935); cf. Bankruptcy Act §§ 77(b), 77(e) (1978). Chapter XI of the Bankruptcy Act, which provided solely for an arrangement of unsecured claims, contained no parallel provision. See Bankruptcy Act §§ 356, 362 (1978). The Chapter X and Chapter XII adequate protection provisions were superseded by the “cramdown” requirements under Chapter 11 of the Code. See 11 USC § 1129(b) (1993) (discussed *infra* notes 166-170). The concept of adequate protection under the Bankruptcy Act does not readily translate into adequate protection under the Code because the purposes for protecting property interests during a bankruptcy case differ significantly from the purposes for treating secured claims under a plan. The former Bankruptcy Act did not expressly provide for the protection of secured creditors' property interests during the pendency of a bankruptcy case. The development of such protections was left to the courts, generally in the context of secured creditors' challenges to a trustee's authority under the Bankruptcy Act and the Fifth Amendment to the U.S. Constitution to use, dispose of, compel the turnover of, or impose a priming lien on the creditor's collateral. See *Wright v. Vinton Branch Bank*, 300 US 440 (1937) (impairment of secured creditor's enforcement rights by debtor's retention of collateral during enforcement of the automatic stay was not deprivation of Fifth Amendment due process); *Louisville Land Bank v. Radford*, 295 US 555 (1935) (substantial impairment of secured creditors' property rights violates Fifth Amendment); *In re Penn Central Transp. Co.*, 454 F2d 9, 13 (3d Cir. 1972) (rights of secured creditors are subject to modification consistent with the Fifth Amendment, provided such rights are not substantially impaired); *Reconstruction Fin. Corp. v. Kaplan*, 185 F2d 791, 798 (1st Cir. 1950) (“power to order such turnover [of cash collateral] may be inferred from the numerous cases in which the court ordered the reorganization trustee to collect rents and profits from mortgaged realty, or dividends and interest from pledged stocks and bonds”); *Melniker v. Lehman (In re Third Ave. Transit Corp.)*, 198 F2d 703 (2d Cir. 1952) (Bankruptcy Act permits trustee to issue certificates of indebtedness with seniority over existing liens to secure loans for operating expenses, but only if

trustee establishes high degree of likelihood of a successful reorganization within a reasonable time); *In re Chicago, Rock Island & Pac. Ry.* 545 F2d 1087 (7th Cir. 1976) (at the outset of a case, trustee may issue certificates of indebtedness with seniority over existing liens on a showing that reorganization was not clearly impossible); 2 Collier, supra note 3, at ¶ 364.05 at 364-13 (“[t]he requirement of adequate protection is a substitute for the more detailed findings that were required in cases such as *In re Third Avenue Transit Corporation*”); 2 Collier, supra note 3, at ¶ 363.01 at 363-9 (“the bankruptcy power could permit enactment of a bankruptcy act which preserved the value of the secured creditor's position but not its rights in specific collateral”). See also HR Rep. No. 595, 95th Cong., 1st Sess. 4-5 (1977). (The Code “codifies creditors' rights more clearly than the case law, which is in many ways just developing. It defines the protection to which a secured creditor is entitled, and the means through which the court may grant that protection.”); see generally HR Rep. No. 595, 95th Cong., 1st Sess. 339 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978).

[FN26]. The principal provisions of the Code involving adequate protection are Sections 361, 362, 363, 364, 506(a), 507(b), 553 (1993). 11 USC §§ 361, 362, 363, 364, 506(a), 507(b), 553 (1993). Section 901 makes adequate protection applicable in Chapter 9 cases (to the extent that Sections 362, 364, 506 and 553 apply in Chapter 9 cases). 11 USC § 901(a) (1993). In Chapter 12 cases, adequate protection is governed by Section 1205 rather than Section 361. 11 USC § 1205(a) (1993). By virtue of the incorporation of Section 553 into the definition of a “secured claim” under Section 506(a), the claim of a creditor having a right of setoff against estate property is deemed a secured claim to the extent of the amount subject to setoff, with the same entitlement to adequate protection as other secured claims. See 11 USC §§ 506(a), 553 (1993); see also supra notes 22-24 and accompanying text (determination of secured status). The property interests of a co-owner of property of the estate also are entitled to adequate protection. 11 USC §§ 362(d), 363(e) (1993). For ease of reference, this article shall focus on the rights of a creditor holding a security interest or other lien.

[FN27]. *Wright v. Union Cent. Life Ins. Co.*, 311 US 273, 278 (1940) (“Safeguards were provided to protect the rights of secured creditors ... to the extent of the value of the property. [citations omitted] There is no constitutional claim of the creditor to more than that.”); *In re George Ruggiere Chrysler-Plymouth*, 727 F2d 1017, 1019 (11th Cir. 1984) (“security interests are ‘property rights’ protected by the Fifth Amendment”).

[FN28]. The Fifth Amendment states, in part, that: “No person shall be ... deprived of ... property, without due process of law; nor shall private property be taken for public use, without just compensation.” U.S. Const. amend. V.

[FN29]. The U.S. Constitution provides the constitutional authority for the Bankruptcy Code, as follows: “The Congress shall have Power ... To establish ... uniform Laws on the subject of Bankruptcies throughout the United States.” U.S. Const. art. I, § 8, cl. 4. See *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry.*, 294 US 648, 680-681 (1935) (Congress has authority to pass legislation pertinent to bankruptcies even if it impairs the obligation of private contracts).

[FN30]. See *Wright v. Union Cent. Life Ins. Co.*, 311 US 273, 278-279 (1940) (Bankruptcy Act rehabilitates distressed debtors and safeguards the rights of secured creditors); *Lend Lease v. Briggs Transp. Co. (In re Briggs Transp. Co.)*, 780 F2d 1339, 1342 (8th Cir. 1985) (“By providing a creditor with a means of protecting its interest through section 362(d)'s adequate protection requirement, the competing interests of the debtor's need to reorganize and the secured creditor's entitlement to constitutional protection of its bargained-for property interests are reconciled”); see also HR Rep. No. 595, 95th Cong., 1st Sess. 338-339 (1977) (“[T]he concept [adequate protection] is derived from the fifth amendment protection of property interests ... [but] is not inten-

ded to be confined strictly to the constitutional protection required Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws ... the purpose of this section is to insure that the secured creditor receives in value essentially what he bargained for.”); see generally V. Artzt, “Adequate Protection Under the Automatic Stay: Recent Developments in the Theories of American Mariner & In re Alyucan,” 4 Bankr. Dev. J. 61 (1987); D. Baird & T. Jackson, “[Corporate Reorganizations & the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy](#),” 51 U. Chi. L. Rev. 97 (1984); J. Rogers, “[The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause](#),” 96 Harv. L. Rev. 973 (1983); J. Sack, “Adequate Protection,” 2 Bankr. Dev. J. 21 (1985).

[FN31]. 2 Collier, *supra* note 3, at ¶ 361.01 at 361-367.

[FN32]. Section 362(d) provides that “the court *shall* grant relief from the stay ... for cause, including the lack of adequate protection of an interest in property.” 11 USC § 362(d) (1993) (emphasis added). The filing of a petition commencing a case under the Code acts as an automatic stay against a wide range of acts against the debtor and property of the bankruptcy estate or in the possession of the bankruptcy estate. 11 USC § 362(a) (1993); see also *infra* note 78 (filing of case creates estate). Among the acts stayed that may impair or delay a secured creditor's exercise of its rights are: (1) the commencement or continuation against the debtor of litigation that was or could have been commenced prepetition or to recover a claim that arose prepetition; (2) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate; (3) any act to enforce a lien against property of the estate; (4) any act to enforce against property of the debtor a lien that secures a claim that arose prepetition; (5) any act to collect a claim that arose prepetition; and (6) the setoff of any prepetition debt owing to the debtor against any claim against the debtor. 11 USC §§ 362(a) (1), 362(a)(3)- 362(a)(7) (1993). Unless the secured creditor obtains relief from the stay to proceed with action against collateral that is property of the bankruptcy estate (see 11 USC §§ 362(d), 363(d) (1993)), the DIP will be permitted to use, sell, or lease the collateral in or out of the ordinary course of business, as provided under Subsections 363(b) and 363(c). 11 USC §§ 363(b), 363(c) (1993).

[FN33]. 11 USC §§ 363(c)(2), 363(e) (1993). Adequate protection ensures that the value of the secured creditor's lien does not diminish as inventory is sold, accounts collected, cash and cash equivalents spent, raw materials consumed, or as tangible assets decline in value.

Also, the DIP may not compel a creditor to pay to the estate a debt subject to setoff absent adequate protection of the creditor's setoff rights. Section 542(b) provides, in part, that: “an entity that owes a debt that is property of the estate ... shall pay such debt to ... the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.” 11 USC § 542(b) (1993). The Section 553 exception does not fully protect the creditor, however, because Section 553 remains subject to the DIP's right to use, sell, or lease property. “Except as otherwise provided ... in sections ... 363 ..., this title does not affect any right of a creditor to offset a mutual debt.” 11 USC § 553(a) (1993). Section 363 conditions the DIP's right to use, sell, or lease property in which an entity other than the estate has an interest on adequate protection of such interest. 11 USC §§ 363(b), 363(c), 363(e) (1993). Taken together, these provisions suggest that the DIP may compel the payment of a debt subject to offset if the DIP provides adequate protection of the creditor's setoff right. See *supra* note 26 (secured status of a creditor having a right of setoff).

[FN34]. 11 USC § 364(d)(1) (1993).

[FN35]. See [Lend Lease v. Briggs Transp. Co. \(In re Briggs Transp. Co.\)](#), 780 F2d 1339, 1342 (8th Cir. 1985) (“adequate protection is ... provided to protect the rights of secured creditors ... to the extent of the value of their property”).

[FN36]. [United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.](#), 484 US 365, 370 (1988) (“if the [collateral] ... had been declining in value petitioner would have been entitled ... to cash payments or additional security in the amount of the decline”); [Vienna Park Properties v. United Postal Sav. Ass'n \(In re Vienna Park Properties\)](#), 976 F2d 106, 114 (2d Cir. 1992) (“§ 363(c)(2) prohibits the Debtor's use of [the secured creditors' collateral] without the Secured Creditors' consent or court authorization ... such authorization [may not] be granted once the Secured Creditors have requested protection absent a finding that their interests are adequately protected”). The secured creditor also should be entitled to the benefit of any increase in the value of its collateral during the case. [Dewsnup v. Timm](#), 112 S. Ct. 773, 778 (1992); see [In re Landing Assocs., Ltd.](#), 122 BR 288, 293 (Bankr. WD Tex. 1990) (“secured creditor's interest in property may well *grow* during pendency of case”); cf. 11 USC § 1111(b)(2) (1992) (undersecured creditor in Chapter 11 may retain the benefit of any postconfirmation increase in the value of its collateral by electing to forego its deficiency claim and retain its lien in the collateral to secure the full amount of its claim under a plan that provides for the debtor's retention of the collateral); [Etchin v. Star Servs., Inc. \(In re Etchin\)](#), 128 BR 662, 666 (Bankr. WD Wis. 1991) (pursuant to Section 1111(b), “creditor ... may receive the benefit of any appreciation of the collateral”).

[FN37]. See [Drebitko v. Miners Nat'l Bank \(In re Drebitko\)](#), Civ. A. No. 89-20936, 1992 WL 75156, at *2 (ED Pa. April 6, 1992) (“[a]n equity cushion, if sufficient in size and unlikely to erode, can, standing alone, constitute adequate protection”); [In re Senior Care Properties, Inc.](#), 137 BR 527 (Bankr. ND Fla. 1992) (secured lienholders have no interest in their equity cushion in such property as would entitle lienholder to adequate protection of such cushion); [In re Chauncy St. Assocs. Ltd. Partnership](#), 107 BR 7, 8 (Bankr. D. Mass. 1989) (“creditors entitled to adequate protection only of the value of their interest in the collateral”; oversecured creditor not entitled to relief from stay due to erosion of equity cushion); [In re Triplett](#), 87 BR 25, 26-27 (Bankr. WD Tex. 1988) (adequate protection requires only preservation of value of lien); [In re Carson](#), 34 BR 502 (D. Kan. 1983) (relief from stay is denied where erosion of equity cushion would stop before creditor became undersecured). In determining the adequacy of the equity cushion, the courts have looked to the stability of the collateral, the likelihood of reorganization, and the credibility of the DIP's plan for furnishing adequate protection. See, e.g., [Philadelphia Consumer Discount Co. v. Commercial Credit Business Loans, Inc. \(In re Philadelphia Consumer Discount Company\)](#), 37 BR 946, 949 n.9 (ED Pa. 1984). For a discussion of various percentages of equity cushion as protection, see [Kost v. First Interstate Bank of Greybull \(In re Kost\)](#), 102 BR 829, 830-831 (D. Wyo. 1989).

[FN38]. [Bankers Life Ins. Co. v. Alyucan Interstate Corp. \(In re Alyucan Interstate Corp.\)](#), 12 BR 803, 805 (Bankr. D. Utah 1981) (adequate protection in an undefined concept, which is further understood on a case-by-case basis); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978) (“The purpose of this section [361] is to illustrate means by which [adequate protection] may be provided and to define the limits of the concept.”).

[FN39]. Absent the secured creditor's consent, an administrative expense claim will not be deemed adequate protection. 11 USC § 361(3) (1993); [Smith v. Dairymen, Inc. \(In re Smith\)](#), 75 BR 365, 368 (WD Va. 1987).

[FN40]. 11 USC § 361 (1993). The most definitive method of providing adequate protection is requiring the DIP to make lump sum or periodic cash payments. While there may be a dispute with respect to the amount of the payment required, there cannot be an issue with respect to its value—a dollar is a dollar. See, e.g., [Bargas v.](#)

Rice (*In re Rice*), 82 BR 623, 627 (Bankr. SD Ga. 1987); *Greives v. Bank of W. Ind. (In re Greives)*, 81 BR 912, 962-963 (Bankr. ND Ind. 1987). The grant of additional or replacement liens is less certain because the value of the newly pledged collateral may be disputed. See *Martin v. United States (In re Martin)*, 761 F2d at 472, 477 (8th Cir. 1985). Satisfaction of the “indubitable equivalent” catchall requires strict proof. *Southtrust Mobile Servs., Inc. v. Englebert*, 137 BR 975, 983 (ND Ala. 1992) (“adequate protection requires that the secured party be guaranteed that it timely realize the indubitable equivalent of its interest, meaning the whole value of its bargained-for rights”); see *In re Mid-Atlantic Fuels, Inc.*, 121 BR 207, 210-212 (Bankr. SD W. Va. 1990) (“indubitable equivalent” satisfied where periodic payments to creditor were terminated and used for site study to detect and mitigate out-migration of contamination for which the creditor could have been liable). While a guaranty may constitute adequate protection under Section 361(3), the cases generally require that the guaranty be secured adequately. See *In re THB Corp.* 85 BR 192, 194-195 (Bankr. D. Mass. 1988) (secured guaranty held to be sufficient based on substantial stable collateral value); *In re Eureka SRR, Inc.*, 72 BR 813, 820 (Bankr. ND Cal. 1987) (guaranty that protects investment but does not give creditor full profit it expected to make on the transaction is adequate); cf. *In re CF Simonin's Sons, Inc.*, 28 BR 707, 712 (Bankr. EDNC 1983) (“even if there was indisputable evidence of the credit-worthiness of the guarantors, the chance to pursue the guarantor with its uncertainties and costs is not adequate protection”).

[FN41]. See *Lend Lease v. Briggs Transp. Co. (In re Briggs Transp. Co.)*, 780 F2d 1339, 1346 (8th Cir. 1985) (“‘Indubitable equivalence’ ... was designed to broaden, not circumscribe, the range of solutions available”); *In re Beker Indus. Corp.*, 58 BR 725, 736 (Bankr. SDNY 1986) (“adequate protection is not defined in the Code except by implications of examples ... its application is left to the vagaries of each case”); HR Rep. No. 595, 95th Cong., 1st Sess. 339 (1977) (methods of providing adequate protection are “neither exclusive nor exhaustive”); see also D. Baird & T. Jackson, “*Corporate Reorganizations & the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*,” 51 U. Chi. L. Rev. 97, 98 n.6 (1984) (discussion “indubitable equivalence”).

[FN42]. Experience reflects that agreement on the value of collateral or the rate of diminution is rare. The secured creditor generally will seek cash payments, replacement liens, or other protection sufficient to provide adequate protection under a worst-case scenario.

[FN43]. Section 507(a) specifies and establishes the order of distribution of claims and expenses entitled to priority over general unsecured claims. 11 USC § 507(a) (1993); HR Rep. No. 595, 95th Cong., 1st Sess. 357 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978). Section 507(b) accords the secured creditor a priority over all such priority claims to the extent that the adequate protection is deficient. 11 USC § 507(b) (1993). See generally *Grundy Nat'l Bank v. Rife*, 876 F2d 361, 363-364 (4th Cir. 1989) (“§ 507(b) converts a creditor's claim where there has been a diminution in the value of a creditor's secured collateral by reason of a § 362 stay into an allowable administrative expense claim under § 503(b)”); *Gill v. CBS Records, Inc. (In re Peaches Records & Tapes, Inc.)*, 102 BR 193, 195-196 (Bankr. 9th Cir. 1989) (claim arising from the diminution in value of collateral is afforded superpriority status pursuant to Section 507(b)). Although the rationale underlying Section 507(b) could support the opposite result, the Code accords administrative claims incurred in a superseding Chapter 7 case (after conversion of the case from Chapter 11 reorganization to Chapter 7 liquidation) priority over Section 507(b) “inadequate protection” claims incurred in the Chapter 11 case prior to conversion. 11 USC §§ 503, 726(b) (1993); see *In re California Devices, Inc.*, 21 Bankr. Ct. Dec. 895 (CRR) (Bankr. ND Cal. 1991); *Allis-Chalmers Credit Corp. v. Nordyke (In re Nordyke)*, 43 BR 856, 864 (Bankr. D. Or. 1984); see also 11 USC § 1112 (1993) (conversion).

[FN44]. See discussion *infra* notes 158-171 and accompanying text concerning the Code's distribution scheme.

[FN45]. See 11 USC §§ 364(c), 364(d) (1993). A superpriority claim is entitled to payment before all other priority claims, including Section 507(b) claims, if the order granting the superpriority so provides. 11 USC § 364(c)(1) (1993).

[FN46]. Section 552 provides:

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Except as provided in section 363, 506(c), 522, 544, 545, 547 and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable non-bankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 USC § 552 (1993). The exceptions set forth in Section 552(b) deal with (1) the DIP's right to use, sell, or lease property, including cash collateral (Section 363); (2) the DIP's right to recover from the secured creditor's collateral the reasonable and necessary costs of preserving or disposing of the collateral (Section 506(c)); (3) an individual debtor's right to claim exemptions and to avoid the fixing of certain liens on exempt property (Section 522); and (4) the DIP's transfer and lien avoidance powers and preference recovery powers (Sections 544, 545, 547). See 11 USC §§ 363, 506(c), 522, 544, 545, 547 (1993). The protections accorded by Section 552(b) also remain subject to the "equities of the case." For example, a court may order that a prepetition lien not extend to postpetition proceeds if the DIP requires use of such proceeds for a successful organization and the creditor is otherwise adequately protected. See generally *In re Sunberg*, 729 F2d 561, 562 (8th Cir. 1984); *In re Lawrence*, 56 BR 727, 728 (Bankr. D. Minn. 1984); *In re Johnson*, 47 BR 204, 207 (Bankr. WD Wis. 1985).

[FN47]. 11 USC § 552(a) (1993).

[FN48]. 11 USC § 552(b) (1993); see also *Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F2d 1430, 1439 (4th Cir. 1990).

[FN49]. See *infra* note 330 (discussing the ongoing debate concerning whether Chapter 11 maximizes value).

[FN50]. 11 USC § 364 (1993).

[FN51]. B. Henoch, "Postpetition Financing: Is There Life After Debt?", 8 *Bankr. Dev. J.* 575, 584 (1991) ("companies in chapter 11 will have little chance of success unless a mechanism exists for them to obtain post-petition financing ... banks will not want to lend to companies in bankruptcy unless given strong incentives to do so").

[FN52]. 11 USC § 364(a) (1993).

[FN53]. 11 USC § 364(b) (1993).

[FN54]. 11 USC § 364(c) (1993).

[FN55]. 11 USC § 364(d) (1993).

[FN56]. See 11 USC §§ 364(c), 364(d) (1993); 2 Collier, *supra* note 3, at ¶ 364.04, at 364-69; see also *In re Ames Dep't Stores, Inc.*, 115 BR 34, 37 (Bankr. SDNY 1990) (“[A] Court ... may not approve any credit transaction under subsection (c) unless the debtor demonstrates that it has reasonably attempted, but failed, to obtain unsecured credit under sections 364(a) or (b). [citations omitted] Similarly, obtaining credit under section 364(d) may not be authorized if it appears that credit can be obtained under the other subsections of 364.”); *In re Antico Mfg. Co.*, 31 BR 103, 105 (Bankr. EDNY 1983) (approving financing agreement where debtor's attempts to obtain unsecured or nonpriority financing were unsuccessful); cf. *Bray v. Shenandoah Fed. Sav. & Loan Ass'n (In re Snowshoe Co.)*, 789 F2d 1085, 1088 (4th Cir. 1986) (“statute imposes no duty to seek credit from every possible lender before concluding that such credit is unavailable”). Also, as discussed *infra* note 34 and accompanying text, the DIP cannot obtain credit secured by a senior or equal lien in encumbered property unless the interest of the existing lienholder is accorded adequate protection. 11 USC § 364(d) (1993); see *In re First S. Sav. Ass'n*, 820 F2d 700 (5th Cir. 1987) (increase in collateral value as a result of capital improvements made with proceeds of Section 364(d) loan constitutes adequate protection); *Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (In re Center Wholesale Inc.)*, 759 F2d 1440, 1450 (9th Cir. 1985) (junior secured creditor was not adequately protected); *In re Plabell Rubber Prods., Inc.*, 137 BR 897 (Bankr. ND Ohio 1992) (debtor did not prove inability to obtain credit other than through grant of superpriority lien and did not provide adequate protection).

[FN57]. Court approval after notice and a hearing is required for the DIP to obtain administrative priority credit out of the ordinary course of business, superpriority credit, or secured credit, but not for the DIP to obtain administrative expense priority extensions of unsecured credit in the ordinary course of business (typically trade credit). See, e.g., *In re Crouse Group, Inc.*, 71 BR 544, 549 (Bankr. ED Pa. 1987); *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon)*, 596 F2d 1092, 1098-1099 (2d Cir. 1979).

[FN58]. *In re Sobiech*, 125 BR 110 (Bankr. SDNY), *aff'd*, *Mulligan v. Sobiech*, 131 BR 917 (SDNY 1991) (lender who was granted collateral to secure postpetition loans was not implicitly granted administrative expense status for the unsecured portion of the postpetition loan if the collateral proved to be insufficient). Similarly, postpetition credit extended under the authority of Section 364(c)(1) should not be superior to a Section 507(b) adequate protection deficiency claim unless the financing order so provides. See 11 USC § 364(c)(1) (1993) (“priority over *any or all* administrative expenses of the kind specified in section 503(b) or 507(b)”) (emphasis added). Conversely, postpetition credit extended under the authority of Section 364(c)(1), which is granted priority over Section 503(b)(1) administrative expense claims, will have priority over claims for fees incurred by counsel and other professionals retained by the DIP or creditors' committee unless the order provides otherwise. See *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F2d 73, 76-77 (2d Cir. 1984) (court disallowed payment of professional fees where lender had lien in assets and superpriority claim). To prevent the lender from tying the hands of the DIP and the creditors' committee, some courts have declined to approve financing orders that do not provide exceptions to the Section 364(c) priority in amounts sufficient to pay the reasonable fees of counsel and other professionals retained by the DIP and the creditors' committee. See, e.g., *In re Ames Dep't Stores, Inc.*, 115 BR 34, 38 (Bankr. SDNY 1990).

[FN59]. See discussion *infra* notes 149, 328 and accompanying text. See generally J. Bohm, “The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases,” 59 Am. Bankr. LJ

289 (1985); Stripp, *supra* note 3; C. Tabb, “[Emergency Preferential Orders in Bankruptcy Reorganizations](#),” 65 *Am. Bankr. LJ* 75 (1991) (hereafter “[Emergency Preferential Orders](#)”). Also, for example, at least one court has authorized contingent fee enhancements, which are not expressly listed in [Section 364](#), to induce a lender to extend the maturity date of its postpetition financing in order to permit the DIP to conduct a going concern asset sale. *In re Defender Drug Stores, Inc.*, 126 BR 76, 81-82 (Bankr. D. Ariz. 1991), *aff’d*, *Resolution Trust Corp. v. Official Unsecured Creditors Comm. (In re Defender Drug Stores, Inc.)*, 145 BR 312, 316 (Bankr. 9th Cir. 1992) (enhancement fee calculated as 10 percent of the gross sale proceeds in excess of the outstanding obligation to the lender; “Bankruptcy courts ... have regularly authorized postpetition financing arrangements containing lender incentives beyond the explicit priorities and liens specified in [section 364](#)”); cf. *In re Tenney Village Co.*, 104 BR 562 (Bankr. DNH 1989) (refusing to approve proposed financing arrangement providing lender with extensive control, including selection of chief operating officer and scrutiny of payment of fees to debtor’s attorney).

[FN60]. “White wash” clauses vary, but they generally include a determination of the amount of the secured creditor’s prepetition claims, a finding that the secured creditor’s liens are valid, perfected, nonavoidable and prior to all other liens, a waiver and release of all objections and claims that the DIP and its Chapter 11 estate might have against the secured creditor or with respect to the secured creditor’s prepetition claims and liens, and, in some cases, a finding that the secured creditor’s prepetition claims are fully secured or oversecured. See, e.g., *Unsecured Creditors’ Comm. v. First Nat’l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co.)*, 834 F2d 599 (6th Cir. 1987), *cert. denied*, 488 US 817 (1988) (debtor waived right to challenge the validity of the lenders’ prepetition security interests).

[FN61]. [Section 364\(e\)](#) provides:

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.

11 USC § 364(e) (1993). The good faith element of [Section 364\(e\)](#) is discussed at *infra* notes 257-272 and accompanying text.

[FN62]. See *Gwartney of Smithfield, Ltd. v. Chesapeake Bay Found., Inc.*, 484 US 49, 66-67 (1987), quoting *United States v. WT Grant Co.*, 345 US 629, 633 (1953) (case is moot if “there is no reasonable expectation that the wrong will be repeated”); *Mills v. Green*, 159 US 651, 653 (1895) (appeal is moot if court is unable to grant effective relief); cf. *Honig v. Doe*, 484 US 305, 317-323 (1988) (case is not moot if the court finds “a sufficient likelihood” that the same harm will occur); see also J. Grippando, “[Circuit Court Review of Orders on Stays Pending Bankruptcy Appeals to U.S. District Courts or Appellate Panels](#),” 62 *Am. Bankr. LJ* 353-355 n.3 (1988) (if any party obtains a stay pending appeal, the status quo is maintained, and an appellate court could render effective relief); C. Tabb, “[Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma](#),” 50 *Ohio St. LJ* 109, 125-128 (1989) (hereinafter “[Lender Preference Clauses](#)”) (appeal is moot if the court is unable to grant appropriate relief).

[FN63]. As discussed *infra* notes 244-251 and accompanying text, those courts that have declined to apply [Section 364\(e\)](#) to orders providing for cross-collateralization have concluded that it is possible to return a secured creditor to the status quo ante with respect to its prepetition claims. See generally “[Emergency Preferential Orders](#),” *supra* note 59, at 107.

[FN64]. See, e.g., *Ellingsen*, 834 F2d at 603 (Section 364(e) protects a financing order from reversal or modification on appeal if the order has not been stayed pending appeal; thus lenders comfortably may advance new funds); *Adams Apple*, 829 F2d at 1484, 1489 (“To permit a court to impose a stay after a creditor has lent money to a debtor would intrude on a reorganization process already underway and would interfere with the lender’s ability to plan for its outlay of funds.”); “Lender Preference Clauses,” supra note 62, at 125 (“the mootness argument emphasizes the fact that the lender has advanced money to the debtor pursuant to the appealed order, supposedly making it impossible for the appellate court to grant effective relief; since it cannot restore the status quo ante”).

[FN65]. See supra note 64. Also, parties in interest seeking to gain personal advantage or to undermine the DIP’s strategies could, by the mere filing of an appeal, sabotage the DIP’s reorganization efforts by demanding preferential treatment in exchange for dismissing the appeal.

[FN66]. See *Ellingsen*, 834 F2d at 603 (“the need for fresh capital and difficulties in obtaining the capital and wherewithal to run a business are obvious”); *In re Antico Mfg. Co.*, 31 BR 103, 106 (Bankr. EDNY 1983) (“this situation is a classic case of probably getting nothing on liquidation if we don’t have the financing” [citation omitted]).

[FN67]. The procedure for obtaining a stay pending appeal in a bankruptcy case, including a stay pending appeal of a postpetition financing order, is set forth in Bankruptcy Rule 8005. Fed. R. Bankr. P. 8005. See also Fed. R. Bankr. P. 7062 (Fed. R. Civ. P. 62, which stays enforcement of judgments for 10 days, applies in Code cases, but financing orders are excluded from its effects).

[FN68]. Grippando, supra note 62, at 355 n.5.

[FN69]. See “Lender Preference Clauses,” supra note 62, at 129 (and cases cited therein); Grippando, supra note 62, at 355 n. 5 (and cases cited therein); see also *In re Sicherman v. Ohio Rehabilitation Servs. Comm’n*, 137 BR 247, 249 (Bankr. ND Ohio 1992) (establishing standard for obtaining stay); *In re Baldwin United Corp.*, 45 BR 385, 386 (Bankr. SD Ohio 1984) (movants failed to prove likelihood of success on merits, irreparable harm, or lack of harm to other parties).

[FN70]. Fed. R. Bankr. P. 8005; see generally *State Bank of Spring Hill v. Bucyrus Grain Co. (In re Bucyrus Grain Co.)*, 127 BR 52, 53 (D. Kan. 1991) (bankruptcy court has discretion to stay proceedings pending appeal and to require supersedeas bond).

[FN71]. *Saybrook*, 963 F2d at 1490, 1493-1496; see discussion infra notes 234-272 and accompanying text. Note that orders entered under Section 363 authorizing the use of cash collateral and granting adequate protection for such use do not enjoy the same mootness protection as is accorded financing orders entered under Section 364 of the Code. In language similar to that of Section 364(e), Section 363(m) provides that, in the absence of a stay pending appeal, the reversal or modification on appeal of an order authorizing the *sale or lease* of estate property does not affect the validity of the sale or lease if the entity purchasing or leasing the property acted in good faith. 11 USC § 363(m) (1993). Section 363(m) does not provide similar protection for the *use* of estate property, including cash collateral. Pursuant to the maxim *inclusio unius est exclusio alterius*, the inclusion of one provision and the omission of a parallel provision reflects the “desire to achieve disparate results.” *Carter v. Director, Office of Workers’ Compensation Programs, US Dep’t of Labor*, 751 F2d 1398, 1401 (DC 1985); see also *Connecticut Nat’l Bank v. Germain*, 112 S. Ct. 1146, 1149 (1992) (“courts must presume that a legislature says in a statute what it means and means in a statute what it says there”). Thus, an appeal from an order author-

izing or prohibiting the use of cash collateral or granting adequate protection therefore is not subject to dismissal for mootness based solely on the fact that no stay has been obtained. [11 USC § 363\(m\)](#) (1993); cf. [11 USC § 364\(e\)](#) (1993); see generally [Transamerica Mortgage Advisors, Inc. v. Lewis](#), 444 US 11, 19-24 (1979).

[FN72]. [United Virginia Bank v. Slab Fork Coal Co. \(In re Slab Fork Coal Co.\)](#), 784 F2d 1188, 1191 (4th Cir.), cert. denied, 477 US 905 (1986) (valid prepetition security interest is not affected by filing of bankruptcy petition).

[FN73]. [11 USC §§ 361, 362\(d\), 363\(c\)](#) (1993); see discussion supra notes 24-45 and accompanying text.

[FN74]. [11 USC § 364\(d\)](#) (1993); see discussion supra note 34 and accompanying text.

[FN75]. [11 USC § 552\(b\)](#) (1993); see discussion supra note 48 and accompanying text.

[FN76]. [11 USC § 364](#) (1993); see discussion supra note 55 and accompanying text.

[FN77]. [Saybrook](#), 963 F2d 1490, 1491-1492; see also [Otte v. Manufacturers Hanover Commercial Corp. \(In re Texlon Corp.\)](#), 596 F2d 1092 (2d Cir. 1979) (postpetition assets secured prepetition indebtedness); [In re Antico Mfg. Co.](#), 31 BR 103 (Bankr. EDNY 1983) (prepetition assets secured postpetition indebtedness); see generally Bohm, supra note 59, at 290.

[FN78]. The filing of a petition commencing a case under the Code creates an estate comprising virtually all legal and equitable interests of the debtor in property. [11 USC § 541](#) (1993). Thereafter, all property acquired by the estate, certain property acquired by the debtor, and all property recovered by the trustee also will be included in the estate. See [11 USC §§ 541\(a\)\(3\)- 541\(a\)\(7\)](#) (1993); see also [11 USC §§ 329\(b\), 363\(n\), 543-550, 553, 724\(a\)](#) (1993) (transfer recovery provisions).

[FN79]. This is true regardless of when the estate's property interest arose and regardless of whether the lender obtains a lien in unencumbered property, or obtains a junior, equal, or senior lien in encumbered property. See [11 USC §§ 364\(c\)\(2\), 364\(c\)\(3\), 364\(d\)](#) (1993); see also [Antico](#), 31 BR at 103, 105 (“the lender is not improving the position of an existing claim, but is merely enacting as security for future advances lien or interest in what may well be the only tangible assets the debtor can offer”). A small degree of the confusion surrounding cross-collateralization could be avoided if the granting of liens to secure postpetition advances of new credit were referred to simply as DIP financing collateralization (or [Section 364](#) collateralization or postpetition financing collateralization) rather than as “cross-collateralization.”

[FN80]. This is true whether the assets were generated postpetition or were in existence in the petition date but were not subject to the creditor's prepetition liens.

[FN81]. See, e.g., Bohm, supra note 59 (concluding that cross-collateralization clauses are permissible under the Code, but should be approved only after close scrutiny); R. Ordin, “Case Comment: [In re Texlon Corporation](#), 596 F2d 1092 (2d Cir. 1979): Finality of Order of Bankruptcy Court,” 54 Am. Bankr. LJ 173, 176-180 (1980) (criticizing [Texlon](#) decision and urging that financing orders be subjected to strict scrutiny at the outset of the case); “Emergency Preferential Orders,” supra note 59, at 115 (urging adoption of “uniform rule refusing to approve the preferential treatment of any pre-petition claims”); “Critical Reappraisal,” supra note 3, at 175 (“courts should *always* refuse to approve cross-collateralization clauses”); B. Weintraub & A. Resnick, “From the Bankruptcy Courts: Cross-Collateralization of Pre-Petition Indebtedness as an Inducement for Post-Petition

Financing: A Euphemism Comes of Age,” 14 UCCLJ 86, 91 (1981) (cross-collateralization permissible “after a hearing on notice results in the conclusion that no other methods or acceptable terms of financing are available to save the reorganizing debtor from forced liquidation”).

[FN82]. For example, as discussed *infra* notes 85-86 and accompanying text, *Texlon* defines cross-collateralization broadly in terms of a prepetition lender receiving liens in postpetition assets to secure prepetition claims. *Texlon*, 596 F2d at 1092, 1097. *Saybrook* refers to this practice as *Texlon*-type cross-collateralization, distinguishing it from the collateralization of postpetition loans with prepetition assets. *Saybrook*, 963 F2d at 1490, 1492. Bohm also distinguishes only these two general types of cross-collateralization. Bohm, *supra* note 59, at 290. See also *Antico*, 31 BR at 103, 105 (“[DIP] may attempt ... to grant the lender a lien or interest in *post-petition* collateral to secure an outstanding *pre-petition* debt ... [or] to grant the lender a lien or interest in *pre-petition* collateral to secure *post-petition* indebtedness”); cf. “Critical Reappraisal,” *supra* note 3, at 110 (“partially secured pre-bankruptcy lender is given a preference over other creditors as to its unsecured prepetition claim in return for providing financing in the reorganization”).

A significant amount of the confusion surrounding cross-collateralization could be avoided if, in fashioning and interpreting cash collateral and DIP financing orders and agreements, DIPs, secured creditors, and courts focused more precisely on the nature and purpose of the postpetition liens proposed to be granted to the prepetition creditor. Conceivably a prepetition lender could be granted liens (1) to secure a prepetition unsecured claim, undersecured claim, fully secured claim, or oversecured claim; (2) to induce new loans, provide adequate protection of a secured claim, preserve a secured creditor's lien in the proceeds of its collateral, induce a secured creditor's consent to the use of its cash collateral, or to achieve other goals; (3) in unencumbered property or junior to, on par with, or senior to existing liens in encumbered property. Liens granted for purposes of adequate protection should be referred to simply as adequate protection liens, not as cross-collateralization liens. Liens granted to preserve a prepetition secured creditor's interest in postpetition proceeds should be referred to simply as proceeds liens or [Section 552](#) liens.

Note that, although *Saybrook* and *Texlon* involved the use of cross-collateralization to induce the prepetition lender to provide postpetition financing, cross-collateralization also frequently is requested by a prepetition secured creditor as a condition to the creditor's consent to the DIP's use of cash collateral, even where the creditor is not providing a new postpetition loan. *Saybrook*, 963 F2d at 1491; *Texlon*, 596 F2d at 1095; see generally Stripp, *supra* note 3, at 575-576 n.56 (“In cash collateral situations ... there is ordinarily little or no justification for approving cross-collateralization.”); *Critical Reappraisal*, *supra* note 3, at 140-145; see also *In re AMT Inv. Corp.*, 53 BR 274, 276 (Bankr. ED Va. 1985) (“Congress did not extend ... administrative priority ... to the protection of a cash collateral creditor where no new credit has been extended”); 11 USC § § 361, 363 (1993).

[FN83]. Cf. “Critical Reappraisal,” *supra* note 3, at 141 n.165 (distinguishing adequate protection from cross-collateralization).

[FN84]. 596 F2d 1092 (2d Cir. 1979). Although it was decided under the former Bankruptcy Act, *Texlon* continued to be viewed widely as the leading case on cross-collateralization up until the *Saybrook* decision. See, e.g., Bohm, *supra* note 59, at 290-302; “Emergency Preferential Orders,” *supra* note 59, at 83; “Critical Reappraisal,” *supra* note 3, at 113.

[FN85]. 596 F2d at 1094.

[FN86]. See *Texlon*, 596 F2d at 1097-1098. *Texlon*-type cross-collateralization is further discussed *infra* notes 309-313 and accompanying text.

[FN87]. Under the former Bankruptcy Act, Chapter VIII provided for voluntary and involuntary railroad reorganizations. Bankruptcy Act § 77. Chapter X provided for voluntary and involuntary corporate reorganizations. Bankruptcy Act §§ 101-276. Chapter XI provided for voluntary “arrangements” or compositions between a business debtor and its unsecured creditors and could not affect secured claims absent the secured creditors' consent. Bankruptcy Act §§ 301-399. See generally A. Corotto & I. Picard, “Business Reorganizations Under the Bankruptcy Reform Act of 1978—A New Approach to Investor Protections and the Role of the SEC,” 28 DePaul L. Rev. 961, 968 & n. 44 (1979). Chapter XII provided for voluntary real property arrangements by persons other than corporations. Bankruptcy Act §§ 508-526.

[FN88]. Former Bankruptcy Act Section 344, applicable in Chapter XI cases, provided:

During the pendency of a proceeding for an arrangement, or after the confirmation of the arrangement where the court has retained jurisdiction, the court may upon cause shown authorize the receiver or trustee, or the debtor in possession, to issue certificates of indebtedness for cash, property, or other consideration approved by the court, upon such terms and conditions and with such security and priority in payment over existing obligations as in the particular case may be equitable.

Bankruptcy Act § 344.

[FN89]. *Texlon*, 596 F2d at 1094. MHCC's prepetition claims arose from MHCC's factoring of Texlon's accounts and from a purchase money security interest loan secured by Texlon's machinery, equipment and fixtures. *Id.* at 1094 n.1.

[FN90]. *Id.* at 1099.

[FN91]. Under the former Bankruptcy Act, “debtor” referred to the qualified entity seeking reorganization under Chapter X (Bankruptcy Act § 106(5)), an arrangement under Chapter XI (Bankruptcy Act § 306(3)), or a real property arrangement under Chapter XII (Bankruptcy Act § 406(6)); “bankrupt” referred generally to any entity entitled to relief under the Bankruptcy Act, and ordinarily contemplated a liquidating entity (Bankruptcy Act § 4). Under the Code, the use of the term “bankrupt” has been eliminated and the concept of adjudication as a bankrupt (Bankruptcy Act §§ 4, 302) has been superseded by the concept of the entry of an “order for relief.” See 11 USC §§ 102(6), 301, 303(h) (1993).

[FN92]. Under Chapter XI of the former Bankruptcy Act, the creditors could nominate a trustee at the first meeting of creditors unless a trustee previously has been elected or appointed. See Bankruptcy Act §§ 2(17), 44, 338; former Bankr. Rules 207, 209, 221.

[FN93]. *Texlon*, 596 F2d at 1095.

[FN94]. *Id.*

[FN95]. *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 3 Bankr. Ct. Dec. (CRR) 1013, 1017 (Bankr. SDNY), rev'd, 596 F2d 1092 (2d Cir. 1979).

[FN96]. *Id.* at 1016-1017. On the first point, the court cited Section 64(a)(1) of the former Bankruptcy Act, which set forth certain claims that were entitled to priority, including, but not limited to, the costs and expenses of administration, referee's salary, and attorney fees and expenses. See Bankruptcy Act § 64. The bankruptcy court in *Texlon* stated:

Insofar as this court is concerned, it will denounce any effort in Chapter XI financing orders to give a

lender a head start. After all, that lender is secured and can decide for itself how far it will go in the Chapter XI financing to ensure that its security will remain unimpaired. Those dealing with a debtor in the Chapter XI case, who remain unpaid and who can look to no security, are entitled to where Congress put them in the grand design of section 64(a).

3 Bankr. Ct. Dec. (CCR) at 1016. The Second Circuit held that Section 64(a) was not violated because the financing order involved a lien, not a priority. [596 F2d at 1096](#). On the second point, the court cited Section 70(d)(5) of the former Bankruptcy Act, which provided that “no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee.” Bankruptcy Act § 70(d)(5). The bankruptcy court held:

swiftly and surely, section 70(d)(5) denounces a post-petition transfer and just as swiftly and just as surely section 1(30), 11 U.S.C. § 1(30), defining a transfer, leaves no room to doubt that the giving of the security interest to [the bank] constituted a transfer within the meaning of section 70(d)(5).

3 Bankr. Ct. Dec. (CCR) at 1017. The Second Circuit held that Section 70(d) was irrelevant because it related only to transfers during the “gap period” prior to the adjudication of bankruptcy. [596 F2d at 1069](#).

[FN97]. [Texlon](#), [596 F2d at 1095](#).

[FN98]. [Id.](#) at 1094.

[FN99]. [Id.](#) at 1097. See also HR Rep. No. 595, 95th Cong., 1st Sess. 177-178 (1977) (“the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor”); see also [Tenney Village](#), [104 BR 562, 569](#) (“only euphemistically can such a provision be called ‘cross-collateralization;’ it is a post-petition preference for which no statutory authority can be found”).

[FN100]. [Texlon](#), [596 F2d at 1099](#). This reasoning appears to have been based on the grant of additional collateral for the unsecured portion of MHCC's prepetition claim, although the court did not expressly discuss the extent to which MHCC's prepetition claim was secured.

[FN101]. [Id.](#) at 1097. Section 344 of the former Bankruptcy Act authorized the DIP to issue secured certificates of indebtedness. Bankruptcy Act § 344 (set forth *supra* note 88). The bankruptcy court's general equitable powers were codified in Section 2(a)(15) of the former Bankruptcy Act. Bankruptcy Act § 2(a)(15).

[FN102]. [596 F2d at 1098](#).

[FN103]. One commentator, incorrectly in the authors' view, characterizes this holding as dicta and characterizes *Texlon's* dicta concerning the inequity of cross-collateralization as the court's holding. Bohm, *supra* note 59, at 291-292.

[FN104]. [596 F2d at 1098-1099](#) (emphasis added). The court contrasted the *ex parte* nature of the *Texlon* order with the requirement of the then recently enacted Code [Section 364](#) that “all orders authorizing a trustee to obtain unsecured or secured credit (except unsecured credit in the ordinary course of business allowable as an administrative expense) can be made only after notice and hearing.” *Id.* at 1099; [11 USC § 364\(d\)\(1\)](#) (1993). The court also noted the provision of [Section 102\(1\)\(B\)\(ii\)](#) (as in effect at the time the Code was enacted) permitting the court to dispense with an actual hearing if “there is insufficient time for a hearing to be commenced before such act must be done.” [11 USC § 102\(1\)\(B\)\(ii\)](#) (1978). This provision subsequently has been supplemented by the adoption of and amendments to Bankruptcy Rule 4001, which prohibits the conduct of a final hearing on a motion for authority to use cash collateral or obtain credit earlier than 15 days after service of the motion. The

court may conduct a preliminary hearing before such 15-day period expires, but may authorize (1) “the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing” or (2) “the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.” [Fed. R. Bankr. P. 4001\(b\)\(2\), 4001\(c\)\(2\)](#).

[FN105]. See discussion *infra* note 112.

[FN106]. [Texlon](#), 596 F2d at 1099.

[FN107]. *Id.* at 1099-1100. The application of [Fed. R. Civ. P. 60\(b\)](#) is discussed *infra* notes 297-307 and accompanying text.

[FN108]. 300 US 131 (1937). [Texlon](#) also cited [Pfister v. Northern Ill. Fin. Corp.](#), 317 US 144 (1942), as supplementing [Wayne](#), by applying the administrative order doctrine to orders entered by conciliation commissioners under the Bankruptcy Act. [Texlon](#) characterized such commissioners as the “functional” equivalent of bankruptcy judges. [Texlon](#), 596 F2d at 1100; see also “Lender Preference Clauses,” *supra* note 62, at 135-141 (discussing [Texlon](#)’s resurrection of the administrative order doctrine).

[FN109]. [Texlon](#), 596 F2d at 1100. The 1973 Advisory Committee Note to former Bankruptcy Rule 924 declared the administrative order doctrine inapplicable in bankruptcy proceedings. Fed. R. Bankr. P. 924 (superseded) (Adv. Comm. Note 1973). Former Bankruptcy Rule 924 supplanted the administrative order doctrine by making [Fed. R. Civ. P. 60\(b\)](#), which establishes the bases for relief from a judgment or order, applicable in bankruptcy cases, with certain exceptions. The Second Circuit, in [Texlon](#), declined to follow the Advisory Committee Note, reasoning that Bankruptcy Rule 924 did not clearly overrule the administrative order doctrine because the Advisory Committee Note did not *expressly* refer to [Wayne](#) or [Pfister](#). [Texlon](#), 596 F2d at 1101.

[FN110]. Specifically, the court noted that:

While it may be that MHCC 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 F2d at 1101.

[FN111]. See discussion of adequate protection liens and proceeds liens *supra* notes 24-48 and accompanying text.

[FN112]. [In re General Oil Distribs., Inc.](#), 20 BR 873 (Bankr. EDNY 1982); [In re Flagstaff Foodservice Corp.](#), 16 BR 132 (Bankr. SDNY 1981); [Borne Chem. Co. v. Lincoln First Comm. Corp. \(In re Borne Chem. Co.\)](#), 9 BR 263 (Bankr. DNJ 1981); see “Critical Reappraisal,” *supra* note 3, at 116-117.

[FN113]. See, e.g., [In re Roblin Indus., Inc.](#), 52 BR 241, 244-245 (Bankr. WDNY 1985) (applying four-part test established by [Vanguard](#), suggesting that cross-collateralization provisions would be appropriate, but declining to approve order on other grounds); [In re Vanguard Diversified, Inc.](#), 31 BR 364, 366 (EDNY 1983) (authorizing cross-collateralization and establishing four-part test to determine whether cross-collateralization should be approved); [Borne Chemical](#), 9 BR 263, 268-270 (debtor unable to obtain financing for its plan of reorganization without the cross-collateralization provisions contained in its financing arrangement); see also [Adams Apple](#), 829 F2d at 1484, 1490 (cross-collateralization clause may be necessary to achieve goal of debtor rehabilitation);

Ames Dep't Stores, 115 BR at 39 (cross-collateralization permissible if estate, rather than prepetition creditor, is principally benefited); *In re Keystone Camera Prods. Corp.*, 126 BR 177, 182 (Bankr. DNJ 1991) (cross-collateralization is valid only if financing is otherwise unattainable). See generally Bohm, *supra* note 59, at 296 (*Texlon*-type cross-collateralization will assist the debtor in achieving a successful reorganization); B. Weintraub & A. Resnick, "From the Bankruptcy Courts: Cross-Collateralization of Prepetition Indebtedness as an Inducement for Postpetition Financing: A Euphemism Comes of Age," 14 UCCLJ 86 (1981) (cross-collateralization may be authorized to save the reorganization effort if a debtor will be forced to liquidate without such a provision in the financing order).

[FN114]. See, e.g., *In re Monach Circuit Indus., Inc.*, 41 BR 859, 862 (Bankr. ED Pa. 1984) (given the "preferential nature of cross-collateralization," financing arrangements providing for cross-collateralization are "forbidden" by the Code); cf. *Citibank v. Transamerica Comm. Fin. Corp. (In re Sun Runner Marine, Inc.)*, 116 BR 712, 719 (Bankr. 9th Cir. 1990), vacated in part, *aff'd* in part, 945 F2d 1089 (9th Cir. 1991) (nothing in Section 364(c) authorizes payment of prepetition debt with estate assets; declining to rule that cross-collateralization as a matter of law is never permissible); *Tenney Village*, 104 BR at 562, 569-570 (court has no authority to approve a financing arrangement that grants administrative expense priority to the unsecured portion of a prepetition claim). See generally "Critical Reappraisal," *supra* note 3 (cross-collateralization conflicts with the fundamental bankruptcy law principle of equal distribution, is beyond the ambit of the bankruptcy court's power and should be eliminated as a financing practice in bankruptcy cases).

[FN115]. *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 127 BR 494, 495 (MD Ga. 1991), *rev'd*, 963 F2d at 1490 (11th Cir. 1992).

[FN116]. *Id.* at 495; *Saybrook*, 963 F2d at 1490, 1491.

[FN117]. Presumably, the order also provided for the use of MH's cash collateral, although neither the district court opinion nor the circuit opinion refers to the nature of MH's collateral, the use of cash collateral, adequate protection, or MH's rights under Section 552. See discussion of adequate protection liens and proceeds liens *supra* notes 24-48 and accompanying text.

[FN118]. See Fed. R. Bankr. P. 4001(c)(2) (1978), discussed *supra* note 104.

[FN119]. The Shapiros had been the prior owners of the company who sold the business through a leveraged buyout and received proceeds from the leveraged buyout in payment for the sale of their stock. In the bankruptcy case, the Shapiros asserted claims arising from the termination of their employment, which claims were disputed by Saybrook. Telephone interview with C. David Butler, attorney with Alston & Bird in Atlanta, Ga., attorney for Chemical Bank Corporation (successor to Manufacturer's Hanover Trust Company & Manufacturer's Hanover Bank (Delaware)) and Union Trust Company in the *Saybrook* case (December, 1992).

[FN120]. 963 F2d at 1491; 127 BR at 495.

[FN121]. Section 364(e) is discussed *supra* notes 61-71 and accompanying text.

[FN122]. 127 BR at 496, 499.

[FN123]. *Id.* at 499. In reaching this conclusion, the court followed the reasoning of *Adams Apple*, 829 F2d at 1484, 1488-1489 and *Ellingsen*, 834 F2d at 599, which held that Section 364(e) protected financing orders from

reversal or modification on appeal, absent a stay pending appeal, unless the lender acted in bad faith. See discussion *infra* notes 245-249 and accompanying text.

[FN124]. *Saybrook*, 127 BR at 499-500. In support of their argument that MH had acted in bad faith, the Shapiros argued that MH should have known that cross-collateralization was inappropriate because MH was an affiliate of the lender in *Texlon*. *Id.* at 499. The district court rejected this argument. *Id.* at 499-500. The court of appeals did not reach the good faith issue because it ruled that [Section 364\(e\)](#) did not apply.

[FN125]. *Saybrook*, 963 F2d at 1492.

[FN126]. *Id.* at 1493.

[FN127]. *Id.*

[FN128]. *Id.*

[FN129]. *Id.* at 1495.

[FN130]. *Id.* at 1492. The court defined “*Texlon*-type” cross-collateralization by quoting the *Texlon* definition set forth *supra* text accompanying note 85. As in *Texlon*, the court appeared to be concerned primarily with the collateralization of the unsecured portion of the secured creditor's prepetition claim. The nature of *Texlon*-type cross-collateralization is considered *supra* notes 80-83 and accompanying text and *infra* notes 309-313 and accompanying text.

[FN131]. *Id.* at 1493.

[FN132]. *Id.* at 1494-1495.

[FN133]. *Id.* at 1495.

[FN134]. *Id.* at 1496; see also “Critical Reappraisal,” *supra* note 3, at 145-153 (cross-collateralization violates the principle of equitable distribution).

[FN135]. 963 F2d at 1495-1496. The court reasoned that “cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code.” *Id.* at 1495, citing “Critical Reappraisal,” *supra* note 3, at 145-153.

[FN136]. The Eleventh Circuit did not address whether MH should have been entitled to retain liens on “postpetition” assets as the proceeds of MH's prepetition collateral or as adequate protection against any diminution in the value of its collateral. See 11 USC §§ 361, 363, 552 (1993) (discussed *supra* notes 24-48 and accompanying text). Subsequent to the remand, MH filed a complaint in the bankruptcy court seeking a declaration that the issues raised by the appeal were moot as a factual matter. MH's mootness argument is based on the fact that all of *Saybrook*'s assets ultimately were liquidated for the aggregate amount of approximately \$3.75 million. Of those proceeds, approximately \$2 million was attributable to inventory, the asset in which MH did not hold a prepetition lien but obtained a postpetition cross-collateralization lien. All of *Saybrook*'s assets, including the inventory, had been pledged to secure MH's \$3 million postpetition new loan. MH argues that the \$2 million attributable to the inventory plus an additional \$1 million of proceeds was applied to repay the postpetition loan. The excess (approximately \$750,000), MH argues, was entirely consumed by MH's postpetition interest and ex-

penses and MH's valid prepetition security interest, without taking into account the cross-collateralization. As of the writing of this article, MH's declaratory judgment action is pending before the bankruptcy court. Complaint for Declaratory Judgment, Chemical Bank Corp. & Union Trust Co. (In re Saybrook Mfg., Inc.) (Adversary No. 92 5088).

[FN137]. *Saybrook* cites to Tabb's article, which contains an excellent and comprehensive analysis of the arguments against cross-collateralization. The following discussion is intended to summarize those arguments rather than reiterate them in detail. "Critical Reappraisal," supra note 3. See also C. Tabb, "Requiem for Cross-Collateralization," 2 J. Bankr. L&P 109 (1993) May/June.

[FN138]. 963 F2d at 1495. *Ellingsen*, 834 F2d at 599, 602 ("[S]ection 364(c) authorized priority or liens only for post-petition debt, not *pre-petition* debt. The order in controversy bolstered liens securing pre-petition debt, and thus may exceed the scope of section 364(c)."); *Tenney Village*, 104 BR at 562, 570 ("Section 364(d) speaks only of the granting of liens as security for new credit authorized by the court"); *In re FCX, Inc.*, 54 BR 833, 841 (Bankr. EDNC 1985) ("court may not change the priorities set out in the Bankruptcy Code ... [and, thus,] may not authorize a § 364(c)(1) priority for pre-petition claims"); cf. *In re Defender Drug Stores, Inc.*, 126 BR 76, 81 (Bankr. D. Ariz. 1991) ("Although ... [section] 364 enumerates some incentives that a court may grant to postpetition lenders, the list is not exhaustive. Courts frequently have authorized the use of inducements not specified in the statute."), aff'd, 145 BR 312 (Bankr. 9th Cir. 1992).

[FN139]. 11 USC § 364(c)(1) (1993).

[FN140]. 11 USC § 364(c)(2) (1993).

[FN141]. 11 USC § 364(c)(3) (1993).

[FN142]. 11 USC § 364(d) (1993).

[FN143]. *Saybrook*, 963 F2d at 1495.

[FN144]. See *Tenney Village*, 104 BR at 562, 570 ("Section 364(d) speaks only of the granting of liens as security for new credit authorized by the court"); *Monach*, 41 BR at 859, 862 ("§ 364(c) appear[s] to limit the extent of the priority or lien to the amount of credit or debt incurred" postpetition).

[FN145]. *Saybrook*, 963 F2d at 1493-1496; see also *Tenney Village*, 104 BR at 569-570; *Monach*, 41 BR at 861-862; "Critical Reappraisal," supra note 3, at 119-140.

[FN146]. "Critical Reappraisal," supra note 3 at 119-153.

[FN147]. HR Rep. No. 595, 95th Cong., 1st Sess. 346 (1977), S. Rep. No. 989, 95th Cong., 2d Sess. 57 (1978); see generally "Critical Reappraisal," supra note 3 at 119-140.

[FN148]. The legislative history suggests that Congress intended to gather together, in Section 364 of the Code, all provisions regarding postpetition financing. "Critical Reappraisal," supra note 3, at 121.

[FN149]. It is not entirely clear whether this conclusion logically follows. Tabb suggests that Section 364 of the Code "specifically authorizes and states the prerequisites for granting every type of inducement to a prospective lender to the bankruptcy estate—whether a lien, priority or both—that was accepted and approved generally un-

der the Act.” “Critical Reappraisal,” supra note 3, at 121. One could argue that this reasoning proves too much because it implies that the court may only approve those terms expressly listed in [Section 364](#) to induce postpetition extensions of new credit. Tabb acknowledges that [Section 364](#) is not intended to be read so narrowly. Financing orders and agreements generally contain detailed terms relating to interest rates, fees, covenants, defaults, remedies, and other provisions. It would be difficult, if not impossible, for Congress to codify each and every possible term of a DIP financing order. See discussion supra notes 59 and accompanying text (discussing the terms of financing orders); see also Hensch, supra note 3, at 597-603 (discussing commonly included provisions in postpetition financing arrangements, including cross-collateralization, carve-out for attorneys fees, and waiver of rights); M. Prager, “[Financing the Chapter 11 Debtor: The Lenders' Perspective](#),” 45 *Bus. Law.* 2127 (1990) (discussing various provisions to induce postpetition lending); “Emergency Preferential Orders,” supra note 59, at 79-92 (discussing commonly included provisions in postpetition financing arrangements, including cross-collateralization, cross-prioritization, white wash clauses and drop-dead clauses). Tabb proposes that a line may be drawn distinguishing financing “inducements” from other terms. He suggests that [Section 364](#) lists the only permissible “inducements” to repayment of the postpetition loan, but that interest and other terms, not relating to repayment of the postpetition debt, may be approved, even though such terms are not expressly listed in [Section 364](#). “Critical Reappraisal,” supra note 3, at 121 n. 75, 136. Indeed, many courts have concluded that interest rates may be specified in the financing arrangement even though not expressly authorized by [Section 364](#). See, e.g., [Resolution Trust Corp. v. Official Unsecured Creditors' Comm. \(In re Defender Drug Stores, Inc.\)](#), 145 BR 312, 316 (Bankr. 9th Cir. 1992) (“courts have implicitly held that [section 364](#) authorizes interest on postpetition loans”). Nevertheless, the vulnerability of this reasoning is that it may be difficult to determine where to draw the line in attempting to distinguish repayment inducements from other terms. For example, covenant, default, drop-dead, foreclosure, and remedy provisions, which are common enforcement terms, arguably relate to repayment of the postpetition debt, but are not listed in [Section 364](#). Conversely, one could argue that liens and priorities are enforcement or repayment provisions because they are unnecessary unless the debt is not paid according to its terms. Also, cross-collateralization could be viewed as simply one “other” permissible term not relating to repayment of the postpetition debt and, therefore, not required to be listed in [Section 364](#). Thus, any attempt to distinguish among the types of clauses as inducements, costs, enforcement mechanisms, or “other” terms is vulnerable to challenge as artificial. A clearer distinction, consistent with the language, legislative history, and purposes of [Section 364](#), may be drawn merely by concluding that [Section 364](#)'s terms and protections apply only to postpetition new credit, but that [Section 364](#) permits other terms not listed in [Section 364](#) so long as such terms relate directly to the postpetition new credit. This distinction would also be consistent with *Saybrook*. See discussion regarding purposes of [Section 364](#), supra note 51; discussion regarding [Section 364\(e\)](#) and challenges to financing terms outside the scope of [Section 364](#), infra note 328.

[FN150]. [NLRB Bildisco & Bildisco](#), 465 US 513, 527 (1984) (“Bankruptcy Court is a court of equity”); [In re United Energy Corp.](#), 944 F2d 589 (9th Cir. 1991) (same); [In re Anderson](#), 936 F2d 199 (5th Cir. 1991) (same); [United States v. Cardinal Mine Supply, Inc.](#), 916 F2d 1087 (6th Cir. 1990) (same); [Kenneally v. Standard Elec. Corp.](#), 364 F2d 642, 647 (8th Cir. 1966) (same).

[FN151]. Section 105(a) of the Code codifies these equitable powers as follows:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 USC § 105(a) (1993). By its terms, [Section 105](#) suggests that courts may grant relief not *expressly* provided

under the Code, but that such relief must “carry out,” rather than contravene, the specific provisions of the Code. [11 USC § 105\(a\)](#) (1993). If relief were limited to that expressly provided for in the Code, [Section 105](#) would be superfluous. See generally [Boise Cascade Corp. v. United States EPA](#), 942 F2d 1427, 1432 (9th Cir. 1991) (courts “must interpret statutes as a whole, giving effect to each word and making every effort not to interpret a provision in a manner that renders other provisions of the same statute inconsistent, meaningless or superfluous”); [United States v. Nordic Village, Inc.](#) 112 S. Ct. 1011, 1015 (1993) (“a statute must, if possible, be construed in such a fashion that every word has some operative effect”). Conversely, “equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.” [Official Comm. of Equity Security Holders v. Mabey](#), 832 F2d 299, 302 (4th Cir. 1987), cert. denied, 485 US 965 (1988). “The specific limitations on the power of an equity court relevant to the bankruptcy court’s power to approve cross-collateralization clauses are three: (1) new substantive rights may not be created; (2) actions inconsistent with the Code are forbidden; and (3) the distributive scheme of the Code may not be altered to fit the court’s notion of equity.” “Critical Reappraisal,” supra note 3, at 154; see also [Butner v. United States](#), 440 US 48 (1979) (state law determines property rights in the bankruptcy estate and equity cannot alter the determination); [Sea Harvest Corp. v. Riviera Land Co.](#), 868 F2d 1077, 1080 (9th Cir. 1989) ([Section 105](#) “does not empower courts to issue orders that defeat rather than carry out explicit provisions of the Bankruptcy Code”). The history and scope of the bankruptcy court’s equitable powers under [Section 105](#) are examined in M. Leal, “The Power of the Bankruptcy Court: Section 105,” 29 S. Tex. L. Rev. 487 (1988). [FN152]. See [NLRB v. Bildisco & Bildisco](#), 465 US 513, 527 (1984) (bankruptcy court may use its equitable powers to supplement and implement the Code); Leal, supra note 151, at 489-490 (Congress granted bankruptcy courts broad equitable powers to address situations not expressly covered by the Code).

[FN153]. [NLRB v. Bildisco & Bildisco](#), 465 US 513, 527 (“[T]he Bankruptcy Court must focus on the ultimate goal of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize freewheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization.”); see also [Saybrook](#), 963 F2d at 1495 (bankruptcy court’s equitable powers are not unlimited); [Tenney Village](#), 104 BR at 570.

[FN154]. [Saybrook](#), 963 F2d at 1495; [Johnson v. First Nat’l Bank of Montevideo](#), 719 F2d 270, 273 (8th Cir. 1983), cert. denied, 465 US 1012 (1984) (bankruptcy court’s broad equitable powers may be exercised only in a manner that is consistent with the provisions of the Code), cert. denied, 465 US 1012 (1984); [In re JM Wells, Inc.](#), 575 F2d 329, 331 (1st Cir. 1978) (same); [In re Texas Consumer Fin. Corp.](#), 480 F2d 1261, 1265 (5th Cir. 1973) (same); [In re Middleton Arms Ltd. Partnership](#), 934 F2d 723 (6th Cir. 1991) (same).

[FN155]. See discussion infra notes 158-183, 205-224 and accompanying text.

[FN156]. [Saybrook](#), 963 F2d at 1496.

[FN157]. [Saybrook](#), 963 F2d at 1495-1496.

[FN158]. [11 USC § 507\(a\)](#) (1993). [Section 507](#) of the Code sets forth the “kinds of claims that are entitled to priority in distribution, and the order of priority.” HR Rep. No. 959, 95th Cong., 1st Sess. 357 (1977). Claims entitled to priority status include administrative expenses allowable under [Section 503\(b\)](#) (“the actual, necessary costs and expenses of preserving the estate,” including postpetition wages, salaries, and commissions; postpetition tax claims; and reimbursement and compensation of certain professionals, creditors, and indenture trustees), court costs, professional compensation ([Section 507\(a\)\(1\)](#)), involuntary “gap” period claims ([Section 507\(a\)\(2\)](#)),

certain prepetition wages, salaries, and commissions ([Section 507\(a\)\(3\)](#)), certain employee benefit plan contributions claims ([Section 507\(a\)\(4\)](#)), certain claims of grain producers, grain storage facility owners or operators, fishermen, and fish storage or processing facility operators ([Section 507\(a\)\(5\)](#)), certain individual consumer deposit claims ([Section 507\(a\)\(6\)](#)), certain governmental tax claims ([Section 507\(a\)\(7\)](#)), and certain claims relating to the debtor's commitment to maintain the capital of an insured depository institution ([Section 507\(a\)\(8\)](#)).

[FN159]. *Saybrook*, 963 F2d at 1495-1496 (citations omitted). In so concluding, *Saybrook* cited *Sun Runner Marine*, 945 F2d at 1089, 1094 (permitting debtor to pay lender's unsecured claims in full while others remain unpaid violates priority scheme); *Tenney Village*, 104 BR at 562, 570 ([Section 364](#) does not authorize courts to change the priorities set forth in [Section 507](#)), and *FCX*, 54 BR at 833, 840.

[FN160]. See [11 USC § 726 \(1993\)](#). The order of distribution is as follows: first, in payment of priority claims of the kind specified in and in the order specified in [Section 507](#); second, in payment of allowed general unsecured claims for which a proof of claim was timely filed or deemed timely filed; third, in payment of allowed unsecured claims for which a proof of claim was tardily filed; fourth, in payment of certain allowed claims for fines, penalties, forfeiture or multiple, exemplary or punitive damages; fifth, in payment of interest on allowed claims; and sixth, to the debtor. The only express exception from this distribution scheme relates to the subordination of certain claims. See [11 USC § 510 \(1993\)](#).

[FN161]. [Section 725](#) provides that “before final distribution of property of the estate under [section 726](#) ... the trustee ... shall dispose of any property in which an entity other than the estate has an interest such as a lien.” [11 USC § 725 \(1993\)](#). The legislative history to [Section 725](#) notes that:

The purpose of the section is to give the court appropriate authority to ensure that collateral or its proceeds is returned to the proper secured creditor Current law is curiously silent on this point, though case law has grown to fill the void. The section is in lieu of a section that would direct a certain distribution to secured creditors. It gives the court greater flexibility to meet the circumstances.

HR Rep. No. 595, 95th Cong., 1st Sess. 382-383 (1977); Sen. Rep. No. 989, 95th Cong., 2d. Sess. 96 (1978).

[FN162]. The requirements for confirmation of a Chapter 11 plan of reorganization are set forth in [Section 1129](#) of the Code. See [11 USC § 1129 \(1993\)](#).

[FN163]. A claim is impaired unless the plan (1) leaves unaltered the creditor's legal, equitable, and contractual rights; (2) provides for the cure of all defaults (other than ipso facto defaults based on the debtor's financial condition or bankruptcy filing), reinstates the original maturity, compensates the creditor for actual pecuniary damages, and reinstates the creditor's legal, equitable, and contractual rights; or (3) provides for cash payment of the allowed amount of the creditor's claim in full on the effective date of the plan. [11 USC § 1124 \(1993\)](#).

[FN164]. See [11 USC § 1129\(a\)\(7\)\(A\) \(1993\)](#). This requirement is referred to as the “best interests” test.

[FN165]. See [11 USC § 1126 \(1993\)](#) (voting requirements and majorities). Under a Chapter 11 plan, all claims are grouped into classes, the constitution of which is based on the claim holders' legal rights vis-à-vis the debtor. See generally [11 USC § 1123\(a\)\(1\) \(1993\)](#) (plan must specify classes of claims). A secured claim will be classified separately from unsecured claims because the Code permits a plan to place a claim in a particular class only if the claim is “substantially similar” to other claims in the class. [11 USC § 1122\(a\) \(1993\)](#). The rights of a holder of a secured claim are not substantially similar to the rights of the holder of an unsecured claim because only the holder of the secured claim has recourse against particular assets of the debtor's bankruptcy estate to satisfy its claim.

[FN166]. If a plan meets all of the standards for confirmation set forth in [Section 1129\(a\)](#) except that not every impaired class has accepted the plan (see [11 USC § 1129\(a\)\(8\)](#) (1993)), the court nevertheless may confirm the plan under the “cramdown” power if: (1) The proponent of the plan requests confirmation; (2) the plan does not discriminate unfairly; and (3) the plan is fair and equitable. [11 USC § 1129\(b\)\(1\)](#) (1993). Even in these circumstances, at least one impaired class of claims must accept the plan, without counting acceptances by insiders. See [11 USC § 1129\(a\)\(10\)](#) (1993); [In re Future Energy, Inc.](#), 83 BR 470 (Bankr. SD Ohio 1988). The plan proponent must satisfy the requirements of [Section 1129\(b\)](#) only with respect to those impaired classes that have not accepted the plan. [11 USC § 1129\(b\)](#) (1993); [Kane v. Johns-Manville Corp. \(In re Johns-Manville Corp.\)](#), 843 F2d 636, 650 (2d Cir. 1988).

[FN167]. In determining whether a plan discriminates unfairly, the primary focus is on classification and treatment of claims and interests vis-à-vis other claims and interests. See HR Rep. No. 595, 95th Cong., 1st Sess. 413-418 (1977); 124 Cong. Rec. H11,103 (Sept. 28, 1978); 124 Cong. Rec. S17,420 (Oct. 6, 1978) (discussing cram down).

[FN168]. The “fair and equitable” requirement continues the absolute priority rule of Chapter X of the former Bankruptcy Act in a modified form. [Section 1129\(b\)\(2\)](#) sets forth the tests to determine whether a plan is fair and equitable with respect to secured claims, unsecured claims, and equity interests. “However, technical compliance with all the requirements in [section 1129\(b\)\(2\)](#) does not assure that the plan is ‘fair and equitable.’” [FSLIC v. D&F Constr., Inc. \(In re D&F Constr., Inc.\)](#), 865 F2d 673, 675 (5th Cir. 1989) (“A court must consider the entire plan in the context of the rights of the creditors under state law and the particular facts and circumstances when determining whether a plan is ‘fair and equitable.’”).

[FN169]. A plan will be fair and equitable to a rejecting class of secured claims if one of three alternative tests is satisfied: (1) The secured creditor retains the liens securing the claim, to the extent of the allowed amount of the secured claim, whether the property subject to the liens is retained by the debtor or transferred, and receives deferred cash payments having a present value as of the effective date of the plan at least equal to the value of the creditor's interest in the estate's interest in the lien property; (2) the collateral is sold, the lien attaches to the proceeds, and the lien on proceeds is treated either under (1) or (3), as follows; or (3) the secured creditor receives the “indubitable equivalent” of its claim. [11 USC § 1129\(b\)\(2\)\(A\)](#) (1993).

[FN170]. To be fair and equitable with respect to a class of unsecured claims, the plan must provide either that (1) each unsecured creditor receives property having a present value, as of the effective date of the plan, equal to the allowed amount of its claims or (2) if unsecured claims are not paid in full, then no class of claims or interests junior to that of the dissenting class receives or retains any property. [11 USC § 1129\(b\)\(2\)\(B\)](#) (1993). See generally [Case v. Los Angeles Lumber Prods. Co.](#), 308 US 106, reh'g denied, 308 US 637 (1939); [Kane v. Johns-Manville Corp. \(In re Johns-Manville Corp.\)](#), 843 F2d 636, 650 (2d Cir. 1988).

[FN171]. See generally “Critical Reappraisal,” *supra* note 3, at 145-153 (cross-collateralization conflicts with a fundamental principle of bankruptcy law, equality of distribution).

[FN172]. [Saybrook](#), 963 F2d at 1496, citing [Texlon](#), 596 F2d at 1096. Under [Section 547\(b\)](#), the DIP may avoid and recover a transfer of an interest of the debtor in property if the transfer (1) was made to or for the benefit of a creditor; (2) was on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made on or within 90 days before the petition date or between 90 days and 1 year of the petition date if made to or for the benefit of an “insider”; and (5) enabled such creditor to receive more than it would have received if the case

were a Chapter 7 case, the transfer had not been made, and such creditor had received a distribution under the provisions of Chapter 7 of the Code. [11 USC § 547\(b\)](#) (1993).

[FN173]. [Saybrook](#), 963 F2d at 1496, citing [Texlon](#), 596 F2d at 1097.

[FN174]. The DIP may avoid a postpetition transfer not authorized by the Code or the bankruptcy court, or made during the “gap period” between the filing of an involuntary case and the entry of an order for relief, or made in good faith by a party without knowledge of the bankruptcy case. [11 USC § 549\(a\)](#) (1993). [Section 549](#) does not provide any support for the avoidance of a postpetition transfer made with court approval.

[FN175]. [Saybrook](#), 963 F2d at 1490, 1496 (cross-collateralization “impermissibly violate[s] the priority scheme of the [Bankruptcy Code](#)”); [Texlon](#), 596 F2d at 1092, 1097-1098 (court characterizes cross-collateralization as a “post-adjudication preference”); [Monach](#), 41 BR at 859, 861-862 (cross-collateralization afforded lender preferential treatment); cf. [FCX](#), 54 BR at 833, 840 (where a creditor's prepetition claims are oversecured there is no risk of preferential treatment; court authorized cross-collateralization under the circumstances “because of the difficulty in segregating and applying the proceeds of pre-petition and post-petition collateral”).

[FN176]. [Saybrook](#), 963 F2d at 1491. Based on the ultimate disposition of the assets in [Saybrook](#) (see supra note 136), however, the cross-collateralization arguably proved to be of no value to MH.

[FN177]. 41 BR at 859.

[FN178]. The order was entered by stipulation without notice or a hearing one week after the debtor filed its Chapter 11 petition. [Id.](#) at 860.

[FN179]. [Id.](#)

[FN180]. Two months after entry of the order, the creditors' committee filed a motion for reconsideration, which was pursued by the Chapter 7 trustee after conversion of the case to Chapter 7. The court rejected the lender's argument that the action was barred by laches, reasoning that “any delay in instituting and prosecuting this action was not unreasonable and no prejudice has been shown.” [Id.](#) at 861.

[FN181]. [Id.](#) at 862.

[FN182]. [Id.](#) The court reasoned that cross-collateralization was the equivalent of a preference prohibited by [Section 547](#) and was not permissible under the Code.

[FN183]. See also [Texlon](#), 596 F2d at 1092, 1099 (“the risk of [liquidation], occurring only when the debtor has no unmortgaged assets adequate, in addition to those created by advances, to induce existing creditors or new sources of financing to make them, is not too high a price to pay in order to protect the basic aim of the Bankruptcy Act to avoid inequality in the treatment of pre-petition debt”).

[FN184]. See *infra* notes 184-224; see generally Bohm, *supra* note 59 (ample legal bases exist for approving cross-collateralization); Henoch, *supra* note 3 (without incentive of cross-collateralization, DIP would have difficulty securing postpetition financing); see also M. Prager, “[Financing the Chapter 11 Debtor: The Lender's Perspective](#),” 45 *Bus. Law.* 2127 (1990) (emphasizing congressional policy of encouraging postpetition financing of debtors by providing “safe harbor” under [Section 364\(e\)](#) for financing orders).

[FN185]. [52 BR 241, 247 \(Bankr. WDNY 1985\)](#).

[FN186]. No evidence was presented with respect to the value of the collateral.

[FN187]. Chase did not participate in the postpetition loan. Although it is not entirely clear from the opinion, Chase's prepetition claims also appear to have received the benefit of the postpetition cross-collateralization liens.

[FN188]. U.S. Trust also objected to provisions in the proposed financing order which: (1) stipulated that the banks had properly accelerated prepetition obligations and demanded payment; (2) stipulated and determined that the banks held valid, properly perfected security interests in the prepetition collateral; (3) provided the banks with a "superpriority" expense for repayment of the prepetition and postpetition debt; and (4) granted the banks a "lien on post-petition assets pursuant to [section 363\(e\)](#) as adequate protection for the debtor's postpetition use of collateral." 152 BR at 243-46.

[FN189]. *Id.* at 244. The best interests inquiry arose from the *Roblin* court's application of the *Vanguard* four-part test. *Id.* at 244-245; see discussion *infra* note 209 and accompanying text regarding *Vanguard*.

[FN190]. *Id.* at 245.

[FN191]. The court did so in the context of considering the propriety of the proposed adequate protection liens, which the court found to be "inextricably bound up with the issue of cross-collateralization." *Id.* at 246.

[FN192]. *Id.* at 247. Unsecured creditors may still be harmed by cross-collateralization even if the reorganization is successful for the reasons discussed *infra* note 202.

[FN193]. The *Roblin* court also considered the likelihood of the business's success without the proposed financing, the DIP's ability to obtain alternative financing on acceptable terms, and the lender's willingness to agree to less favorable terms. [52 BR at 244](#), citing *Vanguard*, [31 BR at 366](#).

[FN194]. [52 BR at 247](#). *Roblin* did not discuss the extent to which *res judicata* or collateral estoppel may prevent unsecured creditors from later challenging the cross-collateralization provision if the reorganization fails and the prepetition lender is positioned to collect all of the assets to satisfy its postpetition and prepetition debt. See discussion *infra* notes 273-296 and accompanying text regarding *res judicata* and collateral estoppel.

[FN195]. [52 BR at 244-245](#). *Roblin* declined to approve provisions determining the validity, perfection, and priority of the lender's prepetition liens and determining that the prepetition obligations were properly accelerated and were due and payable. *Id.* at 243-244.

[FN196]. Bohm, *supra* note 59, at 297.

[FN197]. *Id.*

[FN198]. *Id.* at 298-290.

[FN199]. See "Critical Reappraisal," *supra* note 3, at 127-130 (postpetition lender may be granted a senior lien only if the DIP is unable to obtain alternative credit and the primed secured creditors are adequately protected).

[FN200]. See discussion *infra* note 202.

[FN201]. See discussion *supra* note 83 and accompanying text suggesting that cross-collateralization is relevant only to undersecured claims.

[FN202]. For example, assume that (1) on filing for relief under Chapter 11, a DIP's only significant debts are \$15 million owed to its secured lender and \$10 million owed to its general unsecured creditors; (2) the secured lender holds a lien only on the DIP's real estate, which is valued at \$5 million on both a going concern or liquidation basis; and (3) the DIP's unencumbered assets (accounts receivable, inventory, equipment) are valued at \$10 million on a liquidation basis and \$16 million on a going concern basis. Under this scenario, an immediate liquidation would result in \$5 million real estate sale proceeds being paid to the secured creditor and \$10 million other liquidation proceeds being distributed pro rata in payment of the secured creditor's \$10 million deficiency claim and the other creditors' \$10 million unsecured claims; i.e., a 50 percent recovery on all unsecured claims. Assume further that the DIP borrows \$1 million from a new lender secured by the DIP's unencumbered assets to permit the DIP to continue operating and sell its operations on a going concern basis. If it is successful in so doing, the distribution would be as follows: (1) \$1 million to repay the postpetition loan; (2) \$5 million real estate proceeds to repay the secured portion of the prepetition secured lender's claim; and (3) \$15 million other sale proceeds pro rata to repay the prepetition secured lender's \$10 million deficiency claim and the other creditors' \$10 million unsecured claims; i.e., a 75 percent recovery on all unsecured claims. Assume, instead, that the DIP borrows \$1 million from the prepetition secured lender to permit the DIP to continue operating and, in exchange, grants the secured creditor a lien in all of the DIP's assets to secure the creditor's prepetition claims and postpetition claims. If the DIP then is successful in conducting a going concern sale, the distribution would be as follows: (1) \$1 million to repay the postpetition loan; (2) \$15 million to repay the secured lender's prepetition claim; and (3) no distribution on general unsecured claims. In the latter scenario, even though the postpetition loan preserved \$6 million of value that would have been lost in an immediate liquidation, the entire benefit of the preserved value redounded to the secured creditor. In this hypothetical, where the prepetition secured creditor's deficiency claim is secured by postpetition cross-collateralization liens, the general unsecured creditors would benefit only if the new loan and the DIP's continued operations preserved and added in excess of \$15 million more aggregate value than would have been available on liquidation; i.e., value sufficient to repay the secured lender's entire \$10 million deficiency claim and result in a dividend greater than 50 percent on the \$10 million general unsecured claims.

[FN203]. See "Critical Reappraisal," *supra* note 3, at 136 n.144 (rejecting Bohm's statutory analysis). Nevertheless, some support for Bohm's position may be gleaned from the statement of the Ninth Circuit in *Adams Apple*, 829 F2d 1484 quoted *infra* at text accompanying note 217.

[FN204]. See discussion *supra* notes 139-144 and accompanying text.

[FN205]. See, e.g., Bohm, *supra* note 59, at 295-297.

[FN206]. E.g., *In re Beker Indus. Corp.*, 58 BR 725, 742 (Bankr. SDNY 1986); *Roblin*, 52 BR at 241, 244; *Vanguard*, 31 BR at 364, 366. *Vanguard* cited *Texlon* as approving cross-collateralization and as controlling in its jurisdiction. *Vanguard*, 31 BR at 366.

Beker suggests that Congress sanctioned cross-collateralization by failing to ban the practice when it enacted the Code. *Beker*, 58 BR at 742. *Texlon* was decided in April of 1979, after Congress had enacted the Code. Thus, Congress cannot have been expected to respond to *Texlon* in enacting the Code (as *Beker* implies). One might, however, attribute to Congress knowledge of lower courts' approval of cross-collateralization (including the lower courts in the *Texlon* case). *Texlon* noted that cross-collateralization "has been authorized not infre-

quently by bankruptcy judges in the Southern District of New York.” *Texlon*, 596 F2d at 1094. (*Texlon* cited no authority for this proposition.) The lack of any reference to the practice in the legislative history, however, combined with the fact that the legislative history to Section 364 states that Section 364 “governs all obtaining of credit and incurring of debt,” HR Rep. No. 595, 95th Cong., 2d Sess. 57 (1978), makes even this limited endorsement argument difficult.

[FN207]. *Texlon* stated, in dicta, that a hearing might reveal whether other sources of financing are available, or whether other creditors would like to share in the financing on similar terms, or that the creditors do not wish to continue the business. 596 F2d at 1098-1099, quoted supra text accompanying note 104. One could infer from this statement that cross-collateralization may be permissible if no other financing is available, other creditors are given an opportunity to participate in the financing, and creditors are willing to permit cross-collateralization as a cost of continuing the DIP's business in question.

[FN208]. 31 BR 364 (Bankr. EDNY 1983).

[FN209]. *Id.* at 366 (citations omitted).

[FN210]. The financing order also granted the lender (1) subordinate mortgages on the DIP's real property; (2) a superpriority pursuant to Section 364(c) for all prepetition and postpetition claims; and (3) a certificate of indebtedness. *Id.*

[FN211]. *Id.* at 366-367.

[FN212]. 52 BR at 241.

[FN213]. The Court is satisfied that, absent the proposed financing the debtor will be unable to purchase inventory, meet its payroll, maintain its property, and continue in operation ... no eager financier has rushed to succor the debtor ... the Banks were not willing to lend on any terms other than those proposed ... [and] [a]n ongoing operation which maintains the value of plant and equipment at a level in excess of liquidation is in the best interests not only of the Banks but of all creditors.

Id. at 244-245.

[FN214]. 31 BR at 103.

[FN215]. *Id.* at 105-106.

[FN216]. *Saybrook*, 127 BR at 499.

[FN217]. *Adams Apple*, 829 F2d at 1490. See also “Critical Reappraisal,” supra note 3, at 160-163 (discussing “necessity of payment” rule).

[FN218]. *Adams Apple*, 829 F2d at 1488 n.6. *Adams Apple* and several other decisions that articulate the policies supporting cross-collateralization do so in the context of dismissing challenges to financing orders on mootness grounds. See *Adams Apple*, 829 F2d at 1490; *Ellingsen*, 834 F2d at 603; see also *Saybrook*, 127 BR 494, 496-499 (M.D. Ga. 1991), rev'd, 963 F2d 1490 (4th Cir. 1992). In *Ellingsen*, the court dismissed the appeal as moot, but, in dicta, characterized cross-collateralization as “a valuable financing tool in arranging post-petition credit to keep debtors in reorganizing going.” 834 F2d at 602. Each of the circuit judges wrote separately. In the majority opinion, Judge Wellford stated that it was not clear whether the postpetition liens secured the prepeti-

tion claims or merely the postpetition loans. In either event, Judge Wellford held that [Section 364\(e\)](#) was not limited to the protection of new postpetition advances, but protected every term of a financing order (including the cross-collateralization and “settlement” provisions) from reversal or modification on appeal in the absence of a stay pending appeal. Accordingly, the majority opinion dismissed the appeal as moot. [Ellingsen, 834 F2d at 605](#). Judge Nelson concurred, agreeing that the appeal should be dismissed as moot, but disagreeing with Judge Wellford's suggestion that the financing order had not authorized cross-collateralization. [Ellingsen, 834 F2d at 605-607](#) (Nelson, J., concurring). While declining to say whether [Section 364](#) authorizes cross-collateralization, Judge Nelson noted that “[Section 364\(c\)\(2\)](#) does empower the bankruptcy court to authorize the incurring of additional debt ‘secured by a lien,’ ... and the statute does not expressly say that under no circumstances may such a lien secure pre-petition debt as well.” [Id. at 606](#) (Nelson, J., concurring); see also [Roblin, 52 BR 241](#) (discussed supra notes 185-195 and accompanying text). Judge Merritt dissented, reasoning that [Section 364\(e\)](#) “is not designed to cut off the right to appeal rulings on *pre-petition* matters, such as fraudulent conveyances and preferences, but only affects authorized post-petition loans and liens to secure such loans.” [Ellingsen, 834 F2d at 607](#) (Merritt, J., dissenting). See also [Butler Paper v. Graphic Arts Lithographers, Inc. \(In re Graphic Arts Lithographers\), 71 BR 774, 777 \(Bankr. 9th Cir. 1987\)](#) (dismissing appeal as moot).

[FN219]. [829 F2d at 1490](#).

[FN220]. [Bohm, supra note 59, at 299-301](#).

[FN221]. [Id.](#); see “Critical Reappraisal,” [supra note 3, at 160-163](#); see generally W. Boe, “Necessity, The Mother Of All Excuses,” 12 Norton Bankr. L. Advisor 1 (Dec. 1991) (and cases collected therein); R. Eisenbert & F. Gecker, “The Doctrine of Necessity and Its Parameters,” 73 Marq. L. Rev. 1 (1989) (and cases collected therein).

[FN222]. See generally Boe, [supra, note 221, at 1](#) (and cases collected therein); Eisenbert & Gecker, [supra, note 221](#) (and cases collected therein).

[FN223]. Boe, [supra, note 221, at 1](#); see also “Critical Reappraisal,” [supra note 3, at 152 n.246, 160-169](#) (criticizing the application of the “necessity of payment” doctrine to postpetition financing cases).

[FN224]. “Critical Reappraisal,” [supra note 3, at 162](#).

[FN225]. [Saybrook, 963 F2d at 1495-1496](#); see also [Monach, 41 BR at 859, 861-862](#).

[FN226]. See [Adams Apple, 829 F2d at 1484, 1490](#) (approving cross-collateralization notwithstanding “goal of treating creditors equally”); [Vanguard, 31 BR at 364, 367](#) (absent postpetition financing arrangement, creditors would not receive a distribution); [Antico, 31 BR at 103, 106](#) (without DIP financing, debtor would liquidate and creditors would receive no distribution); see also discussion [supra notes 205-224](#) and accompanying text.

[FN227]. The terms may be expensive for the DIP and its estate, but they will be easier to quantify and may not be as expensive as the costs that cross-collateralization imposes on the nonpreferred creditors.

[FN228]. The prepetition undersecured creditor may recognize the potential risks of permitting the DIP to liquidate and the potential benefits of advancing new funds, including the potential to obtain an increased dividend on the unsecured portion of the creditor's prepetition claim.

[FN229]. [Vanguard](#) attempted to define a test that would permit the use of cross-collateralization only to induce

the creditor to extend new financing that was crucial to prevent the DIP's liquidation. But see "Critical Reappraisal," *supra* note 3, at 163-165 (criticizing *Vanguard* test).

[FN230]. There is no empirical evidence of which the authors are aware on this issue.

[FN231]. See discussion *supra* notes 329-336 and accompanying text; see also "Critical Reappraisal," *supra* note 3, at 140-145.

[FN232]. See discussion *supra* note 202.

[FN233]. The Code does not contemplate and should not be construed to permit the grant of any postpetition liens to secure the unsecured portion of a prepetition claim, regardless of the asserted "purpose" of the lien. Postpetition liens may, however, be granted to provide adequate protection of the secured portion of a prepetition claim or to preserve a prepetition secured creditor's interest in the proceeds of its collateral. See discussion *supra* notes 24-48 and accompanying text.

[FN234]. 829 F2d at 1484.

[FN235]. 834 F2d at 599.

[FN236]. *Adams Apple*, 829 F2d at 1488 ("section 364(e) is meant to protect the lender by preventing reversal of a cross-collateralization clause unless a stay is obtained pending appeal"); *Ellingsen*, 834 F2d at 604 (Section 364(e) protection extends to all provisions in court's order approving postpetition financing); cf. *Sun Runner*, 945 F2d at 1089 (declining to apply mootness doctrine to dismiss an appeal even though the order had not been stayed pending appeal).

[FN237]. As discussed *supra* note 218, it is not clear whether the clause in the *Ellingsen* order actually contemplated cross-collateralization.

[FN238]. The *Saybrook* court characterized the issue of whether the Code authorizes cross-collateralization as "a question of first impression in this court" and "essentially a question of first impression before any court of appeals." *Saybrook*, 963 F2d at 1493; cf. *Ellingsen*, 834 F2d at 599 (dismissing on mootness grounds challenge to an order granting cross-collateralization). *Ellingsen* is discussed in further detail *supra* note 218 and *infra* notes 245-246. *Saybrook* discounted *Ellingsen*'s support for cross-collateralization as dicta. *Saybrook*, 963 F2d at 1494

[FN239]. *Saybrook*, 963 F2d at 1493. Where Section 364(e) applies, creditors who have not obtained a stay pending appeal may advance their objections to a postpetition financing order entered under Section 364 only by challenging the good faith of the lender or pursuing the extraordinary remedy of mandamus. See *New York Life Ins. Co. v. Revco DS, Inc. (In re Revco)*, 901 F2d 1359, 1367 (6th Cir. 1990) (holding that failure to obtain a stay did not foreclose appeal where bankruptcy court had not made finding of lender's good faith; discussed further *infra* notes 248-249); *In re First S. Sav. Ass'n*, 820 F2d 700, 716 (5th Cir. 1987) (issuing limited writ of mandamus to permit substantive review of appeal of Section 364(d) superpriority financing order).

[FN240]. See discussion *supra* notes 138-144 and accompanying text.

[FN241]. The same argument would apply to a sale order under Section 363(m) (see discussion *supra* note 71).

[FN242]. By remanding the financing order without specific direction on remand, the Eleventh Circuit's opinion in *Saybrook* creates some uncertainty concerning whether one unauthorized provision of an order will negate the entire order. See *supra* note 136 discussing the proceedings on remand. *Saybrook*'s reasoning suggests that those liens, priorities, and terms of the financing order that relate directly to the postpetition loan should be protected by [Section 364\(e\)](#), and should not be modified on remand. See *infra* notes 250-256 and accompanying text (discussing courts' reluctance to sever illegal provisions from financing orders and the package theory).

[FN243]. *Saybrook*'s ruling that [Section 364\(e\)](#) protects only those terms “authorized” under [Section 364](#) could be read broadly to support an argument that any term of a DIP financing order not expressly listed in [Section 364](#) is not “authorized” under [Section 364](#). *Saybrook*'s specific reasoning does not support such an argument. *Saybrook* reasoned that [Section 364](#) applies only to postpetition loans and does not authorize cross-collateralization because cross-collateralization does not relate to the postpetition loan. The logical conclusion is that provisions of a financing order relating to the postpetition loans are within the scope of [Section 364](#), whereas provisions relating to the prepetition debt are beyond the scope of [Section 364](#). See *Ellingsen*, 834 F2d at 607 (Merritt, J., dissenting) (discussed *supra* note 218). Provisions relating to the prepetition debt may be analyzed to determine whether they are appropriate under the Code's provisions relating to the protection of prepetition debt (e.g., adequate protection liens and proceeds liens). See 11 USC §§ 361, 362, 363, 552 (1993); cf. 11 USC § 364 (1993); see also discussion *supra* note 71 comparing [Sections 363\(m\)](#) and [364\(e\)](#).

[FN244]. Bohm, *supra*, note 59, at 305-313 (advocating “package” theory and stressing lender's reliance on financing order). This argument combines elements of inducement (i.e., the lender was induced to loan new funds through the cross-collateralization provision and every other term of the order), reliance (i.e., the lender relied on each term of the order in agreeing to advance new funds), and the package theory (i.e., the terms of the order constitute an inseparable whole). Tabb analyzes these elements separately and in detail in “Lender Preference Clauses,” *supra* note 62, at 118-124.

[FN245]. *Ellingsen*, 834 F2d at 602.

[FN246]. *Id.* at 603.

[FN247]. *Adams Apple*, 829 F2d at 1488.

[FN248]. *Revco*, 901 F2d at 1364.

[FN249]. *Id.* at 1364-1365. The court in *Texaco* also referred to [Section 364\(e\)](#), in dicta, in refusing to sever from a plan of reorganization a provision that had previously been approved by the court under a postpetition financing order. *Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.)*, 92 BR 38, 52-53 (SDNY 1988).

[FN250]. See *Revco*, 901 F2d at 1364 (financing order contained provision for the payment of interest on prepetition secured claims as adequate protection; court held that the interest payment provision was protected by [Section 364\(e\)](#) absent a stay pending appeal); *Ellingsen*, 834 F2d at 602 (debtor's agreement to settle “all controversies regarding the validity of the Banks' security interests ... was part of the whole ‘package’ authorized under [section 364\(c\)](#) ... we are aware of no case authority holding that [section 364\(e\)](#) protection is unavailable to orders purportedly granted under [section 364\(c\)](#) but determined to have exceeded [section 364\(c\)](#)'s scope”); see generally Bohm, *supra* note 59, at 305-313 (lenders rely on a financing order as a whole package).

[FN251]. “Lender Preference Clauses,” *supra* note 62, at 118-125.

[FN252]. “Emergency Preferential Orders,” *supra* note 59, at 107, 109.

[FN253]. *Id.* at 109.

[FN254]. In *Roblin*, a creditor challenged a financing order's provisions for (1) the waiver of rights regarding prepetition acceleration of indebtedness; (2) cross-collateralization; and (3) a determination of the perfection of liens in prepetition collateral. The court concluded that those provisions providing for the waiver of rights and perfection of liens in prepetition collateral were inappropriate. Rather than severing these provisions, however, the *Roblin* court simply refused to approve the proposed financing arrangement. *Roblin*, 52 BR at 241.

[FN255]. *New York Life Ins. Co. v. Revco DS, Inc. (In re Revco DS, Inc.)*, 901 F2d 1359, 1364 (6th Cir. 1990) (“Courts ... reviewing financing orders subject to section 364(e) have been reluctant to sever individual provisions, whether legal or not, in the absence of a stay pending appeal.”); *FCX*, 54 BR at 883, 838 (“A lender makes advances in reliance upon such orders authorized by § 364 and ‘the chapter 11 process would be undermined if this Court were to, in effect, undo those orders’ [citations omitted].”).

[FN256]. See *supra* note 243.

[FN257]. 11 USC § 364(e) (1993). In the *Revco* case, certain preferred shareholders appealed the bankruptcy court's approval of a DIP financing arrangement that authorized interest payments to prepetition lenders during the pendency of the Chapter 11 proceeding. The district court dismissed the appeal as moot because the appellants failed to obtain a stay pending appeal. *Revco*, 901 F2d 1359, 1363. The Sixth Circuit ruled that the appeal was not rendered moot by the absence of a stay because the bankruptcy court did not make an explicit finding of good faith. *Id.* at 1367. On remand, the bankruptcy court determined that the lender had acted in good faith. No further appeal was taken.

[FN258]. See generally “Lender Preference Clauses,” *supra* note 62, at 131-134 (“since some prior lower court cases have approved lender preference clauses, a subsequent lender seeking to include such clauses in its financing cannot know with certainty that the clauses are illegal, and thus is not acting in bad faith”).

[FN259]. *In re EDC Holding Co.*, 676 F2d 945 (7th Cir. 1982).

[FN260]. Prior to the filing of its Chapter 11 case, the principal debtor in *EDC* had defaulted under its loan agreements with its prepetition lender. As a result, the prepetition secured creditor exercised its right of setoff against the debtor's bank account, which was a payroll account, and applied the amounts set off to the payment of a portion of the secured creditor's claims. The offset resulted in the employee's wages not being paid and precipitated the filing of the Chapter 11 case. After the Chapter 11 filing, the debtor's union filed a complaint in the bankruptcy court against the DIP and the secured creditor seeking payment of the employees' wages and asserting a lien in the inventory in which the creditor also claimed a lien. Although the bankruptcy court authorized the creditor to take possession of the inventory, the creditor was prevented from doing so by the union's picketing activities. The union's suit was settled and dismissed as part of the financing agreement under which the secured creditor agreed to advance \$1.7 million, the majority of which was used to pay wages, and the union agreed to permit the creditor to remove and liquidate the inventory. *EDC*, 676 F2d at 946.

[FN261]. *Id.* at 947.

[FN262]. *Id.*

[FN263]. *Id.*; see also *Adams Apple*, 829 F2d at 1485, 1490 (“we conclusively can [not] state that [lender] acted in bad faith by lending with the purpose of securing a prepetition loan”).

[FN264]. 676 F2d at 947.

[FN265]. *Id.* at 949. Under the Code, payment of such fees by the estate would be improper. The court noted that the lender's role as a defendant in the underlying litigation “strengthen[ed] the inference of bad faith.” The lender “was not a disinterested lender but a settling litigant that saw an opportunity to reduce the cost of the settlement by putting the union's lawyers ahead of the general creditors.” *Id.*

[FN266]. 11 USC § 364(e) (1993).

[FN267]. See generally “Lender Preference Clauses,” *supra* note 62, at 132-135 (addressing two bad faith arguments: (1) “lender evinces bad faith by demanding improper concessions” and (2) procedural abuses).

[FN268]. *Id.*; see also UCC § 1-201(19) (1990) (subjective definition of “good faith” as “honesty in fact in the conduct or transaction concerned”).

[FN269]. *EDC*, 676 F2d at 949.

[FN270]. See discussion *supra* note 124 and accompanying text.

[FN271]. See *Ellingsen*, 834 F2d at 599, 605 (“Bankers 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.”); *Adams Apple*, 829 F2d at 1484, 1490 (“[bank] did not act in bad faith as a matter of law simply because some courts have held cross-collateralization clauses to be illegal *per se*”); see generally “Lender Preference Clauses,” *supra* note 62, at 116 n.44, 131-135 (lender does not act in bad faith by demanding provisions questioned by some courts).

Also, an analogy may be drawn to the good faith requirement applicable to votes to accept or reject a plan of reorganization. If a creditor or interest holder is deemed not to have been solicited or not to have voted in good faith, the vote will not be counted in determining whether the class of which the creditor or interest holder is a member has voted to accept or reject the plan. 11 USC § 1126(e) (1993); see also 11 USC §§ 1126(c), 1126(d) (1993). The leading discussion of “good faith” voting is found in *In re Pine Hill Collieries*, 46 F. Supp. 669 (ED Pa. 1942), a case interpreting Section 203 of Chapter X of the former Bankruptcy Act. The court in *Pine Hill* stated:

The Securities and Exchange Commission suggests in its brief that if assent is withheld to serve some ulterior selfish purpose good faith is wanting. If the emphasis is placed on “ulterior” rather than “selfish” this seems to be as practical a test as could be found If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand, pure malice, “strikes,” and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.

Id. at 671. See also *Texas Extrusion Corp. v. Lockheed Corp. (In re Texas Extrusion Corp.)*, 844 F2d 1142, 1162-64 (5th Cir.), cert. denied, 488 US 926 (1988); *Insinger Mach. Co. v. Federal Support Co. (In re Federal Support Co.)*, 859 F2d 17, 19 (4th Cir. 1988). Similarly, it could be argued that a lender's demand for preferential treatment of its prepetition debt as a condition of postpetition financing reflects an “ulterior” purpose not re-

lated to the postpetition financing. But see *Adams Apple*, 829 F2d at 1490 (lending with purpose of securing prepetition loan is not bad faith).

[FN272]. In *EDC*, however, the court severed the illegal provision by remanding with instructions that the order of the bankruptcy court be reversed with respect to the priority accorded to the portion of the loan used to pay the union's attorney fees. *EDC*, 676 F2d at 949.

[FN273]. “Res judicata ‘prevents litigation of all grounds for, or defenses to, recovery that were previously available to the parties, regardless of whether they were asserted or determined in the prior proceeding.’” *Levinson v. United States*, 969 F2d 260, 262 (7th Cir. 1992), quoting, *Brown v. Felsen*, 442 US 127, 131 (1979).

[FN274]. Res judicata arguments may be relevant to financing orders containing cross-collateralization provisions that were entered prior to the *Saybrook* decision and were never challenged on appeal, and to orders entered after *Saybrook* by courts that decline to follow *Saybrook's* reasoning.

[FN275]. Creditors, the trustee, and other parties in interest may be considered in privity with the DIP because the challenges they might raise would be on behalf of the DIP's estate rather than private, individual rights. See *Montana v. United States*, 440 US 147, 153 (1979) (under res judicata, final judgment bar further claims by parties or their privies on the same cause of action).

[FN276]. 41 BR 859 (Bankr. ED Pa. 1984).

[FN277]. 596 F2d 1092 (2d Cir. 1979).

[FN278]. 41 BR 859 (Bankr. ED Pa. 1984). See discussion *infra* notes 177-182 and accompanying text summarizing the facts of *Monach*.

[FN279]. *Id.* at 862. The court, rejecting the lender's argument that the exigencies of the case did not allow time for notice to be given, noted that “[a]lthough mailing notices may not have been practicable, [the lender] has failed to meet the extraordinarily high showing needed to establish that there was inadequate time for attempting telephone notice.” *Id.* at 861. The court also rejected the lender's argument that the trustee was barred by laches from challenging the order. *Id.*; see discussion of laches *infra* note 308.

[FN280]. 596 F2d 1092 (2d Cir. 1979).

[FN281]. *Id.* at 1097. *Texlon* relied, however, on the administrative order doctrine rather than on due process considerations.

[FN282]. Tabb cites several cases that rely on *Texlon* in permitting reconsideration of various types of orders entered under the Code. “Lender Preference Clauses,” *supra* note 62, at 140 ns.206-207. These cases provide little, if any, support for the reconsideration of final financing orders that have been entered after notice and a hearing and from which no appeal has been taken because the majority of these cases involve interlocutory orders or orders entered on an *ex parte* basis.

[FN283]. 686 F2d 593, 595 (7th Cir. 1982).

[FN284]. 815 F2d 1046 (5th Cir. 1987).

[FN285]. 11 USC § 524(e) (1993). The *Newboles* court considered the former Bankruptcy Act predecessor that

mirrored [Section 524\(e\)](#) of the Code. Bankruptcy Act § 16.

[FN286]. [686 F2d at 593](#); see also [In re AOV Indus., Inc., 792 F2d 1140 \(DC Cir.\)](#), vacated in part, [797 F2d 1004 \(1986\)](#) (plan may provide for consensual release of derivative actions by creditors against settlors of fund for creditors, but may not release direct claims against settlors absent additional consideration and consent of each creditor).

[FN287]. [Republic Supply, 815 F2d at 1051 n.6](#).

[FN288]. [Newboles, 686 F2d at 594-595](#).

[FN289]. The Code requires that an individual debtor file a list of exempt property. The trustee or any creditor may object to the debtor's claim of exemptions within 30 days after the conclusion of the first meeting of creditors. [11 USC § 552\(1\) \(1993\)](#); [Fed. R. Bankr. P. 4003\(b\)](#).

[FN290]. [112 S. Ct. 1644 \(1992\)](#).

[FN291]. [Id. at 1646](#). The Chapter 7 debtor had claimed as exempt money that she expected to receive from an employment discrimination lawsuit. Although the trustee properly concluded that the claimed exemption was improper because it had no statutory foundation, the trustee did not object to the exemption because he believed the lawsuit had little or no value. Later, the debtor settled the lawsuit for \$110,000. The trustee then challenged the exemption.

[FN292]. [Id. at 1647-1648](#). Justice Stevens dissented, arguing that federal statutes of limitation often are tolled by demonstrating fraud. He concluded that “unless the debtor could establish some prejudice caused by the trustee's failure to object promptly, I would hold that the filing of a frivolous claim for an exemption is tantamount to fraud for purposes of deciding when the 30-day period begins to run.” [Id. at 1650](#) (Stevens, J., dissenting).

[FN293]. See also [Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F2d 1351, 1355 \(7th Cir. 1990\)](#) (“a lender that extends credit in reliance on a financing order is entitled to the benefit of that order, even if it turns out to be legally or factually erroneous”).

[FN294]. [Greater Los Angeles Council on Deafness, Inc. v. Baldrige, 827 F2d 1353, 1360 \(9th Cir. 1987\)](#); see also [Montana v. United States, 440 US 142, 153 \(1979\)](#) (“[u]nder collateral estoppel, once an issue is actually and necessarily determined by a court of competent jurisdiction, that determination is conclusive in subsequent suits based on a different cause of action involving a party to the prior litigation”); [Ramsay v. Lloyd \(In re Lloyd\), 142 BR 866, 869 \(Bankr. ED Ark. 1992\)](#).

[FN295]. See generally “Lender Preference Clauses,” *supra* note 62, at 116-130 (mootness and estoppel principles). Several courts have considered whether an appeal should be dismissed on estoppel grounds where the appealing creditor failed to obtain a stay pending appeal. See [Ellingsen, 834 F2d at 599, 606](#) (Nelson, J., concurring) (“[t]he unsecured creditors having been made aware of the bankruptcy court's position that under [section 364\(e\)](#) the validity of the replacement liens would not be affected by reversal on appeal unless the amended order were stayed ... acted at their peril in failing to obtain such a stay”); [Trone v. Roberts Farms \(In re Roberts Farms\), 652 F2d 793, 798 \(9th Cir. 1981\)](#) (“[a]n entirely separate and independent ground for dismissal has also been established because Appellants have failed and neglected diligently to pursue their available remedies to obtain a stay of the objectionable orders of the Bankruptcy Court and have permitted such a comprehensive

change of circumstances to occur as to render it inequitable for this court to consider the merits of the appeal”); [Trans World Airlines, Inc. v. Texaco, Inc. \(In re Texaco, Inc.\)](#), 92 BR 38, 45 (SDNY 1988) (“when bankruptcy appellants ‘have failed and neglected diligently to pursue the available remedies to obtain a stay’ ... and thereby ‘have permitted such a comprehensive change of circumstances to occur,’ it is inequitable to hear the merits of their case”), citing [Lawrence v. Revere Copper & Brass, Inc. \(In re Revere Copper & Brass, Inc.\)](#), 78 BR 17, 23 (SDNY 1987). At least one commentator has argued that estoppel is not a legitimate reason for dismissing appeals of financing orders where no stay has been obtained. “Lender Preference Clauses,” supra note 62, at 129. First, even if no stay has been obtained, Tabb argues that no prejudicial change in circumstances has occurred because “[t]he lender preference clauses ... are severable from the postpetition loan, because they relate to the prepetition claim, and no change in circumstances has occurred with regard to the prepetition claim.” *Id.* Second, it is difficult to establish that the creditor has been negligent in failing to obtain a stay because it may be extremely difficult for a creditor to obtain a stay pending appeal of a financing order. “Emergency Preferential Orders,” supra note 59, at 108; see [Adams Apple](#), 829 F2d at 1484, 1489 (“[t]o permit a court to impose a stay after a creditor has lent money to a debtor would intrude on a reorganization process already underway”).

[FN296]. See generally “Lender Preference Clauses,” supra note 62, at 147-161 (discussing concerns regarding notice in connection with financing orders).

[FN297]. [Fed. R. Civ. P. 60\(b\)](#).

[FN298]. Tabb considers each subsection of Bankruptcy [Rule 60\(b\)](#) and persuasively argues that Bankruptcy [Rule 60\(b\)](#) should not be used as an alternative to an appeal pursuant to Bankruptcy Rule 8002 or as a device for obviating the finality of orders by permitting collateral challenges to financing orders. “Lender Preference Clauses,” supra note 62, at 141-147.

[FN299]. [Texlon](#), 596 F2d at 1100, 1101.

[FN300]. The administrative order doctrine is discussed in “Lender Preference Clauses,” supra note 62, at 135-141.

[FN301]. [Texlon](#), 596 F2d at 1092; see “Lender Preference Clauses,” supra note 62, at 143 (noting that relief under Bankruptcy [Rule 60\(b\)\(1\)](#) is rarely granted, and arguing that challenges to postpetition financing orders should only properly be made on appeal, not under Bankruptcy [Rule 60\(b\)\(1\)](#)).

[FN302]. [Texlon](#), 596 F2d at 1099, citing 11 [Wright & Miller, Federal Practice and Procedure](#) § 2862 at 198 (1973) (footnotes omitted); see also [Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. \(In re Center Wholesale, Inc.\)](#), 759 F2d 1440, 1447-1451 (9th Cir. 1985) (final cash collateral and financing order, entered on one day notice, was void pursuant to Bankruptcy [Rule 60\(b\)\(4\)](#)).

[FN303]. See generally “Lender Preference Clauses,” supra note 62, at 147; but see [FCX](#), 54 BR at 839 (court may employ Bankruptcy [Rule 60\(b\)\(6\)](#) even if notice was given) (*dicta*).

[FN304]. See generally “Lender Preference Clauses,” supra note 62, at 141-147 (Bankruptcy [Rule 60\(b\)](#) relief granted when party has not been heard on the merits).

[FN305]. [United States v. ITT Continental Baking Co.](#), 420 US 223, 236-238 (1975); [Dunn v. Carey](#), 808 F2d 555, 559 (7th Cir. 1986).

[FN306]. See *Rufo v. Inmates of Suffolk County Jail*, 112 S. Ct. 748, 760 (1992) (change in circumstances, unforeseen obstacles, detrimental to the public interest); *Mallory v. Eyrich*, 922 F2d 1273, 1280 (6th Cir. 1990) (fraud and mutual mistake of fact); *Freedman v. Air Line Stewards & Stewardesses Assoc.*, 730 F2d 509, 515 (7th Cir.), cert. denied, 469 US 899 (1984) (change in circumstances).

[FN307]. The courts, however, do not appear to apply such strict limits to creditors. See *Ellingsen*, 834 F2d at 599, 604 (“appellants could have avoided the application of section 364(e) ... [by filing] a motion for relief from the order pursuant to Bankruptcy Rule 9024 and Federal Rule of Civil Procedure 60”); *Montco, Inc. v. Barr (In re Emergency Beacon Corp.)*, 666 F2d 754, 759 (2d Cir. 1981) (“Rule 60(b) is properly invoked when there are extraordinary circumstances ... or where the judgment may work an extreme hardship”); *Monach*, 41 BR at 859, 862 (vacating order approving postpetition financing agreement; lender cannot rely on protections of Section 364(e) when court is reconsidering the financing arrangement).

[FN308]. It may also be argued that any party that has actual or constructive notice but fails to file a timely appeal should be barred from challenging a financing order under the equitable doctrine of laches. Laches is generally defined as “neglect to assert right or claim which taken together with lapse of time and other circumstances causing prejudice to adverse party, operates as bar in court of equity.” Black’s Law Dictionary 787 (5th ed. 1979). As an equitable doctrine, laches does not establish any specific time within which a plaintiff must assert a cause of action. Rather, laches acts as a defense to an otherwise valid claim where, as determined on a case-by-case basis, one party’s unreasonable delay or neglect to assert a claim caused harm or unduly prejudiced the other party. See D. Dobbs, *Handbook on the Law of Remedies* § 2.3 (1973). The application of the laches doctrine may be limited if a court finds that no intervening rights have been prejudiced. See *supra* note 110.

[FN309]. *Saybrook*, 963 F2d at 1492.

[FN310]. Presumably, the court’s reasoning would extend as well to assets in existence on the petition date that are not subject to the secured creditor’s liens.

[FN311]. *Saybrook*, 963 F2d at 1491-1492; *Texlon*, 596 F2d at 1094.

[FN312]. See discussion *supra* note 244 and accompanying text.

[FN313]. As discussed *supra* notes 78-79, the authors recommend that the term “cross-collateralization” not be used in reference to such liens.

[FN314]. See, e.g., *Patterson v. Shumate*, 112 S. Ct. 2242 (1992) (resolving a split among the circuits regarding the exclusion of Employee Retirement Income Security Act 29 USC §§ 1001, *et seq.* (1974) (as amended) qualified pension plans from property of the estate, the Court concluded that the phrase “applicable nonbankruptcy law” is unambiguous and is not limited to applicable “state” law); see also *Wade v. Hannon*, 968 F2d 1036 (10th Cir. 1992) (discussing conflict in which Sixth and Tenth Circuits disagree with the Third, Fourth, Ninth, and Eleventh Circuits over the entitlement of an oversecured mortgagee of a Chapter 13 debtor’s residence to postpetition interest). The circuit courts are presently split in a debate analogous to the cross-collateralization debate concerning whether courts should rely on the plain language of the Code, the legislative history, pre-Bankruptcy Code practice or policy arguments. This debate relates to the so-called new value exception to the absolute priority rule, which governs priorities under a Chapter 11 plan. Cf. *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 948 F2d 134 (5th Cir. 1991), cert. denied, 113 S. Ct. 72 (1992) (dictum concerning new value exception withdrawn by supplemental opinion); *Travelers Ins. Co. v. Bryson*

Properties, XVIII (In re Bryson Properties, XVIII), 961 F2d 496 (4th Cir.), cert. denied, 113 S. Ct. 191 (1992) (questioning the viability of the new value exception); *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*, 908 F2d 1351 (7th Cir. 1990) (declining to decide whether the “new value” exception survived the adoption of the Code, but strongly suggesting that it did not); *Snyder v. Farm Credit Bank (In re Snyder)*, 967 F2d 1126 (7th Cir. 1992) (strongly suggesting, in dicta, that the new value exception does remain viable).

[FN315]. Cross-prioritization is the postpetition grant of priority status to a creditor's prepetition unsecured claim. See *In re FCX*, 54 BR 833, 841 (“Section 354(c)(1) ... does not authorize giving a superpriority for prepetition loans”); and *In re Monach Circuit Indus.*, 41 BR 859, 862 (Bankr. ED Pa. 1984) (“the terms of section 364(c) appear to limit the extent of the priority to the amount of the credit obtained or debt incurred after court approval”); *Borne Chem. Co. v. Lincoln First Commercial Corp. (In re Borne Chem. Co.)*, 9 BR 263 (Bankr. DNJ 1981) (approving cross-prioritization based on Section 364(c)(1)); *In re 360 Inns, Ltd.*, 76 BR 573, 579 (Bankr. ND Tex. 1987) (secured creditor cannot use Section 364(c)(1) to elevate its claim to super-administrative priority); *Roblin*, 52 BR at 241, 245-248 (“superpriority” provision is permissible even though it could impair the ability of the creditors' committee to retain professionals); “Emergency Preferential Orders,” supra note 59, at 85-86 (disapproving of cross-prioritization).

[FN316]. See discussion of Section 506(a) supra notes 22-24 and accompanying text.

[FN317]. See, e.g., *Ellingsen*, 834 F2d at 599, 601 (approving financing order containing a provision determining “all controversies” involving the lenders' security interests); *FCX*, 54 BR at 833, 841-842 (provision conceding validity of prepetition lien not reasonable); *Roblin*, 52 BR at 241, 243 (refusing to approve financing arrangement containing a provision by which debtor waived all rights to challenge lender's prepetition liens).

[FN318]. See 11 USC § 506(c) (1993).

[FN319]. See discussion of *Saybrook* supra notes 239-243 and accompanying text; but see discussion of *Revco* supra notes 248-249 and accompanying text; cf. *In re Florida W. Gateway, Inc.*, 147 BR 817 (Bankr. SD Fla. 1992) (Section 364(e) protects financing order, including term acknowledging that certain prepetition obligations had been canceled prepetition, from modification or reversal on appeal in the absence of a stay pending appeal; limiting *Saybrook* to cross-collateralization).

[FN320]. See 11 USC § 506(c) (1993); see generally *In re Bob Grissett Gold Shoppes, Inc.*, 3 Bankr. L. Rep. (CCH) ¶ 70, 608 (Bankr. ED Va. June 25, 1985) (surveying cases and legislative history).

[FN321]. See 11 USC §§ 501, 502, 506(a) (1993); *Fed R. Bankr. P.* 3001(a), 3001(d), 3002, 7001(2).

[FN322]. But see *Florida W. Gateway*, discussed supra note 319.

[FN323]. A guaranty is “upstream” if made by a subsidiary to guarantee its parent's debt, “downstream” if made by a parent to guarantee its subsidiary's debt, and “cross-stream” if made by one subsidiary to guarantee the debt of a sister subsidiary.

[FN324]. 11 USC § 548 (1993); see *Rubin v. Manufacturers Hanover Trust Co.*, 661 F2d 979 (2d Cir. 1981); *In re Augie/Restivo Baking Co.*, 87 BR 242, 247-248 (Bankr. EDNY 1988); see also P. Blumberg, “Intragroup (Upstream, Cross-Stream and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act,” 9 *Cardozo L. Rev.* 685 (1987); D. Walls, “Promises to Keep: Intercorporate Guarantees and Fraudulent Transfer in Bank-

ruptcy,” 19 UCCLJ 219 (1987). [Section 548](#) permits a DIP to avoid any (1) transfer of an interest of the debtor in property, or any obligation incurred by the debtor; (2) that was made or incurred on or within one year before the petition date; (3) if the debtor voluntarily or involuntarily: (a) made such transfer or incurred such obligation with the actual intent to hinder, delay, or defraud existing or future creditors or (b) received less than reasonably equivalent value and (i) was insolvent on the date of the transfer or obligation or became insolvent as a result of the transfer or obligation; or (ii) was engaged in or was about to engage in a business or transaction for which the debtor was left with unreasonably small capital; or (iii) intended to incur or believed it would incur debts beyond its ability to pay as such debts matured. [11 USC § 548\(a\)](#) (1993).

[FN325]. See [Mellon Bank v. Metro Communications, Inc.](#), 945 F2d 635 (3d Cir. 1991) (value given may be indirect), cert. denied, 112 S. Ct. 1476 (1992); [Rubin](#), 661 F2d at 991 (same); [Weiboldt Stores, Inc. v. Schottenstein](#), 94 BR 488, 505 (ND Ill. 1988) (same).

[FN326]. See discussion supra notes 259-267 and accompanying text.

[FN327]. See discussion supra notes 267-271 and accompanying text.

[FN328]. See discussion supra note 256 and accompanying text; see also [28 USC § 959](#) (1992) (DIP must comply with state law applicable to the DIP's use and operation of property of the bankruptcy estate).

[FN329]. The diverse interests affected may include (1) the DIP's interest in continuing in operation; (2) the DIP's employees' interest in retaining their jobs; (3) the secured creditors' interest in preserving the value of their collateral, being repaid and, possibly, in maintaining a continuing lending relationship; (4) the unsecured trade creditors' interest in maximizing their recovery and, potentially, in preserving the long-term viability of the debtor as a customer or supplier; (5) the unsecured bondholders' interest in maximizing their recovery; and (6) the shareholders' interest in preserving some value for their equity interests. All parties in interest have a right to object to cash collateral and postpetition financing agreements and orders. See generally [11 USC § 1109](#) (1993) (right to be heard).

[FN330]. This is a complex decision, which may include an analysis of (1) the borrower's historical financial performance, business plan, capital structure, prospects for rehabilitation, and management; (2) recent trends in and predictive indicators relating to the borrower's industry and operations; and (3) the lenders' internal regulatory restrictions, plans, and goals.

Also, it should be noted that bankruptcy commentators disagree on the issue of whether Chapter 11 maximizes value. See HR Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) (“The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate ... it is more economically efficient to reorganize than liquidate.”). Compare M. Bradley & M. Rosenzweig, “The [Untenable Case for Chapter 11](#),” 101 *Yale LJ* 1043 (1992) (arguing that Chapter 11 does not maximize value; recommending repeal of Chapter 11 and adoption of authors' “financially distressed corporations” model); M. Bradley & M. Rosenzweig, “The Still Untenable Case for Chapter 11: A Reply to Professor Warren,” 103 *Yale LJ* (1993) (recommending repeal of Chapter 11 because of costs on society) with D. Baird, “[Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren](#),” 54 *U. Chi. L. Rev.* 815 (1987) (Chapter 11 maximizes value; goal of bankruptcy is to enhance collection rights of secured creditors); E. Warren, “[Bankruptcy Policy](#),” 54 *U. Chi. L. Rev.* 775 (1987) (Chapter 11 maximizes value; bankruptcy attempts to “reckon a debtor's defaults and to distribute the consequences among many creditors”) and E. Warren, “The [Untenable Case for Repealing Chapter 11](#),” 102 *Yale LJ* 437 (1992) (challenging the Bradley and Rosenzweig recommendation that Chapter 11

should be repealed). Regardless of which view may be more accurate, the financing analysis by a secured creditor may focus less on the statistical empirical realities and more on the creditor's subjective belief that continued operations will maximize value for a particular borrower. Sophisticated lenders generally do not arrive at this conclusion absent a careful analysis of the types of considerations outlined previously in this footnote; however, the exigencies of Chapter 11 may not always allow for a detailed analysis and, even if such an analysis is undertaken, predicting the future is inherently uncertain.

[FN331]. See generally [11 USC § 362\(c\)\(2\)\(B\)](#) (1993).

[FN332]. See generally [11 USC § 364\(d\)](#) (1993).

[FN333]. See [In re Ames Dep't Stores, Inc.](#), [115 BR 34, 35 \(Bankr. SDNY 1990\)](#) (DIP rejected prepetition lender's financing package requiring cross-collateralization in favor of package offered by new lender).

[FN334]. See generally [UCC § 9-207](#) (1990); G. Blanchard, *Lender Liability: Law, Practice & Prevention* ch. 5, ch. 12, ch. 13, ch. 14, ch. 15, ch. 17, ch. 18 (1992); E. Mannino, *Lender Liability and Banking Litigation* ch. 2 (1992).

[FN335]. This latter dilemma often is forced by unsecured creditors or subordinated bondholders who object to a cash collateral or financing order in an attempt to "call the secured creditor's bluff," where the objectors believe that the secured creditor's desire to avoid a shutdown of the business outweighs the creditor's desire to retain all of protections it has negotiated. If successful, the objecting creditors may (1) reduce the lender's leverage, (2) gain advantage in plan negotiations, including by keeping alive the implicit threat of a lender liability suit or challenge to the secured creditor's claims and (2) improve the DIP's financial position by reducing liens and improving cash flow (e.g., by eliminating provisions for cross-collateralization and interest payments). These other creditors also must recognize, however, that their objections could force a liquidation, to their disadvantage, if the lender declines to accept less beneficial terms, no other financing is available, and the DIP cannot obtain access to sufficient funds to operate its business.

[FN336]. See discussion *supra* note 200 and accompanying text.

[FN337]. Also, although there is no published decision addressing the issue, the lender conceivably could be subjected to (1) a lender liability suit if the lender's refusal to modify the terms of the financing agreement is deemed to be an unreasonable and bad faith violation of its contract or (2) a fraudulent conveyance recovery action brought by aggressive creditors or the DIP seeking to recover fees paid to the lender prepetition (on the theory that the DIP did not receive equivalent value for the fees paid). Cf. [Richter v. Bank of Am. Nat'l Trust & Sav. Ass'n](#), [939 F2d 1176 \(5th Cir. 1991\)](#) (lender liability suit; bank held responsible for making false representations concerning its desire to renegotiate credit agreement); [Makoroff v. Allegheny Graphics, Inc. \(In re Allegheny Label, Inc.\)](#) [128 BR 947 \(W.D. Pa. 1991\)](#) (real estate broker required to return commission payments to trustee; commission based on prepetition contract and paid from prepetition escrow account); see generally Blanchard, *supra* note 334, at ch. 2. While the lender may be successful in defending such claims, it may bear a large defense expense (and may find indemnity provisions to be of little value if no reimbursement funds are available). Note, however, that under most DIP financing agreements, bankruptcy court approval is a precondition to the lender's obligation to fund. It would seem unlikely that liability could be imposed on a lender if this precondition has not been satisfied.

[FN338]. See discussion *supra* note 256 and accompanying text.

[FN339]. *Adams Apple*, 829 F2d at 1484, 1486 (approving financing arrangement between debtor and prepetition secured lender, which required debtor to file Chapter 11 case; debtor's prepetition negotiations with other lenders were unsuccessful).

[FN340]. 11 USC § 506(a) (1993) (defining secured claim; discussed supra notes 22-24 and accompanying text).

[FN341]. 11 USC § 363(c)(2) (1993).

[FN342]. 11 USC § 364(d) (1993).

[FN343]. The provisions of Section 364(e) that protect a financing order against modification or reversal on appeal in the absence of a stay do not apply to a cash collateral order entered under Section 363. See supra note 71. Thus, agreements permitting the DIP to use cash collateral often provide that such use may not commence until the period for filing an appeal has expired with no appeal having been filed.

[FN344]. See generally 11 USC §§ 1121 (1992) (who may file a plan); 11 USC § 1123 (1993) (contents of a plan).

[FN345]. See *In re Tenney Village Co.*, 104 BR 562, 568 (Bankr. DNH 1989) (refusing to approve financing arrangement; “[u]nder the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons useable against it for the bankruptcy estates'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”); *In re Antico Mfg. Co.*, 31 BR 103, 106 (Bankr. EDNY 1983) (without financing, debtor would liquidate, and creditors likely would receive no distribution).

[FN346]. 104 BR at 568; Stripp, supra note 3, at 578; “Emergency Preferential Orders,” supra note 59, at 89-92.

[FN347]. Some lenders have created a separate department or facility expressly for DIP financing. See, e.g., D. Moore, “How to Finance a Debtor in Possession,” 6 Com. Lending Rev. 3, 1991; J. Rizzi, “Opportunities in DIP Financing,” *The Bankers Mag.*, July/Aug. 1991, at 43.

[FN348]. Contingency fees (payable on the occurrence of specified events, often relating to the borrower's financial condition or performance), due diligence fees (payable before the lender will proceed with an investigation of the potential borrower's financial affairs and nonrefundable even if the lender never agrees to provide financing or the lender and the borrower never reach agreement on the financing terms), break-up fees (payable if the financing agreement is rejected by the court and the lender agrees to modify the terms of the financing or the DIP obtains financing from another source), availability fees (for funds that are available but have not been borrowed), transaction fees (payable on closing as a cost of the transaction, whether or not funds are ever advanced), and other fees are increasingly commonplace.

[FN349]. Prepetition lenders may be willing to extend postpetition financing in order to increase their return on prepetition claims. See Henoch, supra, note 3, at 580-581; M. Prager, “Financing the Chapter 11 Debtor: The Lender's Perspective,” 45 *Bus. Law.* 2127, 2131-2132 (1990); “Critical Reappraisal,” supra note 3, at 111. Adequate protection liens and proceeds liens will not secure the unsecured portion of a creditor's prepetition claims but will prevent the harsh result of *Texlon*. In *Texlon*, all proceeds from the liquidation of Texlon's assets after the repayment of the lender's postpetition advances were distributed pro rata in payment of all remaining claims. Thus, the lender's entire prepetition claim was treated as an unsecured claim, notwithstanding the fact that the

lender's prepetition claim had been secured to at least some extent on the petition date and the lender presumably was entitled to the equivalent of adequate protection and a continuing lien on collateral proceeds. Similarly, the Eleventh Circuit's opinion in *Saybrook* gives no indication that the prepetition lender was permitted to retain its postpetition liens to the extent that they might have been appropriate as proceeds liens or adequate protection liens.

[\[FN350\]](#). See discussion supra note 256 and accompanying text.
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