

4-1-1999

# Spending Other People's Money: Creditors' Remedies for the Misuse of Cash Collateral in Bankruptcy

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## Recommended Citation

Harley J. Goldstein and Craig A. Sloane, *Spending Other People's Money: Creditors' Remedies for the Misuse of Cash Collateral in Bankruptcy*, 7 U. Miami Bus. L. Rev. 243 (1999)

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**SPENDING OTHER PEOPLE’S MONEY: CREDITORS’  
REMEDIES FOR THE MISUSE OF CASH COLLATERAL IN  
BANKRUPTCY**

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The authors would like to express their gratitude to the Judges for whom they clerked both for providing the time and encouragement for writing this Article, and for guidance throughout the term of their clerkships. Thanks are also due to Barry Herbert, the Deputy Circuit Librarian for the United States Court of Appeals for the Seventh Circuit, and to Rena Samole, an intern in Judge Katz’s chambers, for their assistance in researching this Article.

## I. INTRODUCTION

The theory underlying cash collateral is less complicated than its nomenclature or statutory definition implies.<sup>1</sup> Quite simply, a debtor's possession, of a type which may be circulated as money, secures a debt to a creditor.<sup>2</sup>

By way of the classic example: a lender sells a debtor inventory and takes back a security interest in that inventory. The debtor sells the inventory for cash. By operation of law, the security interest then attaches to that cash,<sup>3</sup> and the cash replaces the inventory as collateral for the loan.<sup>4</sup>

The lender thus acquires a vested interest in the debtor's money. A security interest is a form of property interest.<sup>5</sup> As a result, the debtor assumes

<sup>1</sup> The Bankruptcy Code defines "cash collateral," as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest," including "the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use of occupancy of rooms and other public facilities in hotels, motels, or other lodging properties 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 U.S.C. § 363(a) (1999). Section 552(b), referred to by Section 363(a), creates an exception to Section 552(a)'s general rule that property acquired by the debtor or estate after the filing of bankruptcy is free of any prepetition lien or security interest by permitting "the prepetition security interest to extend to proceeds, product, offspring or [profits] acquired after commencement of the case, subject to certain exceptions." 5 COLLIER ON BANKRUPTCY ¶ 552.01, at 552-53 (Lawrence P. King et al. eds., 15th ed. rev. 1998). Additionally, according to Section 552(b), "a prepetition security interest may extend to rents generated by the collateral and to payments for the use and occupancy of rooms in lodging properties, again subject to certain exceptions." *Id.*

The term "Bankruptcy Code" refers to Title 11 of the United States Code, as enacted by the Bankruptcy Reform Act of 1978 and subsequently amended. The Bankruptcy Reform Act of 1978 repealed and replaced the amended Bankruptcy Act of 1898, generally referred to as the "Bankruptcy Act."

<sup>2</sup> Although the statutory definition should be relied upon, *see* 11 U.S.C. § 363(a), a likening of cash to that which "circulates as money" may be found in BLACK'S LAW DICTIONARY 216 (6th ed. 1990).

<sup>3</sup> *See* U.C.C. § 9-306(2) (1999) ("Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.")

<sup>4</sup> Of course, the secured lender should not be permitted to immediately appropriate these proceeds. Without benefit of the use of the cash collateral, reorganization may be futile. In accordance with this example, a debtor without the use of cash collateral could purchase no more inventory, or even, for that matter, pay its employees. Thus, Section 363 of the Code permits the debtor, under certain circumstances, the benefit of use of its cash collateral, much as a debtor could still use machinery which was the subject of a lender's lien.

<sup>5</sup> *See generally* *Butner v. United States*, 440 U.S. 48, 54-55 (1979) (including security interests among property interests); BLACK'S LAW DICTIONARY 1357 (6th ed. 1990) (defining "security interest" as a "form of interest in property ...."); Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the*

the role of a fiduciary for the holder of the security interest—a trustee, of sorts.

Even in the absence of statute or court order, if one misappropriates another's property, common law dictates that that party will be held accountable. If this defalcation flies in the face of statute or in derogation of court order, more severe consequences may adhere.

But scrutinize the Bankruptcy Code for a statutory remedy for the misuse of cash collateral, and you will search in vain. In response, courts have been forced to devise judicially created remedies.

Certainly this issue is not novel.<sup>6</sup> Recently, however, the Congressionally-sponsored National Bankruptcy Review Commission recommended an amendment of the Code to add the unauthorized use of cash collateral as an explicit ground warranting dismissal of a Chapter 11 bankruptcy reorganization, conversion of a Chapter 11 bankruptcy reorganization to a Chapter 7 liquidation proceeding, or the appointment of a trustee to replace a Chapter 11 debtor in possession as caretaker of the bankruptcy estate.<sup>7</sup> The authors of this Article contend that a clear Congressional expression of intent is by far the superior method of approaching this quandary. Absent such a lucid gesture, however, courts continue to fashion remedies, and this Article, consequently, examines their propriety.

## II. USE OF CASH COLLATERAL IN BANKRUPTCY

The Bankruptcy Code prohibits the use of cash collateral by a trustee or debtor in possession<sup>8</sup> without either the security holder's consent or permis-

*Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562, 565 & n.13 (1991) ("A security interest is property which is protected by the United States Constitution."); John F. Dolan, *The U.C.C. Framework: Conveyancing Principles and Property Interests*, 59 B.U. L. REV. 811, 811, 821, 823-25 (1979) (finding security interests to be one of the "basic property interests" upon which the Uniform Commercial Code rests).

<sup>6</sup> In fact, published opinions regarding the improper use of cash collateral date nearly date back to the Code's genesis. See *Midlantic Nat'l Bank v. Anchorage Boat Sales, Inc.* (*In re Anchorage Boat Sales, Inc.*), 4 B.R. 635 (Bankr. E.D. N.Y. 1980).

<sup>7</sup> See *Report of the Nat'l Bankr. Review Comm'n* at 623-24, 650-56 (Oct. 20, 1997) (Recommendation 2.5.9). As a default, the Chapter 11 debtor is permitted to operate the bankrupt entity by remaining a "debtor in possession." See 11 U.S.C. § 1107(a) (1999).

<sup>8</sup> Although the Code's text refers to use of cash collateral by a trustee, who may operate a business for a limited period under Chapter 7, see 11 U.S.C. § 721 (1999), or who may operate a business under Chapter 11, see 11 U.S.C. § 1108, a Chapter 11 debtor in possession acts in place of a trustee, see 11 U.S.C. § 1107(a), at least unless and until the court appoints a trustee to replace the debtor in operating the business. See discussion *infra* Part IV(K). Thus, in a Chapter 11 reorganization, the debtor in possession has statutory authority to pursue an order authorizing the use of cash collateral. Code Section 363 also applies in Chapter 12 and, with certain limits, in Chapter 13 cases, where a debtor may exercise the Section

sion of the court.<sup>9</sup> In the absence of this authority, cash collateral must be segregated and accounted for, apart from other estate funds.<sup>10</sup> If cash collateral use is subject to conditions or limitations, sums which are not to be used must be segregated.<sup>11</sup>

To effect authorization by the security holder's consent, all parties affected must affirmatively acquiesce after becoming aware of the present or impending bankruptcy.<sup>12</sup> Implied consent is generally insufficient.<sup>13</sup>

As any agreement between the debtor and a secured creditor regarding the use of cash collateral will affect other creditors,<sup>14</sup> any such agreement must be

363 powers, but does not apply in cases under Chapter 9 of the Code. 11 U.S.C. §§ 103, 901(a) (1999). See 3 COLLIER ON BANKRUPTCY ¶ 363.01, at 363-39, ¶ 363.03, at 363-23 (Lawrence P. King et al. eds., 15th ed. rev. 1998).

<sup>9</sup> It is important to note that the Code draws a distinction between the use of cash collateral in, and outside, the ordinary course of business. While authorization may be procured by consent where the proposed use is within the ordinary course of business, see 11 U.S.C. § 363(c), no such provision exists where the use is outside the ordinary course of business. In that instance, court permission is required. See 11 U.S.C. § 363(b) (1999). To achieve authorization by consent, "each entity that has an interest in such cash collateral" must acquiesce. 11 U.S.C. § 363(c)(2)(A) (1999). Court permission requires proper notice and a hearing. See 11 U.S.C. §§ 363(b)(1), (c)(2)(B) (1999).

<sup>10</sup> See 11 U.S.C. § 363(c)(4) (1999).

<sup>11</sup> *Id.*

<sup>12</sup> See *Freightliner Market Dev. Corp. v. Silver Wheel Freightliners*, 823 F.2d 362, 368 (9th Cir. 1987) ("The purposes underlying § 363(c)(2) & (4) require that a debtor seek affirmative express consent from all parties involved before using cash collateral."); *Weiss v. People Savings Bank (In re Three Partners, Inc.)*, 199 B.R. 230, 237 (Bankr. D. Mass. 1995) ("[T]his Court does not believe that the failure of a secured creditor to object to the unauthorized use of cash collateral is tantamount to that creditor's consent to the use of cash collateral."); *Hartigan v. Pine Lake Village Apartment, Co. (In re Pine Lake Village Apartment Co.)*, 16 B.R. 750, 755-56 (Bankr. S.D.N.Y. 1982) ("The consent to the use of cash collateral contemplated under Code § 363(c)(2)(A) must, of necessity, be regarded as post-petition consent.").

As with any contract, a written agreement expressing consent to the debtor's use of cash collateral is preferable, see LUDWIG MANDEL, *THE PREPARATION OF COMMERCIAL AGREEMENTS* 2-3 (7th ed. 1978) ("[E]ven when the contract is not required to be in writing, the advantages of reducing it to writing are many. A writing constitutes a ready reference for settling honest disputes as to what the parties intended when they made their agreement. In the event of a lawsuit, it is 'the best and most reliable, and most convincing form of testimony you can offer....' The very fact that the contract is in writing lessens the likelihood of a breach"), and the creditor should include a provision in this contract providing it with additional protection in exchange for its consent. See Stripp, *supra* note 5, at 566-67 ("Adequate protection of a security interest in cash collateral... ensures just compensation for the loss of the secured creditor's right to use cash collateral to repay debt").

<sup>13</sup> See *Freightliner Market Dev. Corp.*, 823 F.2d at 368-69 ("[W]e find implied consent to be insufficient to satisfy the requirements of § 363(c)(2)").

<sup>14</sup> As is expected, available assets in bankruptcy tend to be insufficient to satisfy all debt obligations. Increasing the allocation of limited resources to one creditor results in a concomitant reduction in the amount of assets available to satisfy the other creditors. See Stripp, *supra* note 5, at 573.

approved by the court upon a Rule 4001(d) motion.<sup>15</sup> An unapproved agreement may be later invalidated.<sup>16</sup> Alternatively, a debtor may seek permission to use cash collateral from the bankruptcy court by Rule 4001(b) motion.<sup>17</sup> Debtors do not maintain a unitary entitlement to seek orders

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<sup>15</sup> See FED. R. BANKR. P. 4001(d) (1999). This motion and a copy of the underlying agreement must be served upon the official committee of unsecured creditors (or any other official committee), if one exists, or, in a Chapter 11 reorganization, upon the twenty largest creditors if a creditors' committee does not exist or has not yet been formed. A creditors' committee may be elected in Chapter 7 pursuant to Code Section 705, or appointed under Chapter 11 pursuant to Section 1102. See FED. R. BANKR. P. 4001(d)(1) (1999). Unless the court orders otherwise, interested parties are provided fifteen days from the notice's mailing to file an objection. See FED. R. BANKR. P. 4001(d)(2) (1999). Even in the absence of objection, the court may nevertheless conduct a hearing, or even approve or disapprove the agreement without a hearing. See FED. R. BANKR. P. 4001(d)(3) (1999). As cash collateral agreements often (inappropriately) grant protections beyond Section 361's adequate protection requirement, see Stripp, *supra* note 5, at 574, the court has an obligation to review them. See *id.* at 596 ("The bankruptcy court has the right and the obligation to see to it that no party to a bankruptcy case takes unfair advantage of other parties.... Thus, if the court determines that a consensual cash collateral order contains provisions that are inappropriate..., the court may either decline to enter the order or make such modifications as justice requires."). Finally, motions relating to cash collateral must be served on the United States Trustee. See FED. R. BANKR. P. 9034(f) (1999). Although federal judicial districts within Alabama and North Carolina employ the services of a Bankruptcy Administrator in lieu of a United States Trustee, this Article, for the sake of simplicity, merely refers to the United States Trustee. See FED. R. BANKR. P. 9035 (1999). In cases within those two states, the Bankruptcy Administrator functions, and must be served, as would the United States Trustee.

<sup>16</sup> See 9 COLLIER ON BANKRUPTCY ¶ 4001.07[1], at 4001-28 (Lawrence P. King et. al. eds., 15th ed. rev. 1996) (citing *In re Cross Baking Co.*, 818 F.2d 1027 (1st Cir. 1987)).

<sup>17</sup> See 11 U.S.C. § 363(c)(2)(B) (1999); FED. R. BANKR. P. 4001(b) (1999). As with Rule 4001(d) motions, a Rule 4001(b) motion must be served upon any creditors' committee or on the twenty largest unsecured creditors, see discussion *supra* note 15, and upon any entity holding a security interest in the cash collateral, as well as upon the United States Trustee. See FED. R. BANKR. P. 9034(f) (1999); discussion *supra* note 15. This motion engenders a contested matter under Bankruptcy Rule 9014, see FED. R. BANKR. P. 4001(b)(1) (1999), and the court is to hold a final hearing on the merits no sooner than fifteen days after service. A movant may request a preliminary hearing if use of the cash collateral is required in less than fifteen days. See 11 U.S.C. § 363(c)(3) (1999); FED. R. BANKR. P. 4001(b)(2) (1999) (requiring a minimum of fifteen days between service of the cash collateral motion and the final hearing on the merits). An emergency motion to use cash collateral may be filed concurrently with a petition requesting a preliminary hearing. Upon preliminary hearing, the court may authorize the use of cash collateral only to the extent "necessary to avoid immediate and irreparable harm to the estate," FED. R. BANKR. P. 4001(b)(2) (1999), and only where "there is a reasonable likelihood that the trustee will prevail at the final hearing." 11 U.S.C. § 363(c)(3) (1999).

While it is the secured party's burden to establish, by a preponderance of evidence, the validity, priority, and the extent of its security interest, see 11 U.S.C. § 363(o)(2) (1999); *In re 523 East Fifth Street Hous. Preservation Dev. Fund Corp.*, 79 B.R. 568, 572 n.2 (Bankr. S.D.N.Y. 1987), the trustee or debtor in possession has the burden of showing that the secured party is adequately protected. See 11 U.S.C. § 363(o)(1) (1999). There exists a split in authority as to the standard of proof required to establish adequate protection. Earlier caselaw held that clear and convincing evidence was required. See *In re O.P. Held, Inc.*, 74 B.R. 777, 784 (Bankr. N.D.N.Y. 1987); *Northern Trust Co. v. Leavell (In re Leavell)*, 56 B.R. 11, 13 (Bankr. S.D. Ill. 1985); *In re Sheehan*, 38 B.R. 859, 868 (D.S.D. 1984). More recently, courts have

regulating the use of cash collateral. In order to adequately protect their interests, security holders may also seek to obtain an order prohibiting or conditioning the use of cash collateral.<sup>18</sup>

### III. MISUSE OF CASH COLLATERAL

There are a number of manners in which cash collateral may be misused: (1) use in the absence of authorization; (2) use outside the scope of authorization; (3) use other than to benefit the bankruptcy estate; and (4) failure to segregate and account for cash collateral not authorized for use.

First, if cash collateral is used without either creditor consent or court authorization, such use violates the requirements of Code Section 363(c)(2), and is cash collateral misuse. Second, cash collateral may only be used to the extent, and in accordance with the terms, authorized in the consent agreement or by the court order. Any deviation from the stipulation or order's scope amounts to cash collateral misuse. Third, use which is "unrelated to the operation, care, preservation[,] and maintenance" of the bankruptcy estate amounts to misuse of cash collateral.<sup>19</sup> Finally, cash collateral not authorized

required proof by preponderance of the evidence. See *In re Ernst Home Center, Inc.*, 209 B.R. 955, 965 (Bankr. W.D. Wash. 1997); *In re Glasstream Boats, Inc.*, 110 B.R. 611, 613 (Bankr. M.D. Ga. 1990); *McCombs Properties VI, Ltd. v. First Texas Savings Ass'n (In re McCombs Properties VI, Ltd.)*, 88 B.R. 261, 267-68 (Bankr. C.D. Cal. 1988).

<sup>18</sup> See 11 U.S.C. § 363(e) (1999); discussion *infra* Part IV(L). This motion is governed by Bankruptcy Rule 4001(a), results in a Rule 9014 contested matter, and requires service as would any other cash collateral motion. See FED. R. BANKR. P. 4001(a)(1) (1999); discussion *supra* notes 15-17. Again, the Court may grant relief with or without a hearing, see 11 U.S.C. § 363(e) (1999), or may grant *ex parte* relief under exigent circumstances. See FED. R. BANKR. P. 4001(a)(2) (1999) (explaining the requirements for, and the procedure to obtain, *ex parte* relief).

A nonexclusive list of methods of providing adequate protection may be found in Code Section 361. As a security interest is a property right protected under the Fifth Amendment to the United States Constitution, see sources *supra* note 5, the Bankruptcy Code's adequate protection requirement ensures that a court's cash collateral order does not amount to an unconstitutional "taking" of a creditor's secured interest. See Stripp, *supra* note 5, at 565-69.

<sup>19</sup> *Chaussee v. Morning Star Ranch Resorts Co. (In re Morning Star Ranch Resorts)*, 64 B.R. 818, 822 (Bankr. D. Colo. 1986); see *Travelers Ins. Co. v. Plaza Family Partnership (In re Plaza Family Partnership)*, 95 B.R. 166, 172-74 (E.D. Cal. 1989) ("[I]t is evident that cash collateral can be used by the debtor under section 363 only for a business purpose.... Even in situations where adequate protections are available cash collateral can not be used for a nonbusiness purpose."); see also *Walter v. Sunwest Bank (In re Walter)*, 83 B.R. 14, 18-20 (B.A.P. 9th Cir. 1988) (estate property generally); *Ranch Partners, Ltd. v. Resolution Trust Corp. (In re Ranch Partners, Ltd.)*, 146 B.R. 833, 835-36 (D. Colo. 1992) (payment of bankruptcy legal fees from cash collateral is a misuse); cf. *In re Triplett*, 87 B.R. 25, 27 (Bankr. W.D. Tex. 1988) ("In cases where the debtor clearly demonstrates that the value of collateral adequately protects the interests of the secured creditor,... cash collateral... may be used by the debtor for the general benefit of the estate ...").

for use must be segregated from other estate funds and from exploitable cash collateral.<sup>20</sup> If funds are not properly segregated, this may be considered a passive misuse of cash collateral.<sup>21</sup>

#### IV. REMEDIES FOR MISUSE

Despite the Code's proscription of cash collateral misuse, no explicit statutory remedy presently exists.<sup>22</sup> In the absence of statutory remedy, courts have fashioned a palette of remedies from which creditors may choose. The remedies are diverse; each is appropriate under particular circumstances and each varies in its severity.<sup>23</sup>

Courts have long derived authority to remedy cash collateral violations and sanction violators from Section 105(a) of the Code, which states that courts "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code.<sup>24</sup> Responding to a debtor's argument that the Code does not allow for a remedy for cash collateral violations, one judge concluded early on that nothing short of "anarchy" would result if "a valid lien of a creditor is recognized by the Court but both the Court and the creditor are powerless to preserve and protect that lien after bankruptcy has been initiated."<sup>25</sup> Finding that such "cannot be the result intended by Congress," the court interpreted Section 105(a) "as giving to the Court the power and the duty to do those things which are reasonably

<sup>20</sup> See 11 U.S.C. § 363(c)(4) (1999).

<sup>21</sup> See *In re Placid Oil Co.*, 102 B.R. 538, 544 (Bankr. N.D. Tex. 1988).

<sup>22</sup> In contrast, other Code sections, such as Section 362, provide remedies for violations of those sections. See 11 U.S.C. § 362(h) (1999) (providing for actual, and even punitive, damages for willful violation of the automatic stay).

<sup>23</sup> As the consequences of implementing each remedy will vary with the facts of each case, an objective "ranking" of these remedies according to their severity is impossible. However, the authors have attempted to list these forms of relief, at least to the extent possible, in ascending order, from the most lax to most harsh.

<sup>24</sup> Courts do not need to be prompted by interested parties to exercise this power. Section 105(a) continues:

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 U.S.C. § 105(a) (1999).

<sup>25</sup> *Mercantile Nat'l Bank at Dallas v. Aerosmith Denton Corp.* (*In re Aerosmith Denton Corp.*), 36 B.R. 116, 119 (Bankr. N.D. Tex. 1983). The court concluded that the debtor had violated the cash collateral provisions of Section 363 through its use of proceeds from accounts receivable in which the bank had a security interest. See *id.* While citing Section 363(c)(1), the *Aerosmith* court presumably intended to invoke Section 363(c)(2) as the provision requiring consent or court permission preceding use of cash collateral. See *id.*



required to protect the Court's jurisdiction and to carry out the intent of" the Code.<sup>26</sup>

Despite this broad interpretation of Section 105(a), there are limits to this power. A court may not run amuck in exercising its Section 105(a) authority,<sup>27</sup> and should not invent an atypical form of relief, but should instead "borrow" one from another Code provision, such as those provided to rectify Section 362 violations.<sup>28</sup>

Ideally, a court faced with cash collateral misuse should decide what purpose the institution of a remedy will serve. Only then should the court choose an appropriate solution to effect these goals.

As with other areas of the law, the provision of a remedy may serve a utilitarian or a retributive function. However, the propriety of a bankruptcy court's implementation of a remedy to serve a retributive function is suspect. Generally, as a civil court sitting in equity,<sup>29</sup> a bankruptcy court's action should not be punitive.<sup>30</sup> Instead, it should limit itself to coercing debtors against future violation.<sup>31</sup>

The appropriateness of redress should therefore be contemplated from a utilitarian perspective. This encompasses two functions: remedial and prophylactic action. While remedial relief aims to restore the creditor's pre-violation condition, such as by the provision of adequate protection,<sup>32</sup> a court

<sup>26</sup> *Id.* Based on this reasoning, the court granted the secured creditor a replacement lien against the debtor's post-petition accounts receivable, supplemented, as necessary, by an administrative priority claim. *Id.*

<sup>27</sup> 11 U.S.C. § 362(h) (1999); see 2 COLLIER ON BANKRUPTCY ¶ 105.01[2], at 105-6.1 to 7 (Lawrence P. King, et al. eds., 15th ed. rev. 1998) ("[I]t should be universally recognized that the power granted to bankruptcy courts under section 105 is not boundless and should not be employed as a panacea for all ills confronted in the bankruptcy case").

<sup>28</sup> A remedy should be tied to another section of the Bankruptcy Code and is in the discretion of the bankruptcy court. 2 COLLIER ON BANKRUPTCY ¶ 105.01[2], at 105-6.1 to 7 (Lawrence P. King, et al. eds., 15th ed. rev. 1998); *Aerosmith Denton*, 36 B.R. at 119.

<sup>29</sup> See generally *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934) ("[C]ourts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.")

<sup>30</sup> See *In re Torres*, 117 B.R. 379, 382 (Bankr. N.D. Ill. 1990); William J. Woodward, *New Judgment Liens on Personal Property: Does "Efficient" Mean "Better"?*, 27 HARV. J. ON LEGIS. 1, 42-43 (Winter 1990); see also Part IV(I) of this Article.

<sup>31</sup> See Part (IV)(H) of this Article. This is not to imply that a bankruptcy court may never assess punitive damages. See 11 U.S.C. § 362(h) (1999); *In re Latanowich*, 207 B.R. 326, 336-38 (Bankr. D. Mass. 1997) (creditor's "willful and intentional flouting of the Bankruptcy Code" warranted punitive damages).

<sup>32</sup> Where a violation has already occurred, the provision of adequate protection is actually *retroactive* adequate protection. In addition to granting adequate protection to a creditor when a debtor seeks to use cash collateral, adequate protection, when used in these remedies, can be retroactively granted. See *In re Rankin*, 49 B.R. 565, 570 (Bankr. W.D. Mo. 1985); *Aerosmith Denton*, 36 B.R. at 119. Section 361 of the Bankruptcy Code provides three methods which the bankruptcy court can use to give the secured

may institute prophylactic measures to dissuade the debtor,<sup>33</sup> or even to discourage other debtors,<sup>34</sup> from prospective misuse of cash collateral.

### A. Replacement Lien

One form of curative relief is a court's provision of a replacement lien<sup>35</sup> on other unencumbered property of the estate<sup>36</sup> to the extent that a debtor's use of cash collateral decreases the value of the creditor's original security interest.<sup>37</sup> Although this may provide the creditor with a measure of restitution,<sup>38</sup> its effectiveness is limited. A court's grant of a replacement lien provides little deterrent for further misuse of cash collateral, but instead merely replaces that which was wrongfully appropriated. Furthermore, a

creditor adequate protection: cash payments, additional or replacement liens, and other relief that will "result in the realization by such entity of the indubitable equivalent of such entity's interest in such property." 11 U.S.C. § 361(3) (1999). The term "indubitable equivalent" is a term of art.

These methods are not meant to be exclusive or exhaustive. H.R. REP. NO. 95-595, at 339 (1977). The trustee, debtor in possession, or creditor will generally propose the means by which protection is provided, and the court will determine if it is adequate. S. REP. NO. 95-989, at 49 (1978). The court also has the obligation to determine if an agreement for adequate protection and the use of cash collateral is harmful to other creditors and the estate. See *supra* note 15 and accompanying text. The Honorable Steven A. Stripp performs a thorough analysis of cash collateral agreement provisions that courts should carefully scrutinize. See Stripp, *supra* note 5, at 574-83.

<sup>33</sup> See Part (IV)(E) and (H)-(L) of this Article.

<sup>34</sup> See Part (IV)(F)-(I) and (M)-(R).

<sup>35</sup> See 11 U.S.C. § 361(2) (1999); *Casbeer v. State Fed. Sav. & Loan Ass'n of Lubback (In re Casbeer)*, 793 F.2d 1436 (5th Cir. 1986); *Carey v. General Motors Acceptance Corp. (In re Carey)*, 202 B.R. 796 (Bankr. M.D. Ga. 1996) (Chapter 13); *In re Placid Oil Co.*, 80 B.R. 824 (Bankr. N.D. Tex. 1987); *Aerosmith Denton*, 36 B.R. at 116. *But see Cargocaire Engineering Corp. v. Dwyer (In re Gemel Int'l, Inc.)*, 190 B.R. 4 (Bankr. D. Mass. 1995) (quoting *In re J.L. Graphics, Inc.*, 62 B.R. 750 (Bankr. D.N.H.1986)).

<sup>36</sup> Through the operation of Code Section 552(a), property acquired by a debtor post-petition is generally not subject to liens arising from after-acquired property clauses in security agreements. Therefore, debtors in bankruptcy may have unencumbered assets despite their financial situation. This is not absolute, however, as there are broad exceptions to the general rule. See 11 U.S.C. § 552(b) (1999). Generally, Section 552(a) does not act to cut off the secured creditor's interest in "proceeds, product, offspring, or profits" of property in which it has a security interest. See 11 U.S.C. § 552(b)(1) (1999). Certain rents also remain subject to security agreements entered into pre-petition. See 11 U.S.C. § 552(b)(2) (1999).

<sup>37</sup> See Stripp, *supra* note 5, at 575-76. A cash collateral agreement which purports to grant a replacement lien on post-petition assets to secure a pre-petition debt has been held to be an impermissible means of obtaining post-petition financing. See *Shapiro v. Saybrook Mfg. Co., Inc. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1494-96 (11th Cir. 1992); see also *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F.2d 1092 (2d Cir. 1979) (disapproving of, but not reaching the issue on, cross-collateralization). This type of arrangement, known as cross-collateralization, should only be disapproved where the creditor's secured position is increased as a result of the new lien.

<sup>38</sup> See *Aerosmith Denton*, 36 B.R. at 116.

replacement lien is effective only where a debtor possesses unencumbered assets to which the lien may attach.

A court should consider whether the grant of a replacement lien will engender unfairness toward other creditors. In this respect, a replacement lien is proper only where a debtor has a reasonable probability of completing a successful reorganization. In the absence of a successful reorganization, less property will be available, upon liquidation, for distribution to unsecured creditors. The debtor's misappropriation of one creditor's property does not justify redistribution of further assets to the detriment of other creditors. Finally, as the creditor's lien on the debtor's cash collateral has been destroyed through misuse, the argument may be made that the creditor is no longer secured and should seek other remedies.<sup>39</sup>

### B. *Repayment*

Another method of restoring a creditor's position through the provision of adequate protection is to require a debtor to repay the amount used.<sup>40</sup> Code Section 361(1) permits compensation by way of cash payment to remunerate a creditor for any decrease in the value of cash collateral caused by the debtor's use.

As with the grant of a replacement lien, however, this remedy is only of use where unencumbered cash is available, and is not effective in deterring future violations.

### C. *Super-Priority Administrative Expense Claim*

Generally, Section 361(3) of the Bankruptcy Code prohibits the award of an administrative expense claim as adequate protection pursuant to Sections 362, 363, or 364. However, where other adequate protection proves insufficient, Code Section 507(b)<sup>41</sup> allows a court, after notice and hearing and pur-

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<sup>39</sup> Suggested remedies would be a tort action in the nature of conversion against the officers and directors responsible for the misuse, including seeking monetary sanctions and punitive damages, where the debtor is a corporation or partnership, or a Section 523 nondischargeability adversary proceeding where the debtor is an individual. See Part (IV)(F) and (G) of this Article.

<sup>40</sup> See *In re Placid Oil Co.*, 80 B.R. 824 (Bankr. N.D. Tex. 1987); *In re Etch-Art, Inc.*, 48 B.R. 143 (Bankr. D.R.I. 1985); *Centerre Bank Nat'l Ass'n v. Continental Marine Corp.* (*In re Continental Marine Corp.*), 35 B.R. 990, 995 (Bankr. E.D. Mo. 1984); see also *In re Krisle*, 54 B.R. 330 (Bankr. D.S.D. 1985) (debtor held in civil contempt after refusing to obey bankruptcy court's order to turn over cash collateral withdrawn from accounts without creditor consent or court permission).

<sup>41</sup> Section 507(b) of the Bankruptcy Code states:

If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding

suant to Code Section 503(b), to grant an administrative expense claim with priority over all other administrative expense claims. Therefore, in granting a super-priority claim to a creditor, a court should first determine previously ordered adequate protection to be insufficient,<sup>42</sup> keeping in mind that rearranging priorities detrimentally affects unsecured creditors.<sup>43</sup> Furthermore, because a court's provision of a super-priority claim for the purpose of "retroactively" establishing adequate protection expressly contravenes Code Section 507(b), a court may not achieve this result via the Bankruptcy Code's "omnibus provision,"<sup>44</sup> Section 105(a).<sup>45</sup>

In addition, such a grant should require that an actual benefit inure to the bankruptcy estate. The United States Court of Appeals for the Fourth Circuit has held, as a condition of a creditor's award of a super-priority expense claim, that the estate must receive a concrete benefit from a debtor's actual use of that creditor's property.<sup>46</sup> The court, in balancing the equities underlying the grant of such a claim, explained:

[W]e agree that in many cases "it would be inequitable to tax the creditor with the burden of the court's error if the judicially determined adequate protection later proves to be 'inadequate.'" However, it also strikes us as inequitable to tax unsecured creditors for a decline in the value of collateral when the decline does not result from a use that actually benefits the estate: "To prioritize... claims where they are not clearly entitled to such treatment, is not only inconsistent with the policy of equality of distribution but it also dilutes the value of the

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such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim under such subsection.

11 U.S.C. § 507(b) (1999).

<sup>42</sup> Often, cash collateral agreements will include a provision providing for an automatic grant of a super-priority administrative expense claim to the extent that adequate protection has proven insufficient. Because of its effect on other creditors, this approach is problematic.

<sup>43</sup> See *Aerosmith Denton*, 36 B.R. at 116. Rearranging priorities detrimentally affects unsecured creditors because conversion of an unsecured claim to a priority claim reduces the amount of assets available for distribution to unsecured creditors.

<sup>44</sup> Credit for Section 105's analogy to an "omnibus provision" is due to 2 COLLIER ON BANKRUPTCY ¶ 105.01, at 105-5 (Lawrence P. King et al. eds., 15th ed. rev. 1998). A bankruptcy court's power under Section 105(a) is discussed in notes 24-28, *supra*, and accompanying text.

<sup>45</sup> See *Smith v. Dairyman, Inc.*, (*In re Smith*) 75 B.R. 365 (W.D. Va. 1987); *In re AMT Investment Corp.*, 53 B.R. 274 (Bankr. E.D. Va. 1985).

<sup>46</sup> See *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860 (4th Cir. 1994).

priority for the claims of creditors Congress in fact intended to prefer.<sup>47</sup>

Finally, because a Section 507(b) super-priority administrative expense claim is appropriate only as a measure of restitution, it should be permitted only to the extent that the aggrieved creditor has been harmed by the failure of other adequate protection.

#### D. *Tracing*

Where traceable, courts have allowed a creditor's security interest to follow the disposition of cash collateral by operation of Section 9-306 of the Uniform Commercial Code.<sup>48</sup> Tracing requires that the proceeds received from the use of the collateral are identifiable.<sup>49</sup> To be sure, the usefulness of this remedy is also limited, as it, too, carries little deterrent value, and, because funds are easily commingled, tracing the disposition of funds will rarely be successful.

#### E. *Injunction*

As a bankruptcy court may issue an injunction<sup>50</sup> pursuant to Code Section 105(a),<sup>51</sup> a secured creditor may seek injunctive relief to halt a debtor's continuing cash collateral misuse. By way of example, one court enjoined a debtor "from taking any action to transfer, sell or dispose of cash collateral which is subject to the plaintiff's interests, pending further order" of that

<sup>47</sup> *Dobbins*, 35 F.3d at 868 (citations omitted) (quoting *Cheatham v. Central Carolina Bank & Trust Co.* (*In re Cheatham*), 91 B.R. 382, 387 (E.D.N.C. 1988) and *In re Chicago, Milwaukee, St. Paul and Pac. R.R.*, 658 F.2d 1149, 1163 (7th Cir. 1981)); see *In re Lovay*, 205 B.R. 85, 87 (Bankr. E.D. Tex. 1997).

<sup>48</sup> See *Unsecured Creditors Comm. v. Marepcon Fin. Corp.* (*In re Bumper Sales, Inc.*), 907 F.2d 1430 (4th Cir. 1990); *First State Bank of Manchester v. Heims* (*In re Heims*), 65 B.R. 112 (Bankr. N.D. Iowa 1986).

In fact, under the recent revisions to Article 9 of the Uniform Commercial Code, the definition of "proceeds" has been broadened. See George A. Nation, III, *Revised Article 9 of the UCC: The Proposed Revisions Most Important to Commercial Lenders*, 115 BANKING L.J. 212, 223-24 (1998).

<sup>49</sup> See *Bumper Sales*, 907 F.2d at 1439.

<sup>50</sup> See *Midlantic Nat'l Bank v. Anchorage Boat Sales, Inc.* (*In re Anchorage Boat Sales, Inc.*), 4 B.R. 635 (Bankr. E.D.N.Y. 1980). But see *In re Epstein*, 26 B.R. 354 (Bankr. E.D. Tenn. 1982) (creditor's request for an injunction denied because cash collateral was being used for actual and ordinary business expenses).

<sup>51</sup> See 2 COLLIER ON BANKRUPTCY ¶ 105.02 to 105.03[5][b], at 105-8 to 105-57 (Lawrence P. King et al. eds., 15th ed. rev. 1998).

court.<sup>52</sup> An injunction may be obtained in bankruptcy by way of adversary proceeding.<sup>53</sup>

The utility of this remedy is predicated on the fact that an injunctive order provides indisputable notice that further cash collateral misuse will not be tolerated,<sup>54</sup> and that unpleasant consequences will adhere upon further breach. As explained *infra*, an injunction may be a necessary prerequisite to seeking a bankruptcy court's contempt order.<sup>55</sup>

#### F. *Exception from Discharge*

A secured creditor may seek to have a bankruptcy court declare that its debt is excepted from a debtor's discharge<sup>56</sup> by adversary proceeding.<sup>57</sup> To except a debt from discharge pursuant to Section 523, a creditor must prove all required elements by a preponderance of the evidence.<sup>58</sup>

To have a debt declared nondischargeable on the basis of a debtor's unauthorized use of cash collateral, the creditor may proceed under a conversion theory, under certain circumstances.<sup>59</sup> For purposes of bankruptcy,

<sup>52</sup> *Anchorage Boat Sales*, 4 B.R. at 645.

<sup>53</sup> See FED. R. BANKR. P. 7001(7) (1999).

<sup>54</sup> However, a debtor should, in any event, be on notice that cash collateral misuse is improper pursuant to statutory provisions and any cash collateral orders or agreements in the bankruptcy case.

<sup>55</sup> See Part IV(H) of this Article.

<sup>56</sup> See *National City Bank of Marion v. Imbody (In re Imbody)*, 104 B.R. 830 (Bankr. N.D. Ohio 1989); *In re Beasley*, 62 B.R. 653 (Bankr. W.D. Mo. 1986); *American Savings and Loan Ass'n v. Weber*, 99 B.R. 1001 (Bankr. D. Utah 1989).

<sup>57</sup> See FED. R. BANKR. P. 7001(6) (1999).

<sup>58</sup> See *Grogan v. Gardner*, 498 U.S. 279 (1991). Although Section 523 is applicable in Chapter 7, 11, 12, and 13 cases, see 11 U.S.C. § 103(a) (1999), debts based on cash collateral misuse may nevertheless be dischargeable in Chapter 12 and 13 cases. See 11 U.S.C. §§ 1228(a), 1328 (1999). In addition, because cash collateral misuse in bankruptcy occurs subsequent to the filing of the bankruptcy petition, and a Chapter 7 case may only discharge pre-petition debts, see 11 U.S.C. § 727(b) (1999), cash collateral misuse does not provide grounds for a Section 523 action in that same bankruptcy proceeding, and instead only provides grounds for such an action where the misuse was in a prior bankruptcy proceeding. See, e.g., *Green River Production Credit Assoc. v. Alvey (In re Alvey)*, 56 B.R. 170 (Bankr. W.D. Ky. 1985). Furthermore, cash collateral misuse is unlikely to occur where a trustee controls estate property. However, debts arising subsequent to the petition date but prior to the confirmation of a plan of reorganization may be discharged in a Chapter 11 case. See 11 U.S.C. § 1141(d) (1999). Therefore, a Section 523 action for cash collateral misuse will typically provide a remedy in a Chapter 11 case.

<sup>59</sup> See *Associates Fin. Serv. Co. v. Koran Enterprises, Inc. (In re Koran Enterprises, Inc.)*, 61 B.R. 321, 326-27 (Bankr. W.D. Mo. 1986). Although failure to segregate cash collateral funds as required by Section 363(c)(4), without consent or court permission to use the funds, might also amount to conversion (since a debtor would be wrongfully exercising control over the property of another—the creditor's security interest—without consent of the owner or other authorization), it is unlikely that, under these facts, the requisite intent can be shown, because a failure to segregate is more likely an act of omission than an act

courts have uniformly defined conversion as “a wrongful exercise of dominion by one person over property of another. It must be shown that the appropriation of property was unauthorized and without consent of the owner.”<sup>60</sup> Despite this uniformity, a court should require a creditor to prove all elements of conversion dictated by the appropriate state’s law.<sup>61</sup>

In addition to proving the elements of conversion, the creditor must prove both willfulness,<sup>62</sup> or the deliberate or intentional causing of injury,<sup>63</sup> and maliciousness, which may be established by a mere “finding of implied or constructive malice,”<sup>64</sup> in which the conversion was committed “without just cause or excuse.”<sup>65</sup> Negligent or reckless disregard of one’s duty does not amount to willfulness.<sup>66</sup>

Alternatively, a secured creditor may seek relief from a debtor’s misuse of cash collateral pursuant to Section 523(a)(4)<sup>67</sup> by proceeding under a theory of embezzlement,<sup>68</sup> defined as “the fraudulent appropriation of property by a

with the specific intent to injure. See Craig A. Sloane, *The New “Intentional Tort” Standard Under Section 523(a)(6)*, NORTON BANKR. L. ADV., June 1998, at 12.

<sup>60</sup> *Sears, Roebuck & Co. v. Goycochea* (*In re Goycochea*), 192 B.R. 847, 848 (Bankr. D. Md. 1996).

<sup>61</sup> See *Grogan*, 498 U.S. at 283 (“The validity of a creditor’s claim is determined by rules of state law”).

<sup>62</sup> Cases that discuss this issue use both the “willful” and “wilful” spellings. See *Wolfson v. Equine Capital Corp.* (*In re Wolfson*), 56 F.3d 52, 54 n.2 (11th Cir. 1995). For linguists, we note that English lexicographers regard “willful” and “wilful” as acceptable variants. The American Heritage Dictionary of the English Language 1465-466 (1976).

<sup>63</sup> See *Kawaauhau v. Geiger*, 118 S. Ct. 974, 977 (1998).

<sup>64</sup> *Chrysler Credit Corp. v. Rebhan*, 842 F.2d 1257, 1263 (11th Cir. 1988). *Rebhan* is the majority view. The Eighth Circuit espouses the minority view. In the Eighth Circuit, to prove malice, a separate showing of intentional harm, where the expected harm is substantially certain to occur, is required. See *Barclays American/Business Credit, Inc. v. Long* (*In re Long*), 774 F.2d 875, 881 (8th Cir. 1985). These opinions should all be read in light of *Kawaauhau*.

<sup>65</sup> *Chrysler Credit Corp. v. Perry Chrysler Plymouth, Inc.*, 783 F.2d 480, 486 (5th Cir. 1986).

<sup>66</sup> See *Kawaauhau*, 118 S. Ct. at 978. One pre-*Kawaauhau* court opined that where a debtor sells secured property, uses the proceeds, and fails to demonstrate that the use benefited the estate or served some necessary purpose, then the debt should, under Section 523(a)(6), be held nondischargeable. See *In re Beasley*, 62 B.R. 653, 655-56 (Bankr. W.D. Mo. 1986) (finding that under the facts of the case, the debtor’s unauthorized use of cash collateral was willful and malicious as a matter of law under that three-part test.). The holding in *Beasley* is probably questionable following the Supreme Court’s decision in *Kawaauhau*.

<sup>67</sup> Section 523(a)(4) excepts from discharge debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” Since there is no technical trust involved with a cash collateral violation, the fiduciary prong is not applicable. See *infra* notes 68-69 and accompanying text.

<sup>68</sup> See *Beasley*, 62 B.R. at 654-55. The case of *Green River Production Credit Assoc. v. Alvey* (*In re Alvey*), 56 B.R. 170 (Bankr. W.D. Ky. 1985), held that the unauthorized use of cash collateral by a Chapter 11 debtor is prima facie evidence of a breach of fiduciary duty for purposes of a Section 523(a)(4) nondischargeability complaint for defalcation by a fiduciary in a later Chapter 7 proceeding. *Id.* at 173-74. However, this is not good precedent. The concept of fiduciary under Section 523(a)(4) has been defined

person to whom such property has been entrusted, or into whose hands it has lawfully come,"<sup>69</sup> even where the debtor does not stand in a fiduciary capacity to that creditor.<sup>70</sup> Embezzlement requires that the debtor "knowingly and willfully misapplie[d] or convert[ed] the property."<sup>71</sup> By way of example, one court found that debt resulting from a debtor's use of cash collateral without the creditor's consent and without explanation amounted to embezzlement, and held that debt to be nondischargeable under Section 523(a)(4).<sup>72</sup>

Despite a debt's exception from discharge, Section 523(a) lacks effectiveness where a debtor has only a dim prospect of possessing assets subsequent to the bankruptcy from which a creditor may collect. Finally, a Section 523(a) action may only be brought against an "individual debtor," and not against a corporation or partnership.<sup>73</sup>

### G. Tort Liability (Conversion)

In addition to providing a basis for a nondischargeability action pursuant to Code Section 523(a), the remedy of conversion may also provide an independent cause of action.<sup>74</sup> By bringing an adversary proceeding alleging

narrowly as "applying only to technical or express trusts, and not those which the law implies from the contract." See *LSP Investment Partnership v. Bennett* (*In re Bennett*), 989 F.2d 779, 784 (5th Cir. 1993). Thus, the fiduciary requirement in Section 523(a)(4) does not apply where there is only a constructive trust, see *Beasley*, 62 B.R. at 654, which appears to be the case in *Alvey* regarding the Chapter 11 debtor in possession. Furthermore, the *Alvey* court relied on a case involving a Section 727 action for a complete denial of discharge, and not on the specific provisions of Section 523(a)(4). *Alvey*, 56 B.R. at 173. This is significant because the stricter requirement of an actual trust is different from the usual state law definition of fiduciary. On the other hand, a fiduciary relationship does not have to exist for a creditor to prevail on an embezzlement claim under Section 523(a)(4).

<sup>69</sup> See *Carlson v. Rigsby* (*In re Rigsby*), 152 B.R. 776, 778 (Bankr. M.D. Fla. 1993).

<sup>70</sup> See *id.*

<sup>71</sup> *Id.* at 779. The *Rigsby* court went on further to say that "[i]f the actions of the parties are more in the nature of a debtor-creditor relationship," there is no embezzlement. *Id.* The court in *Rigsby* specifically distinguished the facts before it from where the objecting party has a security interest in proceeds of a sale. *Id.* at 778.

<sup>72</sup> *Beasley*, 62 B.R. at 656. The court also found the debt to be nondischargeable under Section 523(a)(6) (as conduct effecting a conversion). *Id.*

<sup>73</sup> See *Yamaha Motor Corp. U.S.A. v. Shadco, Inc.*, 762 F.2d 668, 670 (8th Cir. 1985). Importantly, this only seems to matter in a case under Chapter 11 of the Code, because although a corporation or partnership may liquidate under Chapter 7 of the Code, only an individual may be granted a discharge. See 11 U.S.C. § 727(a)(1) (1999); 4 COLLIER ON BANKRUPTCY ¶ 523.02, at 523-14 to 523-16 (Lawrence P. King et al. eds., 15th ed. rev. 1998). "Unlike in any other chapter, section 1228(a) makes the section 523(a) exceptions to discharge applicable to corporate and partnership debtors as well as individual debtors." 4 COLLIER ON BANKRUPTCY ¶ 523.02, at 523-15 (Lawrence P. King et al. eds., 15th ed. rev. 1998). Chapter 13 is only available to individuals. 11 U.S.C. § 109(e) (1999).

<sup>74</sup> See *Associates Fin. Serv. Co. of Texas v. Koran Enterprises, Inc.* (*In re Koran Enterprises, Inc.*),



conversion, a creditor may recover the "converted" property and obtain monetary damages.<sup>75</sup>

As cash collateral must be segregated,<sup>76</sup> it "represents a special fund as the traceable proceeds of the intangible chattels."<sup>77</sup> Therefore, despite money's fungible nature, cash collateral's unauthorized use may amount to conversion.<sup>78</sup> To be successful, a conversion action in bankruptcy court must fulfill all elements of conversion required by the appropriate state's law.<sup>79</sup>

In addition to a debtor, any participants in the conversion including, where appropriate, a debtor's attorney and a corporate debtor's officers, directors, and shareholders, may be held liable for damages following from the conversion.<sup>80</sup> All participants in a conversion are jointly and severally liable for ensuing damages.<sup>81</sup>

The traditional remedy for conversion—recovery of damages—may not be appropriate against a debtor in bankruptcy due to the harm which would be caused to unsecured creditors.<sup>82</sup> As personal liability may be imposed against the debtor's officers, directors, shareholders, or attorneys for their conduct,<sup>83</sup> the conversion remedy is especially valuable where an impecunious corporate debtor's principals may be held liable. Where a creditor recovers damages from a debtor's officers, directors, shareholders, or attorneys, direct detriment to the debtor is avoided, and those assets available for distribution to other

61 B.R. 321 (Bankr. W.D. Mo. 1986); *Hassett v. BancOhio Nat'l Bank (In re CIS Corp.)*, 172 B.R. 748 (S.D.N.Y. 1994).

<sup>75</sup> As cash collateral is property of the estate, *see* 11 U.S.C. § 541 (1999), an action alleging that its post-petition use amounts to conversion falls within a bankruptcy court's core jurisdiction. *See* *Koran*, 61 B.R. 321, 325-26 (Bankr. W.D. Mo. 1986) ("The prohibited use of cash collateral amount[s] to post-bankruptcy conversion of estate property which has historically been remedied by the bankruptcy court's summary power of turnover."). *But see* *Hassett v. BancOhio Nat'l Bank (In re CIS Corp.)*, 172 B.R. 748, 758 (S.D.N.Y. 1994) (distinguishing the *Koran* case as having core jurisdiction due to the debtor's use of cash collateral, which is explicitly governed by 11 U.S.C. § 363(c)(2), and rejecting the proposition that post-petition conversion of property of the estate is sufficient to grant a conversion action core status).

<sup>76</sup> *See* 11 U.S.C. § 363(c)(4) (1999).

<sup>77</sup> *Koran*, 61 B.R. at 327.

<sup>78</sup> *Id.*; *see supra* notes 59-61 and accompanying text. This may appear odd because conversion usually concerns goods; however, cash collateral is unique and, according to the Bankruptcy Code, must be segregated from other funds. *See* 11 U.S.C. § 363(c)(4) (1999).

One might argue that a security interest cannot be converted, at least where that security interest is not destroyed, but instead follows the funds' disposition or can be traced. However, even in that case, liability arguably exists on the ground that such disposition is nevertheless a wrongful use.

<sup>79</sup> *See supra* note 61 and accompanying text.

<sup>80</sup> *Koran*, 61 B.R. at 327.

<sup>81</sup> *Id.*

<sup>82</sup> *See* discussion *supra* Part (IV)(A). In this context, assessing punitive damages against a debtor is particularly inappropriate, as the funds used to pay those damages might be distributed to other creditors.

<sup>83</sup> *See* *Koran*, 61 B.R. at 327-28.

creditors will not be depleted. Finally, proceeding against those causing the conversion not only serves to reconstitute the creditor, but also directly punishes those responsible for the injury.

#### H. Civil Contempt of Court

As a remedy for violations within bankruptcy proceedings, a bankruptcy court may sanction an offending party for contempt.<sup>84</sup> The source of a bankruptcy court's sanction and contempt power is, however, unsettled. Most courts find that this power is derived from Section 105(a).<sup>85</sup> However, courts have also held that contempt power stems from Bankruptcy Rule 9020, which dictates procedural requirements for adjudicating determinations of contempt committed in, or outside, the presence of a bankruptcy judge.<sup>86</sup> In addition, courts may sanction parties for violations of Bankruptcy Rule 9011, which governs representations to the court.<sup>87</sup>

Also unsettled is the scope of a bankruptcy court's power to sanction, and to hold in contempt, parties, their principals, and their counsel. Civil contempt of court is intended "to coerce compliance with a court order or to

<sup>84</sup> See *Placid Refining Co. v. Terrebone Fuel and Lube, Inc.* (*In re Terrebone Fuel and Lube, Inc.*), 108 F.3d 609 (5th Cir. 1997); *Hardy v. United States* (*In re Hardy*), 97 F.3d 1384 (11th Cir. 1996); *Eck v. Dodge Chemical Co.* (*In re Power Recovery Systems, Inc.*), 950 F.2d 798 (1st Cir. 1991); *Burd v. Walters* (*In re Walters*), 868 F.2d 665 (4th Cir. 1989); *In re Krisle*, 54 B.R. 330 (Bankr. D.S.D. 1985); *In re Etch-Art, Inc.*, 48 B.R. 143 (Bankr. D.R.I. 1985); *Centerre Bank Nat'l Assoc. v. Continental Marine Corp.* (*In re Continental Marine Corp.*), 35 B.R. 990 (Bankr. E.D. Mo. 1984); see generally *Laura B. Bartell, Contempt of the Bankruptcy Court—a New Look*, 1996 U. ILL. L. REV. 1 (1996).

<sup>85</sup> See *Terrebone*, 108 F.3d at 613; *Hardy*, 97 F.3d at 1389; *Mountain America Credit Union v. Skinner* (*In re Skinner*), 917 F.2d 445, 447 (10th Cir. 1990); *Walters*, 868 F.2d at 669.

<sup>86</sup> See *Power Recovery Systems*, 950 F.2d at 802; see also *Skinner*, 917 F.2d at 449 (bolstering its argument that it is constitutional for bankruptcy courts to exercise civil contempt power by stating that such an order is subject to *de novo* review by a district court under Bankruptcy Rule 9020).

The source of this power is of significance. Under Bankruptcy Rule 9020, a district court reviews a bankruptcy court's contempt order under the *de novo* standard, as opposed to the traditional abuse of discretion standard which such orders would normally be subject to on appeal.

<sup>87</sup> FED. R. BANKR. P. 9011(c) (1999); see *Caldwell v. Unified Capital Corp.* (*In re Rainbow Magazine, Inc.*), 77 F.3d 278, 282-83 (9th Cir. 1996) (sanctions against principal of corporate debtor); *Midwest Properties No. Two v. Big Hill Investment Co.*, 93 B.R. 357, 361-63 (N.D. Tex. 1988) (sanctions against debtor's president and attorney).

Bankruptcy Rule 9011(c) governs the imposition of sanctions for violations of Bankruptcy Rule 9011(b) (concerning representations to the court), and states, in pertinent part, "[i]f, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation." For a further discussion of a bankruptcy court's power to sanction parties for Rule 9011 violations, see *infra* note 93.

compensate another party for the contemnor's violation."<sup>88</sup> Therefore, sanctions for civil contempt are "purely remedial."<sup>89</sup> Although certain courts have ordered offending parties to pay monetary sanctions,<sup>90</sup> such relief is arguably improper as a remedy for cash collateral violations.<sup>91</sup> A bankruptcy court certainly lacks authority to assess punitive damages for civil contempt.<sup>92</sup>

Even if bankruptcy courts' power to sanction or hold parties in contempt for violations of the Bankruptcy Code rests on unsure footing, these courts surely possess such power with regard to violations of their own court orders. Therefore, as a prerequisite to invoking sanctions for contempt, the entry of a Section 363(e) order prohibiting or conditioning the use of cash collateral, as discussed in Part IV(L) of this Article, or an order enjoining a party from further violations, as discussed in Part IV(E) of this Article, should be considered.<sup>93</sup>

<sup>88</sup> *In re Terrebone Fuel and Lube, Inc.*, 108 F.3d at 612.

<sup>89</sup> *See In re Power Recovery Systems, Inc.*, 950 F.2d at 802. An example of a remedial sanction is incarceration to compel compliance. *See In re Krisle*, 54 B.R. 330 (Bankr. D.S.D. 1985) (indefinitely imprisoning the debtor until he returned the cash collateral he removed from a segregated account, and jailing the debtor's attorney until he advised his client that, by law, he may not refuse to obey the court's order, but may only seek an appeal of such order).

<sup>90</sup> *See Terrebone*, 108 F.3d at 612 (costs and fees of debtor to defend action to collect discharged debt); *Power Recovery Systems*, 950 F.2d at 801 (rental costs for failure to remove heavy equipment from property); *Burd v. Walters (In re Walters)*, 868 F.2d 665, 669 (4th Cir. 1989) (costs and fees of debtor to enforce rights, but not emotional distress).

<sup>91</sup> Under principles of statutory construction, it is not clear that monetary sanctions are appropriate. Section 362(h) allows an *individual* to recover actual and punitive damages for injuries caused by willful violations of the automatic stay. However, Section 363, which provides for the use of cash collateral, does not provide for the award of damages. These differences between closely-related sections could be interpreted as Congressional intent to preclude damage awards for violations of Section 363. In addition, there are good reasons to distinguish between the remedies allowed for violations of these two sections. While an award of damages against a debtor for cash collateral misuse would harm the debtor's ability to reorganize and lessen the funds available to pay unsecured creditors, an adversary proceeding seeking damages for willful violation of the automatic stay is an action against a creditor, and, therefore, does not harm the debtor or other creditors.

<sup>92</sup> *See Hardy v. United States (In re Hardy)*, 97 F.3d 1384, 1389 (11th Cir. 1996). By definition, punitive damages punish the contemnor, and thus are not remedial.

<sup>93</sup> *See In re Krisle*, 54 B.R. 330 (Bankr. D.S.D. 1985) (holding a debtor and his attorney in civil contempt for disobeying the court's order to return misappropriated cash collateral); *Center Bank Nat'l Assoc. v. Continental Marine Corp. (In re Continental Marine Corp.)*, 35 B.R. 990, 992 (Bankr. E.D. Mo. 1984) (violation of statutory cash collateral provisions, absent any non-compliance with a court order, was insufficient to hold the debtor in contempt). Some courts require a showing of willful contempt. *See In re Etch-Art, Inc.*, 48 B.R. 143, 145 (Bankr. D.R.I. 1985) (refusing to find the debtor and its principal in contempt where there was not sufficient proof that the unauthorized use of cash collateral, in violation of statute, court order, and agreement of the parties, was willful).

At least one court has suggested that a Rule 9011 violation is a violation of a court order by virtue of the fact that the Bankruptcy Rules were issued by the United States Supreme Court. *See In re*

Although violation of a court order may provide sufficient justification for that court's award of monetary sanctions, the propriety of issuing monetary sanctions against a debtor should be carefully considered because of its effect on other creditors. As with earlier discussed remedies, however, sanctioning a corporate debtor's responsible parties, such as its officers, directors, shareholders, and counsel, may achieve a suitable outcome—vindicating the harmed creditor's interest, while preserving the estate for the benefit of the debtor's remaining creditors.<sup>94</sup>

A bankruptcy court's contempt order is subject to a district court's *de novo* review,<sup>95</sup> and is therefore not of a binding nature.

### I. Criminal Contempt of Court

In contrast to civil contempt, criminal contempt of court<sup>96</sup> is treated no differently than any other criminal proceeding—and is, among other things, aimed at punishing a contemnor.<sup>97</sup> Although it is well-established that bankruptcy courts have, at least to an extent, the power to sanction and hold parties in civil contempt,<sup>98</sup> it is uncertain whether that power extends to criminal contempt.<sup>99</sup> As discussed in Part IV(H) of this Article, if bankruptcy

Hunter, 190 B.R. 118, 119 (Bankr. N.D. Colo. 1995). This authority bolsters the argument that violation of a cash collateral order may subject a debtor to contempt sanctions.

<sup>94</sup> This protects all creditors and imposes the sanctions upon the parties who actually committed the wrongdoing. See *Caldwell v. Unified Capital Corp.* (*In re Rainbow Magazine, Inc.*), 77 F.3d 278, 282-83 (9th Cir. 1996) (sanctions against principal of corporate debtor); *Midwest Properties No. Two v. Big Hill Investment Co.*, 93 B.R. 357, 361-63 (N.D. Tex. 1988) (sanctions against debtor's president and attorney); *Krisle*, 54 B.R. at 330 (holding a debtor and his attorney in civil contempt for disobeying the court's order to return wrongfully misappropriated cash collateral); see also discussion *supra* Part IV(G).

<sup>95</sup> See FED. R. BANKR. P. 9020(c), 9033 (1999); *In re Carrico*, 214 B.R. 842 (B.A.P. 6th Cir. 1997) (contested contempt order is not a final order); see also *supra* note 86.

<sup>96</sup> See *Brown v. Ramsay* (*In re Ragar*), 3 F.3d 1174 (8th Cir. 1993); *Griffith v. Oles* (*In re Hipp*), 895 F.2d 1503 (5th Cir. 1990); see also *In re Latanowich*, 207 B.R. 326 (Bankr. D. Mass. 1997) (assessing punitive damages against a creditor that violated the discharge injunction); see generally *Laura B. Bartell, Contempt of the Bankruptcy Court—a New Look*, 1996 U. ILL. L. REV. 1 (1996).

<sup>97</sup> See *Bloom v. Illinois*, 391 U.S. 194 (1968); *United States v. United Mine Workers*, 330 U.S. 258, 302 (1947); *Griffith v. Oles* (*In re Hipp*), 895 F.2d 1503, 1509 (5th Cir. 1990).

<sup>98</sup> See *Placid Refining Co. v. Terrebone Fuel and Lube, Inc.*, 108 F.3d 609, 612-13 (5th Cir. 1997); *Hardy*, 97 F.3d at 1389; *In re Ragar*, 3 F.3d 1174, 1178-79; *Power Recovery Systems*, 950 F.2d at 802; *Mountain America Credit Union v. Skinner* (*In re Skinner*), 917 F.2d 444, 447 (10th Cir. 1990); *Burd v. Walters* (*In re Walters*), 868 F.2d 665, 669 (4th Cir. 1989); Part IV(H) of this Article. *But see In re Elias*, 98 B.R. 332, 337 (N.D. Ill. 1989) (collecting cases).

<sup>99</sup> See *Hipp*, 895 F.2d at 1511 (“[B]ankruptcy courts do not have inherent criminal contempt powers, at least with respect to criminal contempts not committed in (or near) their presence.”); *Ragar*, 3 F.3d at 1177-78 (bankruptcy court was, in effect, only making proposed findings of fact and conclusions of law in a non-core proceeding when it held attorney in criminal contempt, where such order was only

courts do not have the power to hold a party in criminal contempt, punitive damages, which are a remedy incident to criminal contempt, are outside the scope of available remedies.

The standard required to hold a party in criminal contempt is more stringent than that required for civil contempt. While civil contempt merely requires clear and convincing evidence that a court order was violated, criminal contempt requires proof beyond a reasonable doubt.<sup>100</sup>

#### J. *Appointment of an Examiner*

Appointment of an examiner is a less severe remedy than appointment of a trustee, discussed in the next section of this Article. Where a trustee is not appropriate, a creditor may seek appointment of an examiner<sup>101</sup> to investigate "any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management of the debtor."<sup>102</sup> An examiner's appointment may be of particular use where a secured creditor believes that a debtor is misusing cash collateral, but the creditor has insufficient proof of the suspected wrongdoing.

#### K. *Appointment of a Trustee*

Cash collateral misuse may amount to "cause"<sup>103</sup> sufficient to justify the appointment of a trustee<sup>104</sup> in a Chapter 11 case.<sup>105</sup> Therefore, a secured creditor may seek appointment of a trustee to replace a debtor in possession

effective if the contemnor did not object within ten days and the order was subject to *de novo* review by the district court if there was an objection).

<sup>100</sup> See *Jove Engineering, Inc. v. Internal Revenue Service*, 92 F.3d 1539, 1545-46 (11th Cir. 1996).

<sup>101</sup> See 11 U.S.C. § 1104(c) (1999). Section 1104 requires that "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate," 11 U.S.C. § 1104(c)(1) (1999), or that "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000." 11 U.S.C. § 1104(c)(2) (1999). For the procedural requirements for this remedy, see Section 1104 of the Code and Bankruptcy Rules 9014 and 9034.

<sup>102</sup> 11 U.S.C. § 1104(c) (1999). For the procedural requirements of this remedy, see Part IV(K) of this Article.

<sup>103</sup> See 11 U.S.C. § 1104(a)(1) (1999).

<sup>104</sup> See *id.*

<sup>105</sup> See *Midlantic Nat'l Bank v. Anchorage Boat Sales, Inc. (In re Anchorage Boat Sales, Inc.)*, 4 B.R. 635 (Bankr. E.D.N.Y. 1980). This remedy is only available in a Chapter 11 case because, in all other applicable chapters, a trustee is appointed at the commencement of the case (remember that Section 363 is not applicable in Chapter 9, see discussion *supra* note 8). See 11 U.S.C. §§ 701, 702, 703, 1104, 1163, 1202, 1302 (1999). For the procedural requirements for this remedy, see Section 1104 of the Code and Bankruptcy Rules 2007.1(a), 9014, and 9034(g).

from controlling estate property<sup>106</sup> and operating the debtor's business.<sup>107</sup> Once Section 1104(a) "cause" exists, a court lacks discretion and must appoint a trustee.<sup>108</sup>

Appointment of a trustee protects a bankruptcy estate from the actions of a debtor in possession which is "spending" a lienholder's collateral for its own gain, to that creditor's detriment. Other than taking control of the business away from the debtor, there is no punitive or restitutionary aspect to this measure.

The inefficiency of this remedy may be problematic. Appointment of a trustee carries with it a concomitant cost to the bankruptcy estate.<sup>109</sup> As this cost will be borne by the debtor's creditors, and may even hinder a successful reorganization, appointment of a trustee may not be an ideal remedy.<sup>110</sup> In addition, a trustee may not possess the ability to operate a debtor's business as productively as would the debtor in possession itself. Thus, a bankruptcy court should analyze whether appointing a trustee is merited in light of the costs and benefits to the estate and creditors.<sup>111</sup> Finally, as appointment of a trustee does not replace improperly used cash collateral, other remedies may prove more effective. Appointment, however, may be beneficial where a debtor's conduct exceeds tolerable limits.

Importantly, the National Bankruptcy Review Commission has recommended the amendment of Section 1104 to include the unauthorized use of cash collateral as an explicit ground for the appointment of a Chapter 11 trustee.<sup>112</sup>

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<sup>106</sup> See 11 U.S.C. §§ 704(2), 1106(a)(1) (1999).

<sup>107</sup> See 11 U.S.C. § 1108 (1999).

<sup>108</sup> As with lift-stay motions under Section 362(d), but unlike motions to convert or dismiss under Section 1112(b), Section 1104(a) uses mandatory ("shall") rather than permissive ("may") language. See 11 U.S.C. §§ 362(d), 1104(a), 1112(b) (1999); Oklahoma Refining Co. v. Blaik (*In re Oklahoma Refining Co.*), 838 F.2d 1133, 1136 (10th Cir. 1988).

<sup>109</sup> After approval by a bankruptcy court following notice and a hearing, see 11 U.S.C. § 330(a)(1) (1999); FED. R. BANKR. P. 2002(a)(6), a Chapter 11 trustee's fee is entitled to a priority as an administrative expense. See 11 U.S.C. §§ 330(a)(1), 503(b)(2), 507(a)(1) (1999). A court may not award a fee that exceeds the limits set in Code Section 326(a). See 11 U.S.C. §§ 326(a), 330(a)(1) (1999).

<sup>110</sup> See *Anchorage Boat Sales*, 4 B.R. at 644 ("The appointment of a trustee in a Chapter 11 case is an extraordinary remedy, and one which may impose a substantial financial burden on a . . . debtor").

<sup>111</sup> See 11 U.S.C. § 1104(a)(2) (1999).

<sup>112</sup> See discussion *supra* note 7 and accompanying text.

### L. Order Conditioning or Denying Future Use

A creditor may seek an order from a bankruptcy court prohibiting a debtor from obtaining authority to use cash collateral.<sup>113</sup> In *Oxford Royal Mushroom Products, Inc.*,<sup>114</sup> the debtor in possession entered into a cash collateral stipulation, and an extension of that stipulation, both of which the bankruptcy court approved. The stipulation stated, in part, that upon breach of the agreement, the bankruptcy court "shall enter an order terminating further use of cash collateral."<sup>115</sup> When the debtor later breached the agreement, the court rescinded its approval under Section 363(c)(2)(B)<sup>116</sup> and terminated the debtor's right to seek authority to use cash collateral in the future.<sup>117</sup>

Despite the bankruptcy court's holding in *Oxford Royal Mushroom Products, Inc.*, nothing in the Bankruptcy Code or the Bankruptcy Rules supports the entry of an order barring a debtor in possession from seeking court permission to use cash collateral. A court's prospective declaration that such a violation precludes any favorable future ruling seems harsh. However, a debtor's violation of a court-approved stipulation is an important factor that a court should consider when hearing a motion for approval of cash collateral use.

Finally, while such an order serves a punitive function, it does not allow an injured party any recompense.

### M. Denial of Confirmation

Generally, a debtor in a Chapter 11 case seeks to obtain confirmation of a plan of reorganization.<sup>118</sup> Through confirmation, the debtor regains rights in all property of the estate, generally free and clear of all claims, interests, and liens, except as provided for by the reorganization plan.<sup>119</sup> More importantly, confirmation entitles the debtor to a discharge of all dischargeable pre-confirmation debts, subject to certain exceptions (such as where the plan liquidates that debtor or where the debtor waives a discharge).<sup>120</sup>

<sup>113</sup> See *In re Oxford Royal Mushroom Products, Inc.*, 19 B.R. 974, 975 n.3 (Bankr. E.D. Pa. 1982).

<sup>114</sup> 19 B.R. 974 (Bankr. E.D. Pa. 1982).

<sup>115</sup> *Oxford*, 19 B.R. at 975 n.3.

<sup>116</sup> 11 U.S.C. § 363(c)(2)(B) (1999).

<sup>117</sup> See *Oxford*, 19 B.R. at 975.

<sup>118</sup> Unless the court orders otherwise, a debtor in possession has the exclusive right to file a plan during the first 120 days after filing a Chapter 11 petition. See 11 U.S.C. § 1121 (1999). After the expiration of that time period, other interested parties may also file plans for consideration. See *id.* The debtor is bound by the terms of a confirmed plan. See 11 U.S.C. § 1141(a) (1999).

<sup>119</sup> See 11 U.S.C. § 1141(b)-(c) (1999).

<sup>120</sup> See 11 U.S.C. § 1141(d) (1999).

The Bankruptcy Code provides that a bankruptcy court shall confirm a plan only where certain requirements are met.<sup>121</sup> One of those requirements, found in Section 1129(a)(2), is that “[t]he proponent of the plan complies with the applicable provisions of” the Bankruptcy Code.<sup>122</sup> As Chapter 3 of the Bankruptcy Code<sup>123</sup> applies to a Chapter 11 case,<sup>124</sup> bankruptcy courts have denied confirmation of the debtor’s proposed plan where that debtor has misused cash collateral in violation of Code Section 363(c)(2).<sup>125</sup>

Any party in interest may file an objection to the confirmation of a plan of reorganization.<sup>126</sup> That objection gives rise to a contested matter under Bankruptcy Rule 9014,<sup>127</sup> and must be served on the debtor, the trustee (if one exists), official committees, the United States Trustee, and any other parties required by the court.<sup>128</sup> Additionally, even in the absence of objection, a creditor, without stating its reasons, may vote against a proposed plan of reorganization.<sup>129</sup>

Because a debtor may seek approval of an alternate plan of reorganization, denial of confirmation is not as severe a remedy as denial of discharge, discussed next in this Article. However, the cause for denial may provide a barrier to confirmation of any future plan. Certainly, an injured creditor will possess additional bargaining leverage as a result of achieving denial of a plan’s confirmation. Finally, denial of confirmation serves a punitive function, but does not offer any restitutionary effect.

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<sup>121</sup> See 11 U.S.C. § 1129(a) (1999).

<sup>122</sup> See 11 U.S.C. § 1129(a)(2) (1999).

<sup>123</sup> See 11 U.S.C. §§ 301-366 (1999).

<sup>124</sup> See 11 U.S.C. § 103(a) (1999).

<sup>125</sup> See *Cothran v. United States* (*In re Cothran*), 45 B.R. 836, 838 (S.D. Ga. 1984). *But see In re The Landing Assoc., Ltd.*, 157 B.R. 791, 810-11 (Bankr. W.D. Tex. 1993) (confirming debtor’s Chapter 11 plan where earlier cash collateral violations had been remedied).

<sup>126</sup> See 11 U.S.C. § 1128(b) (1999).

<sup>127</sup> See FED. R. BANKR. P. 9014 (1999).

<sup>128</sup> See FED. R. BANKR. P. 3015(f), 3020(b)(1) (1999).

<sup>129</sup> See 11 U.S.C. § 1129 (1999).



### N. Denial of Discharge

By filing an adversary complaint<sup>130</sup> within a certain period of time,<sup>131</sup> in limited circumstances,<sup>132</sup> a creditor may seek to deny a debtor a discharge of his or her debts<sup>133</sup> based upon cash collateral misuse. This remedy may be accomplished by proceeding under Section 727(a)(2)(B) of the Bankruptcy Code,<sup>134</sup> which requires the party objecting to discharge<sup>135</sup> to prove the following elements by a preponderance of the evidence:<sup>136</sup> (1) a transfer of property; (2) that transfer involved property of the bankruptcy estate; (3) that transfer occurred after the filing of the bankruptcy petition; and (4) at the time of that transfer, the debtor had an intent to hinder, delay, or defraud a creditor.<sup>137</sup> To keep with the policy of providing a debtor with a "fresh start,"

<sup>130</sup> See FED. R. BANKR. P. 7001(4) (1999).

<sup>131</sup> A complaint objecting to discharge pursuant to Section 727(a) must be filed within sixty days of the Section 341 meeting of creditors. See 11 U.S.C. § 341(a) (1999); FED. R. BANKR. P. 4004(a) (1999). An objection to discharge under Section 1141(d)(3) must be filed by the first confirmation hearing. See FED. R. BANKR. P. 4004(a) (1999). These time periods may be extended by the court. See FED. R. BANKR. P. 4004(b) (1999) ("On motion of any party in interest, after hearing on notice, the court may extend for cause the time for filing a complaint objecting to discharge. The motion shall be made before such time has expired.").

<sup>132</sup> This remedy is only available where the debtor is an individual, see 11 U.S.C. § 727(a)(1) (1999), and where the debtor is liquidating under Chapter 7 or 11 of the Bankruptcy Code. See 11 U.S.C. §§ 727, 1141(d)(3) (1999).

<sup>133</sup> The adversary complaint objecting to discharge must be served upon the United States Trustee, in addition to other required parties. See FED. R. BANKR. P. 9034(j) (1999).

<sup>134</sup> See 11 U.S.C. § 727(a)(2)(B) (1999) ("The court shall grant the debtor a discharge, unless... the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under [the Bankruptcy Code], has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed... property of the estate, after the date of the filing of the petition ....). Section 1141(d)(3)(C) makes Section 727(a) applicable in Chapter 11. See 11 U.S.C. § 1141(d)(3)(C) (1999).

<sup>135</sup> See FED. R. BANKR. P. 4005 (1999).

<sup>136</sup> See *Barclays/American Business Credit, Inc. v. Adams* (*In re Adams*), 31 F.3d 389, 394 (6th Cir. 1994); *Farouki v. Emirates Bank Int'l*, 14 F.3d 244, 250 n.17 (4th Cir. 1994); *Beaubouef v. Beaubouef* (*In re Beaubouef*), 966 F.2d 174, 178 (5th Cir. 1992); *First Nat'l Bank of Gordon v. Serafini* (*In re Serafini*), 938 F.2d 1156, 1157 (10th Cir. 1991).

<sup>137</sup> See *United States v. Ayala* (*In re Ayala*), 107 B.R. 271, 274 (Bankr. E.D. Cal. 1989). Since unauthorized use of cash collateral in this context will always involve a transfer of property made after the date of filing the bankruptcy petition, elements one and three will always be satisfied. In addition, as a debtor's cash collateral is property of that debtor's bankruptcy estate, see 11 U.S.C. § 541(a)(1) (1999) (defining property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case."); *In re Koran Enterprises, Inc.*, 61 B.R. 321, 326 n.14 (quoting *Brown v. Dellinger* (*In re Brown*), 22 B.R. 844, 849-50 (Bankr. N.D.N.Y. 1982)) (legal title is sufficient to bring property into the bankruptcy estate, even where the debtor has no equity in the property);

courts should liberally construe Section 727 in favor of debtors.<sup>138</sup>

To deny a debtor a discharge, a creditor must prove the debtor's actual intent to defraud, hinder, or delay creditors, and not merely constructive fraudulent intent.<sup>139</sup> Since direct evidence of actual fraudulent intent is rarely available, fraudulent intent may be shown with circumstantial evidence, or may be inferred from the debtor's actions.<sup>140</sup>

Where a creditor proves the requisite fraudulent intent, a court should find that a debtor who has wrongfully used cash collateral is not entitled to a bankruptcy discharge.<sup>141</sup> For example, in *Devers v. Bank of Sheridan (In re Devers)*,<sup>142</sup> the debtors, subsequent to the date of their bankruptcy petition, had been selling secured property and commingling the proceeds with their ordinary accounts. Upon learning of this, the bankruptcy court ordered the debtors to notify it of any additional sales of secured property and to segregate the proceeds of the sale. After the debtors converted their cases from Chapter 11 to Chapter 7, the secured creditor discovered that additional property had been sold, and that those proceeds were not properly segregated, in violation of the court's order. As a result, the secured creditor successfully obtained the court's order denying the debtors' discharge pursuant to Section 727(a)(2)(B).<sup>143</sup> Stating that "a debtor in possession has the duty to protect and conserve property in his possession for the benefit of creditors,"<sup>144</sup> the United States Court of Appeals for the Ninth Circuit found, on appeal, the debtors' failure to obey the bankruptcy court's order to be evidence of fraudulent intent, and affirmed the denial of the debtors' discharge.<sup>145</sup> While

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discussion *supra* notes 1, 3, the second element will be satisfied. See 11 U.S.C. § 363(a) (1999) (defining cash collateral to include "proceeds, products, offspring, rents, or profits of property . . ." whether acquired before or after the commencement of the bankruptcy case.).

<sup>138</sup> See *Bernard v. Sheaffer (In re Bernard)*, 96 F.3d 1279, 1281 (9th Cir. 1996); *Rosen v. Bezner*, 996 F.2d 1527, 1534 (3d Cir. 1993).

<sup>139</sup> See *In re Krehl*, 86 F.3d 737, 743 (7th Cir. 1996); *Devers v. Bank of Sheridan (In re Devers)*, 759 F.2d 751, 753 (9th Cir. 1985).

<sup>140</sup> See *Krehl*, 86 F.3d at 743; *Devers*, 759 F.2d at 753-54.

<sup>141</sup> See *Barclays/American Business Credit, Inc. v. Adams (In re Adams)*, 31 F.3d 389 (6th Cir. 1994) (denying discharge under 11 U.S.C. § 727(a)(2)(A), (B) for, *inter alia*, using and transferring postpetition cash collateral without authorization). The size of the sum of money wrongfully used is "immaterial except for the single purpose of tending to negate the [element of] fraudulent intent." *United States v. Ayala (In re Ayala)*, 107 B.R. 271, 275 (Bankr. E.D. Cal. 1989).

<sup>142</sup> 759 F.2d 751 (9th Cir. 1985).

<sup>143</sup> See *In re Devers*, 759 F.2d at 752-53.

<sup>144</sup> *Id.* at 754. Therefore, according to that court of appeals, although property is subject to a security interest, it remains property of the estate for purposes of Section 727(a)(2)(B). See *Ayala*, 107 B.R. at 276 (discussing *Devers*).

<sup>145</sup> See *id.* at 754-55. Because the debtors did not satisfactorily explain the "disappearance" of a tractor in which the secured creditor had an interest, the court of appeals also found grounds for denial of

other courts have held that a debtor's conversion of secured property does not amount to cause sufficient to deny that debtor's discharge,<sup>146</sup> those cases are distinguishable.<sup>147</sup>

Denying a debtor's discharge may serve both restitutionary and punitive functions. However, as with an action to except debt from discharge, collecting debt in the future may prove impossible, rendering any restitution meaningless. Nevertheless, denial of discharge is a powerful remedy, and the potential for its implementation accordingly provides some utility.

### O. *Relief from Stay*

According to Section 362(d)(1) of the Bankruptcy Code,<sup>148</sup> "lack of adequate protection of an interest in property of" a party in interest provides "cause" sufficient to justify that party's relief from the automatic stay of litigation imposed upon creditors in bankruptcy.<sup>149</sup> Therefore, upon notice and a hearing,<sup>150</sup> a creditor may seek a bankruptcy court's permission to foreclose

discharge under Section 727(a)(5). *See id.* at 754. Additionally, the violation of the bankruptcy court's order provided reason for denial pursuant to Section 727(a)(6). *See id.* at 755.

<sup>146</sup> *See* Peoples State Bank of Mazzeppa, Minn. v. Drenckhahn (*In re Drenckhahn*), 77 B.R. 697, 705 (Bankr. D. Minn. 1987); First Nat'l Bank v. Holtz (*In re Holtz*), 62 B.R. 782, 787 (Bankr. N.D. Iowa 1986); Keller Farms v. Ellefson (*In re Ellefson*), 54 B.R. 16, 17 (Bankr. W.D. Wis. 1985).

<sup>147</sup> Those cases, which undertake the analysis under Code Section 727(a)(2)(A), are based on the reasoning that where a debtor has no equity in property, that property cannot be considered "property of the debtor." *See Drenckhahn*, 77 B.R. at 705; *Ellefson*, 54 B.R. at 17. These holdings are not relevant to Section 727(a)(2)(B), which requires a transfer of "property of the estate" and not "property of the debtor." Furthermore, there exists a split in authority on this issue, with more recent cases holding that a lack of equity, in and of itself, should not preclude the denial of a debtor's discharge under Section 727(a)(2)(A). *See Aweida v. Cooper (In re Cooper)*, 150 B.R. 462, 467 (D. Colo. 1993); *Future Time, Inc. v. Yates*, 26 B.R. 1006, 1009 (M.D. Ga. 1983), *aff'd*, 712 F.2d 1417 (11th Cir. 1983); *American Gen. Fin., Inc. v. Burnside (In re Burnside)*, 209 B.R. 867, 871-72 (Bankr. N.D. Ohio 1997). In *Barclays/American Business Credit, Inc. v. Adams (In re Adams)*, 31 F.3d 389 (6th Cir. 1994), the United States Court of Appeals for the Sixth Circuit did not allow the debtors a discharge, under Section 727(a)(2), because the debtors transferred encumbered accounts receivable and used cash collateral without authorization in order to hinder or delay creditors. As recognized in *Burnside*, "[u]nderlying this holding was the notion that the debtors['] conversion of the secured creditor's collateral could constitute a violation of § 727(a)(2)(A)." *Burnside*, 209 B.R. at 872.

<sup>148</sup> *See* 11 U.S.C. § 362(d)(1) (1999).

<sup>149</sup> *See In re La Fayette Dial, Inc.*, 92 B.R. 798, 800-02 (Bankr. N.D. Ind. 1988); *In re O.P. Held, Inc.*, 74 B.R. 777, 781-84 (Bankr. N.D.N.Y. 1987); *In re Krisle*, 54 B.R. 330, 342 & n.8 (Bankr. D.S.D. 1985); *Midlantic Nat'l Bank v. Anchorage Boat Sales, Inc. (In re Anchorage Boat Sales, Inc.)*, 4 B.R. 635, 641-44 (Bankr. E.D.N.Y. 1980). For a discussion of "adequate protection," *see supra* note 18.

<sup>150</sup> *See* 11 U.S.C. § 362(d) (1999). As with a Section 363(e) motion, a motion for relief from the automatic stay must comply with the procedural requirements set forth in Bankruptcy Rule 4001(a). *See* FED. R. BANKR. P. 4001(a) (1999). For a discussion of the strictures of Bankruptcy Rule 4001(a), *see* discussion *supra* note 18.

on the creditor's lien on cash collateral by demonstrating that a debtor's cash collateral misuse has engendered inadequate protection of the creditor's security interest. Upon such a motion, and in the absence of the debtor's demonstration that the creditor is adequately protected,<sup>151</sup> relief is mandatory.<sup>152</sup>

While relief from the automatic stay allows a creditor to proceed with state law foreclosure remedies while the debtor remains in bankruptcy, that debtor's prospect for reorganization may be damaged without use of the cash collateral. As a result, relief from the stay provides a potentially severe remedy for cash collateral misuse.

### P. Dismissal

Pursuant to Section 1112(b)<sup>153</sup> of the Bankruptcy Code and on notice and a hearing,<sup>154</sup> a creditor may seek dismissal of a debtor's Chapter 11 case for proper "cause," including those reasons listed in Section 1112(b).<sup>155</sup> As the statutory list is not exhaustive,<sup>156</sup> bankruptcy courts should consider other appropriate factors, including cash collateral misuse.<sup>157</sup> Dismissal of a bankruptcy case generally restores parties to the same position they were in

<sup>151</sup> The burden of proving adequate protection in a Section 362(d) hearing is on the debtor. See 11 U.S.C. § 362(g)(2) (1999).

<sup>152</sup> The court then possesses no discretion regarding lifting the stay. See 11 U.S.C. § 362(d) (1999) ("[T]he court shall grant relief from the stay ....").

<sup>153</sup> See 11 U.S.C. § 1112(b) (1999).

<sup>154</sup> See *id.* A motion to dismiss is governed by Bankruptcy Rule 9014 and must be served on the United States Trustee, in addition to other required parties. See FED. R. BANKR. P. 9034(c) (1999).

<sup>155</sup> See 11 U.S.C. § 1112(b) (1999).

<sup>156</sup> See H.R. REP. NO. 95-595, at 405-06 (1977); S. REP. NO. 95-989, at 117-18 (1978).

<sup>157</sup> See *In re Wells*, 71 B.R. 554, 557 (Bankr. N.D. Ohio 1987); see also *Cothran v. United States (In re Cothran)*, 45 B.R. 836 (S.D. Ga. 1984) (case dismissed after confirmation denied twice for, *inter alia*, using cash collateral in violation of Section 362(c)(2)). But see *In re Landing Assocs., Ltd.*, 157 B.R. 791, 811 n.33 (Bankr. W.D. Tex. 1993) (Section 1112(b) "does not call for dismissal of the case for violations of cash collateral orders").

In *Landing Associates, Ltd.*, the bankruptcy court reasoned that Congress provided specific examples of "cause" in Section 1112(b), and that the absence of cash collateral violations in that list leads to the conclusion that dismissal is not a proper remedy for a cash collateral violation. That argument is misplaced, however, because the Section 1112(b) list was not meant to be exclusive. See *supra* note 156 and accompanying text. In addition, the *Landing* court cited as examples of cause for dismissal failure to file a plan within the time frame prescribed by the court and failure to pay required fees. See *Landing*, 157 B.R. at 811 n.33. While these are certainly significant violations, they are not as harmful to creditors as cash collateral misuse, and are more appropriately viewed as disrespectful to the court and its procedural necessities. Congress's inclusion of those remedies exhibits its broad strokes in demonstrating the wide scope of behavior which may subject a debtor to dismissal. Finally, *Landing* merely involved confirmation of a Chapter 11 reorganization plan, and the issue of dismissal was not before the court.

prior to the case's commencement,<sup>158</sup> and allows all creditors to immediately pursue state law remedies.<sup>159</sup>

Indeed, the United States Congress is considering an amendment to Section 1112(b), as proposed by the National Bankruptcy Review Commission, that would list unauthorized use of cash collateral as an explicit ground for dismissal.<sup>160</sup>

Dismissal is an extremely severe punitive remedy, but may be appropriate where a debtor deprives a secured creditor of valuable collateral in contravention of the Bankruptcy Code.

#### Q. *Conversion to Chapter 7*

As an alternative to dismissal under Section 1112(b)<sup>161</sup> of the Bankruptcy Code, via that same subsection, a creditor may seek to convert a debtor's Chapter 11 reorganization case to a liquidation under Chapter 7 of the Code.<sup>162</sup> While the procedural requirements and the necessity of demonstrating "cause" are identical to the dismissal remedy,<sup>163</sup> the choice between these two alternative remedies should be determined based upon "whichever is in the best interest of creditors and the estate."<sup>164</sup>

Upon conversion to Chapter 7, a trustee will be appointed to liquidate the property of the bankruptcy estate.<sup>165</sup> Therefore, conversion provides one of the most severe remedies for cash collateral misuse.

While the installation of a trustee may benefit creditors, a trustee does carry a concomitant cost to the bankruptcy estate.<sup>166</sup> Additionally, conversion engenders delay in pursuing state court remedies that could be avoided with dismissal.<sup>167</sup>

As with dismissal, the United States Congress is considering an amendment to Section 1112(b), as proposed by the National Bankruptcy Review

<sup>158</sup> See 11 U.S.C. § 349(b)(3) (1999).

<sup>159</sup> See generally 7 COLLIER ON BANKRUPTCY ¶ 1112.09, at 1112-78 (Lawrence P. King et al. eds., 15th ed. rev. 1998).

<sup>160</sup> See *supra* note 7 and accompanying text.

<sup>161</sup> See 11 U.S.C. § 1112(b) (1999).

<sup>162</sup> See *In re Hewett*, 32 B.R. 605, 606-07 (Bankr. W.D. Wash. 1983) (finding debtor's use of cash collateral, in violation of Section 363(c)(2), to support conversion).

<sup>163</sup> See Part IV(P) of this Article.

<sup>164</sup> 11 U.S.C. § 1112(b) (1999).

<sup>165</sup> See 11 U.S.C. §§ 348(a), 701(a), 704 (1999). Accordingly, a debtor in possession loses control of its business upon conversion. See 11 U.S.C. § 348(e) (1999).

<sup>166</sup> See 11 U.S.C. § 326(a) (1999); see generally Part IV(K) of this Article (discussing trustee costs in Chapter 11 proceedings).

<sup>167</sup> See Part IV(P) of this Article.

Commission, that would list unauthorized use of cash collateral as an explicit ground for conversion.<sup>168</sup>

### R. Criminal Prosecution

Although not truly a creditor's remedy,<sup>169</sup> the fraudulent misappropriation of cash collateral may amount to criminal activity under Section 153 of Title 18 of the United States Code,<sup>170</sup> prosecutable in a United States district court.<sup>171</sup> While this remedy will certainly punish a debtor, and will have a deterrent effect on other debtors, a secured creditor will gain little benefit, as imprisonment provides no remedial effect, and may indeed cause the debtor's limited property to be further dissipated where liquidation results.

## V. CONCLUSION

The inconsistency with which courts have remedied cash collateral misuse has engendered uncertainty and a lack of uniformity. Although a court's ability to fashion relief without constraint and individually tailor remedies on a case-by-case basis may appear to achieve more equitable results, the need for predictability and equality of result counsels strongly in favor of statutory guidance.

The National Bankruptcy Review Commission has proposed an amendment to the Bankruptcy Code which prescribes explicit remedies for cash collateral misuse. Following the Commission's lead, Congress should articulate clear instruction, such that a judge faced with cash collateral misuse need not "innovate at pleasure," portraying "a knight-errant, roaming at will

<sup>168</sup> See *supra* note 7 and accompanying text.

<sup>169</sup> See 18 U.S.C. § 3057(b) (1999) (describing duties of United States Attorney regarding bankruptcy crimes). However, "creditors who assist in the prosecution 'of a criminal offense relating to the [debtor's] case or to the business or property of the debtor' may apply for reimbursement of their 'actual [and] necessary expenses' as a third priority expense of administration." 1 COLLIER ON BANKRUPTCY ¶ 7.10[1], at 7-183 (Lawrence P. King et al. eds., 15th ed. rev. 1998) (quoting 11 U.S.C. § 503(b)(3)(C) (1999)) (alterations in original).

<sup>170</sup> Section 153, which applies to a debtor in possession because the debtor in possession stands in the shoes of a bankruptcy trustee, see 11 U.S.C. § 1107(a) (1999), states, in pertinent part:

A person... who knowingly and fraudulently appropriates to the person's own use, embezzles, spends, or transfers any property or secretes or destroys any document belonging to the estate of the debtor shall be fined under this title, imprisoned not more than 5 years, or both.

18 U.S.C. § 153(a) (1999).

<sup>171</sup> For a general discussion of this remedy, see 1 COLLIER ON BANKRUPTCY ¶¶ 7.03, 7.10 (Lawrence P. King et al. eds., 15th ed. rev. 1998); Mary Jo Heston, *The United States Trustee: The Missing Link of Bankruptcy Crime Prosecutions*, 6 AM. BANKR. INST. L. REV. 359 (1998).

in pursuit of his own ideal of beauty or of goodness.... yield[ing] to spasmodic sentiment ....”<sup>172</sup>

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<sup>172</sup>

BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* 141 (1921).