BANKRUPTCY LAW NEWSLETTER

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§506(c) -- "MANNA FROM HEAVEN?"

By Steven L. Rayman

Lawyers, being a somewhat imaginative lot, have undoubtedly spent countless hours over their professional careers thinking of different ways to get paid. This pursuit, as laudatory as it may be, does not end with the insolvency of one's client but sometimes forces attorneys to think of ways of dipping their fingers into the pocket of the nearest fat cat. The weapon most often used to accomplish this purpose in Bankruptcy Court is §506(c) of the Code. This Section, which brings tears of happiness to bankruptcy lawyers and tears of sadness to secured creditors, was originally intended as a codification of the cases under the Act holding that a lien holder should be charged with the reasonable costs incurred by the debtor or trustee in preserving or disposing of secured property. See Collier's on Bankruptcy, 15th Ed. §506.06. This Section states:

> The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim. §506(c).

"This is great", you may say, "but how does it apply to me?" While this Section, by its own language, limits any recovery to the trustee [or debtor in possession, pursuant to §1107], some courts have extended its provisions to various parties, including: A landlord, In re Staunton Industries, Inc., 16 CBC2d 1348 (Bankr ED Mich 1987); and a power company, In re Henry McKeesport Steel Casting Co., 799 F2d 91, 15 CBC2d 563 (3rd Cir 1986). However, Creditors Committee Counsel beware, §506(c) does not apply to you. In In the Matter of S & S Industries, Inc., 8 CBC2d 947 (Bankr ED Mich 1983), Judge Brodey said "no" to a $16,442.50 bill submitted by Rice, Rice & Gilbert, as Unsecured Creditor Committee counsel. In that opinion, Judge Brodey stated:

> [The] unsecured creditor's committee is appointed to protect the interests of unsecured creditors. Its duties are spelled out in §1103. It may investigate the

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> financial condition of the plan, request the appointment of a trustee or an examiner where warranted and perform such other services as are in the interests of the creditors they represent. The creditors committee is not charged, as a trustee is, with preserving or disposing of property. Therefore, Congress had no reason to provide reimbursement to creditors committees for such costs. Id. at 950.

The opinion of most importance to the reader is that of Interstate Motor Freight System, IMFS, Inc., 18 CBC2d 1116 (Bankr WD Mich 1988), a decision by Judge Howard. In the second opinion in this case, Judge Howard declined to extend §506(c) to the unpaid post Chapter 11 charges of an employee benefit fund. The Fund argued that the debtor utilized the services of the employees to perform certain actions, such as marshalling of collateral, which were only to the benefit of the secured creditors. In this decision, and in his earlier decision, Interstate Motor Freight System, IMFS, Inc., 71 BR 741 (Bankr WD Mich 1987), Judge Howard strictly read the Statute to disallow, on summary judgment, any recovery by any party but the "Trustee". Judge Howard went on to prohibit use of §105, relying on Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963, 18 CBC2d 262 (US Sup Ct 1988), that "whatever equitable powers remain in the Bankruptcy Court must and can only be exercised in the confines of the Bankruptcy Code." Interstate, at 1119. While we wait for the appropriate Sixth Circuit decision extending the definition of "trustee" to include all members of the Bankruptcy Law Section of the Federal Bar Association, we must realize that §506(c) is currently limited to the expenses of the debtor or trustee, and presumably counsel. See In re Chicago Lutheran Hospital Ass'n., 89 BR 719 (Bankr N Ill 1988).

If you can get past the threshold question of whether or not you are one of the few that collect under this Section, the question then becomes - for what can you collect? The answer to this question revolves around what is meant by the term "reasonable, necessary costs and expenses of preserving or disposing of" the secured property. See §506(c).

As to work done in "disposing" of secured property, this is subject to a relatively objective standard. See Collier Bankruptcy Compensation Guide, 1989 §805(2). These charges include fees for: drafting petitions for appointment of auctioneers and appraisers, general drafting of sale documents, negotiation of offers, preparing for and attending sale hearings and otherwise performing professional services relating to the selling of collateral and transferring title free of liens. Id. Also see Collier Bankruptcy Compensation Guide, 1989 §805(2).

As to what expenses may be related to "preserving" collateral, the Circuit Courts have taken several approaches. In General Electric Credit Corp. v. Levin & Weintraub, In re Flagstaff Foodservice Corp. (Flagstaff I), 739 F2d 73, 10 CBC2d 1309 (2d Cir 1984), the Court took the general position that the trustee or debtor must demonstrate that the costs incurred for preserving the collateral were for the "direct" and "primary" benefit of the secured creditor. In that case, the Court followed the Seventh Circuit decision in In the Matter of Trim-X, Inc., 695 F2d 296, 7 CBC2d 955 (7th Cir 1982), and disallowed the payment of fees to the attorneys for the debtor ($57,403.57 and $130,479.77, respectively), and the fees for the attorneys and the accountants of the creditor's committee ($38,388.40 and $22,966.00,

respectively). The Court was particularly mystified as to how work done by the attorneys for the creditor's committee with respect to their challenge of the validity of the secured creditor's security interest, benefited the secured creditor. Oh, well. Two days after the Second Circuit decision, the Eighth Circuit followed suit in Brookfield Production Credit Ass'n. v. Borron, 738 F2d 951, 10 CBC2d 1314 (8th Cir 1984). This opinion appears in CBC2d directly following Flagstaff I. After you finish Flagstaff, just keep reading. The Court rejected the lower Court opinion in Flagstaff, not knowing that earlier in the week the Second Circuit had reversed the District Court. The Eighth Circuit relied on In re Sonoma V, 24 BR 600, 8 CBC2d 1032 (9th Cir 1982); the initial Court of Appeals to follow this rule. Also see In re Codesco, Inc., 6 CBC2d 395 (SD NY 1982) and In re Cascade Hydraulics & Utility Service, Inc., 815 F2d 546, 16 CBC2d 1509 (9th Cir 1987).

Conversely, if one has to relocate, New Jersey may not have the best weather, but the Third Circuit has adopted a more liberal view. In In re Henry McKeesport Steel Castings Company, supra at 563, a utility company was given the right to surcharge the secured creditors for about $57,000.00 in post-petition bills. Basically, the Court, following In re AFCO Enterprises, Inc., 9 CBC2d 1127 (Bankr Utah 1983), came to the conclusion that since other parties, other than a trustee, have been given standing by other courts to recover monies under other provisions of the Bankruptcy Code which also stipulate that only the trustee may act (i.e., §547 preference actions), §506(c) ought to allow the gas company to get its money. Not wishing to offend the Second Circuit, but rejecting the theory of Flagstaff, the Court went on to state that since the gas company, by its continued sale of gas, had contributed to the "going concern" of the debtor, the strict criteria of Flagstaff would have been met. The Court stated, "the definition of benefit passes more than the bottom line of a balance sheet. Preservation of the going concern value of a business can constitute a benefit to the secured creditor." One can imagine all of the lawyers in New Jersey and Pennsylvania running to court explaining how their services contributed to the "going concern" value of the debtor's business to the benefit of the secured creditor. Also see Equibank, N.A. & The FmHA v. Wheeling Pittsburg Steel Corp., 884 F2d 80, 1989 U.S. App. LEXIS 12341 (3rd Cir, Oct. 6, 1989). There, the Court remanded proceedings to the trial court for proofs as to whether or not payment of post-petition real property taxes, paid from proceeds of secured creditor collateral, might be chargeable against the collateral under §506(c).

In any event, we can be certain that there will always be an imaginative lawyer trying to figure out a way for us all to get paid. Perhaps the most imaginative attempt comes from our brothers in New York. In In re Roamers Supply, Inc., 9 CBC2d 218 (Bankr SD NY 1983), counsel for the debtor attempted to use §364(d) and §510(c) to "prime" the secured creditor for its fee. The Judge, essentially ruling that it was a very nice try, stated that "§364(d) was not intended to put attorney fees ahead of secured creditors" and essentially told counsel to go "pound salt". As to the §510 issue, counsel's argument was so weak that the Judge's rejection need not be detailed here. Id., at 224.

As we await future decisions, we should always rest assured that there is some lawyer in New York working with our best interests at heart.

RECENT BANKRUPTCY DECISIONS

The following are summaries of recent court decisions that address important issues of bankruptcy law and procedure. These summaries were prepared by Patrick E. Mears with the assistance of Larry A. Ver Merris.

In re Yurika Foods Corp., Case No. 88-1692 (6th Cir. Oct. 23, 1989). Yurika Foods Corporation ("Yurika") was engaged in the distribution, marketing and selling of food products and used the services of United Parcel Service ("UPS") to ship its products. In December, 1984, Yurika suffered cash flow problems and went into arrears on the payments it owed to UPS. The tariffs of UPS, a common carrier, were regulated by the Interstate Commerce Commission ("ICC"). These tariffs permit UPS to extend credit to a customer for only seven days after UPS mails its bill.

In August, 1985, Yurika commenced a Chapter 11 case in the Eastern District of Michigan. During the 90-day preference period, Yurika made a number of late payments, viz., payments beyond the seven-day credit period, to UPS. In July, 1986, Yurika commenced an adversary proceeding against UPS seeking the return of these payments totalling $40,000 as voidable preferences. In December, 1987, the Bankruptcy Court entered judgment for Yurika which the district court affirmed on appeal in June, 1988. In its decision, the district court ruled that the payments made by Yurika to UPS could not qualify as transfers in the ordinary course of business under 11 U.S.C. § 547(c)(2) since they violated ICC regulations and were therefore "illegal."

On appeal, the Sixth Circuit reversed the decisions of the bankruptcy and district courts "to the extent that they held that the ICC statute and regulations compel a per se conclusion that late payment for freight charges must be considered outside the ordinary course of business." In support of this conclusion, the Sixth Circuit cited Southern Pacific Transportation Co. v. Commercial Metals Co., 456 U.S. 336 (1982), which held that a carrier's violation of ICC credit regulations does not provide an affirmative defense to shippers.

The Sixth Circuit then examined the record below to determine whether the payments in issue were made in the ordinary course of business. The test of what constitutes an ordinary course transfer under 11 U.S.C. § 547(c)(2) requires a court to "engage in factual analysis of 'the business practices which were unique to the particular parties under consideration'." Thus, a court must examine "several factors, including timing the amount and manner a transaction was paid and the circumstances under which the transfer was made." The Sixth Circuit also adopted an "industry standards" test under 11 U.S.C. § 547(c)(2) in addition to the "parties prior dealings" test.

In reviewing the record below, the Sixth Circuit held that the payments in question were made in the ordinary course of business. First, the bankruptcy court found that 87% of Yurika's payments were made after the period specified in the bills and more than 50% were made "after twice the period of seven days specified." Furthermore, the Sixth Circuit concluded on its own factual inquiry that "for many years, 82% of carriers in the industry had not followed the credit limitation set out in the regulation and invoice ter

Consequently, the Sixth Circuit remanded the case for entry of a judgment consistent with its finding that these payments were immune from a preference attack under 11 U.S.C. § 547(c)(2).

Old Kent Bank of Holland v. Kotman, Case No. K 87-394 (W.D. Mich. Oct. 31, 1989). The Kotmans operated a family farm and had mortgaged their real estate to Federal Land Bank ("FLB"), the holder of the first mortgage, and Old Kent Bank of Holland ("OKB"), the holder of the second mortgage. Upon the Kotmans default, FLB commenced mortgage foreclosure proceedings and obtained a sheriff's deed to the realty on September 16, 1987. In January, 1987, OKB purchased FLB's position. Thereafter, the Kotmans commenced a Chapter 12 case by filing a voluntary petition with the Grand Rapids Bankruptcy Court.

On October 5, 1987, Bankruptcy Judge David Nims entered an order authorizing the Kotmans to borrow funds to redeem their realty from foreclosure and to grant to the new lender a first mortgage on the farm. On October 6, 1987, Judge Nims entered a second order authorizing the Chapter 12 trustee to pay to OKB the proceeds of this new loan to effect the redemption. OKB filed a timely appeal from the October 6th order but was unaware of the existence of the order entered the previous day. This order was improperly docketed by the Bankruptcy Court Clerk's office and that office informed OKB that only the October 6th order had been entered.

On April 11, 1989, District Judge Benjamin Gibson entered an order declining to hear OKB's appeal since the October 6th order was not a final one. OKB then moved for reconsideration, arguing that its appeal from the October 6th order should be considered a timely appeal from the October 5th order because of the clerical error by the clerk's office. Judge Gibson agreed with this contention since OKB had established the existence of "unique circumstances." Judge Gibson held that OKB had "relied reasonably and in good faith upon an affirmative statement by the bankruptcy court which lulled it into a state of inactivity" regarding the October 5th order. Nevertheless, Judge Gibson held that OKB's appeal was moot since it had failed to obtain a stay pending appeal, citing In re Ellingsen MacLean Oil Co., 834 F.2d 599 (6th Cir. 1987).

J & S Produce v. Bahadur, Balan and Kazerski, Ltd., Case No. 89-0495 (E.D. Mich. Oct. 31, 1989). The plaintiffs in this action sold perishable commodities subject to the Perishable Agricultural Commodities Act of 1980 ("PACA"). That statute impresses a trust upon monies held by the buyer for the benefit of the growers/suppliers. See In re Prange Foods Corp., 63 Bankr. 211 (Bankr. W.D. Mich. 1986) for a general discussion of PACA and its interface with federal bankruptcy law.

The plaintiffs sold agricultural commodities on credit to Palermo Meat Market, Inc. ("Palermo") before Palermo commenced a Chapter 11 case in the Detroit Bankruptcy Court. In Palermo's Chapter 11 and its subsequent Chapter 7 case, Palermo and its trustee were permitted to use cash collateral after proper notice had been given to plaintiffs. No objections to this use were made by plaintiffs. Certain of these monies were paid to the defendant, a consulting firm, for professional services rendered to the Chapter 11 examiner. Two years after Palermo filed its Chapter 11 petition, the plaintiffs commenced this action against defendant alleging that the monies received by it from Palermo's estate were impressed with the PACA statutory trust and must be returned to plaintiffs.

Defendant moved for summary judgment including res judicata, collateral estoppel and laches. District Judge Richard Suhrheinrich granted this motion on these grounds. The plaintiffs' failure to object to the motions for use of cash collateral, the defendant's fee request and the plaintiffs' failure to seek relief from the automatic stay to recover their PACA trust funds barred them from the relief they requested in this civil action.

In re Clapp, 103 Bankr. 126 (Bankr. E.D. Mich. 1989). In this no-asset Chapter 7 case, Bankruptcy Judge Arthur Spector denied an individual debtor's motion to amend his schedules to add an omitted creditor. The debtor filed a voluntary petition in September, 1986, and received his general discharge four months later. The debtor failed to list as a creditor the holder of the debtor's personal guaranty of indebtedness owed by a corporation the debtor controlled. This creditor commenced a collection action in state court against the debtor in May, 1988, after the corporation failed to satisfy the debt. In February, 1989, the state court entered judgment against the individual debtor on his guaranty for $18,941.64. One month later, the debtor moved to reopen his closed Chapter 7 case and to amend his Schedule A-3 to list this creditor.

In denying the debtor's motion to amend, Judge Spector stated the principles governing that motion as set forth in In re Rosinski, 759 F.2d 539 (6th Cir. 1985):

> There it was held that a debtor may be prevented from amending his schedule to include a creditor originally omitted only if it can be shown that the creditor was somehow prejudiced or if the debtor intentionally or recklessly avoided listing the creditor.

Reviewing the facts relevant to the debtor's motion, Judge Spector concluded that the debtor "either intentionally, or at least recklessly failed" to schedule this creditor on his schedules, which failure prejudiced the creditor. Specifically, the debtor's corporation continued to order products from the creditor after the debtor filed his Chapter 7 petition. According to Judge Spector, "[i]t is quite likely that [the creditor] would not have shipped new product . . . had it known that a principal and a guarantor had just filed personal bankruptcy."

Hertzberg v. Loyal American Life Ins. Co., Adversary Proceeding No. 88-0540-R (Bankr. E.D. Mich. Oct. 25, 1989). This adversary proceeding was commenced by the trustee appointed in the Chapter 11 case of B & K Hydraulic Company pending before Bankruptcy Judge Steven Rhodes. In 1985, the defendant issued a life insurance policy for $1 million to the debtor covering the life of its president, Thomas Beaty. The policy required the debtor to pay premiums annually. In 1986, an involuntary Chapter 7 petition was filed against the debtor, which case was thereafter converted to Chapter 11. In June, 1987, the insurance policy was modified to require monthly payments of premium. These payments were due on the 28th day of each month with a 31-day grace period. The policy provided that, upon failure to make the required payment within the grace period, the policy would lapse.

The Chapter 11 debtor made the required premium payments through October, 1987. On December 11, 1987, Robert Hertzberg was appointed trustee in the case and on January 4, 1988, Beaty died. When the defendant denied coverage on account of the policy's lapse for nonpayment of premium,

Hertzberg commenced this adversary proceeding seeking payment under the policy. Thereafter, Hertzberg and the defendant filed motions for summary judgment.

In his decision granting the defendant's motion for summary judgment, Judge Rhodes found that the life insurance policy lapsed according to its terms when Hertzberg failed to make the November 29, 1987 payment within the 31-day grace period. The termination of the policy was not prohibited by the automatic stay since the defendant took no "act" to cause that termination. Consequently, there was no life insurance policy to assume or reject when Beaty died. Judge Rhodes noted that the practical effect of the defendant's position (and his decision) was to require a trustee to make contract payments "to avoid termination of the contract by its own terms and to maintain the benefits of the contract."

Dery v. United States of America, Case No. 84-0875-R (Bankr. E.D. Mich. Oct. 23, 1989). This decision, also authored by Judge Rhodes, arises from the case of In re Bridge, 90 Bankr. 839 (Bankr. E.D. Mich. 1988), which was summarized in the December, 1988 issue of the Newsletter. In his earlier opinion, Judge Rhodes ordered the United States to turn over to the bankruptcy trustee the proceeds of $670,000 in Canadian treasury bills seized from the debtor and her husband by the U.S. Customs Service. The question before Judge Rhodes in this later opinion was whether to award to the trustee prejudgment interest against the government.

The operative facts are as follows. The treasury bills were seized in September, 1982, two months prior to their maturity. However, rather than immediately redeem them, the Customs Service deposited them in a safe until April 5, 1988, where they earned no interest. In March, 1984, the trustee made a written demand on the government for the turnover of the bills. After their seizure the government conducted a criminal investigation of the debtor's husband which was concluded on November 16, 1984, when he pleaded guilty to the crimes charged. After that date, the treasury bills were no longer needed as evidence in those criminal proceedings.

Judge Rhodes first declared that he had discretion (i) to determine whether to award prejudgment interest; (ii) to decide the time period during which that interest would be assessed; and (iii) to fix the rate of interest so assessed. Judge Rhodes declared that he would award prejudgment interest to the trustee at the annual rate of 8% for the period from November 16, 1984, the date on which the debtor's husband pleaded guilty, through April 5, 1988, the date on which the Canadian Treasury bills were redeemed by the U.S. government.

Kowatch v. Kowatch, 179 Mich App 163, 445 N.W.2d 808 (1989). In this decision, Circuit Judge Randy Tahvonen, sitting on the Michigan Court of Appeals by assignment, considered the issue of what debts constitute nondischargeable alimony obligations under 11 U.S.C. § 523(a)(5)(B). Judge Tahvonen affirmed the lower court's determination that the sums due from Mr. Kowatch to his ex-wife were in the nature of nondischargeable alimony obligations. Judge Tahvonen cited and discussed the Sixth Circuit's decision of In re Calhoun, 715 F.2d 1103 (6th Cir. 1983) and In re Singer, 787 F.2d 1033 (6th Cir. 1986) in support of his finding.

EDITOR'S NOTEBOOK

In In re Yurika Foods Corp., discussed earlier in this issue, not only does the Sixth Circuit expound on the ordinary course of business defense found under Bankruptcy Code §547(c)(2), but also discusses at the Sixth Circuit level, for the first time I believe, the counting of the 90-day preference period. Although dicta, the Court clearly indicates that the 90-day preference period covers that 90-day period of time preceding the voluntary petition date. Thus, if a petition is filed on August 9, as here, the 90-day preference period would run from May 11 through August 8 per Yurika Foods. Note also that Yurika Foods was filed in 1985 and that May 11 of that year fell on a Saturday. Some authors have suggested that if you count backwards 90 days from the petition date and the 90th day falls on a weekend or legal holiday, that you can enlarge (or reduce) the preference period through use of Bankruptcy Rule 9006. Although this is not discussed in Yurika Foods, it appears that that court is rejecting such proposition, which would be consonant with its counting rules enunciated earlier in In re Butcher, 829 F2d 596 (6th Cir 1987); cert den. 108 S Ct 1058, in regard to attempting to extend the two (2) year statute of limitations of Bankruptcy Code §546 through use of that rule. Thus, counting backward or forward appears to be irrelevant in this Circuit.

Yurika Foods also reiterates the need, under §547(c)(2), to examine not only the parties' prior dealings, but further to examine the industry standards for payment timeliness (i.e., was the payment in the ordinary course of business in those parties' industry). This "bifold" test was first set forth by Judge Rhodes of the Eastern District in In re Sterling Steel Improvement Co, 79 BR 681 (1987), but was arguably rejected by the Sixth Circuit in In re Fulghum Const. Corp., 872 F2d 739 (6th Cir 1989). In Fulghum, the court did acknowledge that courts "might" be required to examine industry standards in addition to the parties' prior dealings. Id., at 743, n. 2. However, the court never made the industry standards comparison in that case, presumably because all of the transfers in question involved short term loans between the debtor corporation and its sole shareholder for which there were no "industry standards". Therefore, it would appear that the bifold comparison test of §547(c)(2) is alive and well if there are industry standards which can be applied to the transactions in question.

In the November 14, 1989 edition of the Wall Street Journal, p. B-10, in an article titled "High Court to Decide If Chapter 11 Firms Have to Pay Their Corporate Taxes First", it was noted that the U.S. Supreme Court will decide whether a company in a Chapter 11 reorganization that owes both corporate income taxes and employee withholding taxes to the federal government must pay the corporate taxes first when it is ready to resume paying its debts. The Circuits are split on this issue which may have a vast impact on responsible person liabiility as well as collection of taxes by the federal government. The appeal involves debtors from Massachusetts and Rhode Island who are known as Energy Resources Co., now operated as ERCO Liquidation Trust, and Newport Offshore Ltd. Although not from this Circuit, it would seem that any ruling would effectively

affirm or overrule the Sixth Circuit's opinion in In re Du Charmes & Co, 852 F2d 194 (6th Cir, 1988), reported in Vol. 1, No. 1 of this Newsletter, in which the Sixth Circuit held that payments made under a Chapter 11 plan are "involuntary" and hence the debtor could not designate which taxes those payments could be applied against.

Larry A. Ver Merris

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan during the period from January 1, 1989 through October 31, 1989. These filings are compared to those made during that same period 1 year ago.

	1/1/89-10/31/89	1/1/88-10/31/88
Chapter 7	2,777	2,288
Chapter 11	79	75
Chapter 12	15	31
Chapter 13	1,060	979

STEERING COMMITTEE MEETING MINUTES

Please note that the next Steering Committee meeting will be held on Friday, December 1, 1989, at noon in the Presidents Room (5th floor) at the Peninsular Club.