Receiver-Focused Questions

Receiver Compensation, Priority, and "Getting Paid" in Bankruptcy

1. What are the strongest arguments for treating receiver fees/expenses as secured vs. administrative vs. something else?
    a. Gerard: I normally record a Receiver's Lien in my H&S Cases to create a secured lien for unpaid fees and costs.
2. How do you document receiver fees, so they survive scrutiny from a Chapter 7/11 trustee.
3. What's your view on receiver financing instruments (e.g., receivership certificates) and how they fare once bankruptcy is filed? Can they be primed by other DIP financing? Interest Rates, Terms etc.
4. Where do receivership borrowings fit in the bankruptcy 'pecking order,' and what drafting choices matter?
5. What's the most common mistake that causes receiver professionals to become effectively unsecured?

Why receivership instead of bankruptcy?

1. When does a receivership solve a problem that Chapter 11 can't?

The Moment Bankruptcy Hits: Automatic Stay + "Custodian" Turnover

1. At filing, what receiver actions become stay-sensitive immediately under 11 U.S.C. § 362? California H&S Code has been used to obtain relief from Stay in many instances.
2. How do you triage day-one: preserve property vs. 'administration' prohibited by § 543(a)?"
3. What evidence moves the needle on relief from turnover under § 543(d)
4. What do judges want to see in a motion seeking relief from stay + relief from turnover?
5. How do you avoid 'accidental' stay violations when the receiver is still operating the asset?
6. What's the cleanest protocol for bank accounts, locks, rents, and vendor payments between receiver and DIP/trustee?"

Receiver Exit: Discharge, Final Accounting, Bond Exoneration (and stay modification)

1. "Should the receiver seek stay modification to file a final report/accounting in state court?"
2. "How do courts balance 'judicial economy' with the bankruptcy court's control of estate property when the receiver wants discharge?
3. "What's the best practice to get the receiver discharged and bond exonerated without prejudicing estate administration?

Receiver Compensation, Priority, and "Getting Paid" in Bankruptcy

1. "What are the strongest arguments for treating receiver fees/expenses as secured vs. administrative vs. something else?"
2. "How do you document receiver fees so they survive scrutiny from a Chapter 7/11 trustee?"
3. "What's your view on receiver financing instruments (e.g., receivership certificates) and how they fare once bankruptcy is filed?"

4. “Where do receivership borrowings fit in the bankruptcy ‘pecking order,’ and what drafting choices actually matter?”
5. “What’s the most common mistake that causes receiver professionals to become effectively unsecured?”

Sales: Receiver Sale vs. § 363 Sale (Speed, Liens, Challenges)

1. When is a receiver sale faster/cleaner than a § 363 sale—and when is it not worth the risk?
2. How do you manage lienholders and junior interests in a receiver sale, and what changes if bankruptcy follows?
3. What diligence/marketing record does a receiver need, so the sale doesn’t get attacked later as undervalued or collusive?
4. “What does ‘free and clear’ really mean in receivership practice vs. bankruptcy practice?”

Additional Questions

1. Are the priority claim thresholds that differ in bankruptcy vs. receivership? e.g. (a) I know there is calc for determining claim of a landlord; (b) I think there is a $12k cap for EE claims?
    a. Generally speaking, if a debtor entity is in receivership, depending on how long, the counter “move” is based in large part on core competency; how smart and experienced is the Receiver? If smart and practical, a debtor not in possession might be able to highly function with retention of the Receiver. Of course, first you must understand your client’s objectives and the ever developing exit strategy. If the subject Receiver is neither smart nor practical, then the client would likely take the predictable move to insist on turnover. This decision might be tempered if there is a strong risk that the mismanagement that resulted in the Receiver’s appointment would in turn result in the appointment of a Chapter 11 Trustee
2. Risks to a receiver? If BK filed post-receivership and a Trustee is appointed, do you have Trustee looking into acts of Receiver?
    a. This this move would be highly unusual unless the debt is recourse to guarantor and in exchange for retention of the Receiver, the G gets a release. BTW if the BK was filed first, then the appointment of a Receiver would likely be appointed by agreement in light of the stay. I guess if a debtor had multiple projects and could easily carve one off to placate a secured lender, who wants a receivership, then an accommodation could be made, but again largely based upon the facts presented.
3. Fair warnings to audience about risks or pitfalls (or positives) of certain assets being administered in BK vs. receivership.

592 F.3d 664
United States Court of Appeals,
Fifth Circuit.

In the Matter of: BODENHEIMER, JONES, SZWAK, & WINCHELL L.L.P., Debtor.
David A. Szwak, Appellant,
v.
Dale C. Earwood; Mary E. Winchell, Appellees.

No. 09–30360.
|
Dec. 29, 2009.

Synopsis
Background: In involuntary bankruptcy proceeding filed under Chapter 7 by a general partner of law firm which was in state-law liquidation proceedings, partner appealed order of the United States District Court for the Western District of Louisiana, S. Maurice Hicks, Jr., J., 2009 WL 872482, which affirmed bankruptcy award to firm's federally superseded custodian for services and expenses incurred as liquidator of the partnership and superseded custodian of the bankruptcy estate.

Holdings: The Court of Appeals, Reavley, Circuit Judge, held that:

[1] bankruptcy court erred, when awarding compensation for custodian's services and expenses, by finding that fees and expenses arising out of custodian's opposition to the bankruptcy qualified as reasonable compensation, and

[2] bankruptcy court erred by failing to consider whether custodian's services benefited the estate.

Reversed and remanded for further proceedings.

Procedural Posture(s): On Appeal.

West Headnotes (14)

[1] **Bankruptcy**🔑Scope of review in general
When reviewing a district court order that itself reviews a bankruptcy court order, an appellate court applies the same standard of review as did the district court.
4 Cases that cite this headnote

[2] **Bankruptcy**🔑Clear error
Findings of fact in a bankruptcy case are reviewed for clear error.
3 Cases that cite this headnote

[3] **Bankruptcy**🔑Conclusions of law; de novo review
Issues of statutory interpretation in a bankruptcy case are reviewed de novo, as are mixed questions of law and fact.
6 Cases that cite this headnote

[4] **Bankruptcy**🔑Discretion
When reviewing a bankruptcy court's approval of a compromise settlement, an appellate court reviews for abuse of discretion.
4 Cases that cite this headnote

[5] **Bankruptcy**🔑Moot questions
An appeal in a bankruptcy case is equitably moot when a plan of reorganization has been so substantially consummated that a court cannot order effective relief even though a live dispute remains among some parties to the case.
3 Cases that cite this headnote

[6] **Bankruptcy**🔑Effect of want of stay; conclusiveness of sale
Bankruptcy🔑Moot questions
When determining whether to declare a bankruptcy case equitably moot, court considers (1) whether a stay has been obtained, (2) whether the bankruptcy reorganization plan has been substantially consummated, and (3) whether the relief requested would affect either the rights of

parties not before the court or the success of the plan.

3 Cases that cite this headnote

[7] **Bankruptcy**🔑Effect of want of stay; conclusiveness of sale
Bankruptcy🔑Moot questions

Doctrine of equitable mootness did not bar review of issues raised on appeal of bankruptcy court's order awarding services and expenses incurred by Chapter 7 debtor's federally superseded custodian, even though debtor failed to obtain a stay and even if the liquidation had been substantially consummated; reopening the bankruptcy case to redistribute improperly disbursed funds would not upset the liquidation plan or disturb the settled interests of parties not before the court.

3 Cases that cite this headnote

[8] **Bankruptcy**🔑Moot questions

Ultimate question to be decided in a mootness inquiry in a bankruptcy case is whether the court can grant relief without undermining the plan and, thereby, affecting third parties.

[9] **Bankruptcy**🔑Professional services; attorney fees
Bankruptcy🔑Turnover by custodians

Bankruptcy court erred, when awarding Chapter 7 debtor's federally superseded custodian compensation for services and expenses incurred as state-law liquidator of the debtor and superseded custodian of the bankruptcy estate, by finding that fees and expenses arising out of custodian's opposition to the bankruptcy qualified as reasonable compensation; custodian, who hired an attorney to oppose the bankruptcy petition, was not authorized to oppose the petition or to employ the estate's resources in doing so, and his opposition to the bankruptcy was not necessary to preserve the property of the estate. 11 U.S.C.A. §§ 503(b)(3)(E), 543(c)(2).

13 Cases that cite this headnote

[10] **Bankruptcy**🔑Professional services; attorney fees
Bankruptcy🔑Turnover by custodians

Bankruptcy court erred, when awarding Chapter 7 debtor's federally superseded custodian compensation for services and expenses incurred as state-law liquidator of the debtor and superseded custodian of the bankruptcy estate, by failing to consider whether custodian's services benefited the estate. 11 U.S.C.A. §§ 503(b)(3)(E), 543.

11 Cases that cite this headnote

[11] **Bankruptcy**🔑Time of accrual; prepetition claims
Bankruptcy🔑Professional services; attorney fees

While the Bankruptcy Code generally only accords an administrative expense priority status to claims for postpetition services, it expressly authorizes compensation for the prepetition services of a superseded custodian or receiver and is an exception to the general rule with respect to the allowance of compensation for exclusively postpetition activities as an administrative expense. 11 U.S.C.A. §§ 503(b)(3)(E), 543.

8 Cases that cite this headnote

[12] **Bankruptcy**🔑Construction and Operation

When Congress amends the bankruptcy laws, it does not write on a clean slate, and a court must not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.

2 Cases that cite this headnote

[13] **Bankruptcy**🔑Scope of review in general

When reviewing a bankruptcy court's approval of a compromise settlement, appellate court should ensure that the compromise settlement is fair and equitable and in the best interest of the estate.

2 Cases that cite this headnote

[14] **Bankruptcy**🔑Judicial authority or approval

A bankruptcy court is ordinarily in the best position, as the trial court and as the ongoing supervisory court for the bankruptcy proceeding,

to determine whether a compromise is in the best interest of the estate and fair and equitable; nevertheless, a bankruptcy court abuses its discretion when it bases its decision on legally incorrect principles.

2 Cases that cite this headnote

Attorneys and Law Firms

***666** Robert William Raley (argued), Law Offices of Robert W. Raley, Bossier City, LA, for Szwak.

Randall Stephen Davidson, Julia Elizabeth Blewer (argued), Grant Ernest Summers, Davidson, Jones & Summers, Shreveport, LA, for Earwood.

Bernard S. Johnson, Cook, Yancey, King & Galloway, Shreveport, LA, for Winchell.

Appeal from the United States District Court for the Western District of Louisiana.
Before REAVLEY, CLEMENT and SOUTHWICK, Circuit Judges.

Opinion

REAVLEY, Circuit Judge:

Appellant David Szwak appeals the district court's order affirming the bankruptcy award to Appellee Dale Earwood of $45,227.53 for his services and expenses as a state-law liquidator and later as a federally superseded custodian of a now-bankrupt law firm. Because the bankruptcy court failed to consider how Earwood's services and expenses met the terms of 11 U.S.C. § 543(a) and benefitted the bankruptcy estate when determining whether they qualified as an administrative expense, we hold the award to be error and an abuse of the bankruptcy court's discretion. Accordingly, we REVERSE and REMAND for further proceedings.

I.

In 2006, Szwak and Appellee Mary Winchell were the last remaining partners in Bodenheimer, Jones, Szwak, and Winchell, a Shreveport, Louisiana, law firm ("the Partnership"). In January 2006, Szwak filed a petition for judicial dissolution and liquidation of the Partnership. At a subsequent hearing, a state court judge appointed Earwood to serve as liquidator.

In April 2006, Szwak—in his capacity as a general partner—filed an involuntary petition for commencement of bankruptcy proceedings against the Partnership. Winchell—in her capacity as a general partner—opposed the involuntary bankruptcy and sought dismissal of the case. Earwood, now a federally superseded custodian ***667** of the Partnership, also opposed the bankruptcy. To aid in his opposition to the bankruptcy, Earwood employed outside legal counsel.

In July 2006, Earwood filed an application to recover his fees as liquidator of the Partnership and superseded custodian of the bankruptcy estate, pursuant to 11 U.S.C. § 543(c)(2) and Federal Rule of Bankruptcy Procedure 2016. Specifically, Earwood sought $47,189.78 for both his pre– and post-petition services, $549.78 for his out-of-pocket expenses, and $23,227.85 for his attorneys' fees in opposing the bankruptcy. In August 2006, over Szwak's objection, the bankruptcy court authorized an interim payment of $28,000 to Earwood from the estate, and stayed further proceedings with regard to the application.

A year later, in August 2007, Earwood and the estate's Chapter 7 Trustee[1] reached a settlement and compromise, in which the Trustee offered to pay Earwood $21,500.00 to satisfy all remaining claims Earwood had against the estate. Earwood agreed to the offer of settlement, and the Trustee filed a Motion to Compromise. Szwak opposed the Motion to Compromise.

Later that month, the bankruptcy court conducted an evidentiary hearing on the Trustee's Motion to Compromise. At the conclusion of the hearing, the court found that Earwood "was a poor choice for the liquidator in this case." Specifically, the court found that "the manner and method in which he chose to conduct his fiduciary statutory duties was wrong for this type of business. In fact it jeopardized the client's well-being; it jeopardized individual attorneys' well-being." Nevertheless, the court held that Earwood was entitled to compensation for his work as a liquidator and superseded custodian, including his hiring of counsel to oppose the bankruptcy. Specifically, the court stated that "Earwood believed he was doing what he had been tasked to do, and I believe that his belief was reinforced not once, not twice, but a number of times by the presiding judge ...."

Accordingly, the court stated "that whether I think he was wrong or not is not an issue[.]" The court then informed the parties that it would only approve a compromise that would take into consideration Earwood's expenses for opposing the bankruptcy. Additionally, the court held that Earwood did not need to show that his actions benefitted the estate to claim compensation. Instead, the court held that "[i]t's only necessary that [Earwood] show that the payment would be payment of reasonable compensation for services rendered and cost and expenses incurred by such custodian." At this point, the bankruptcy court dictated to the parties a final Compromise Settlement to which Earwood and the Trustee agreed, once again over Szwak's explicit objections.

In September 2007, the bankruptcy court issued an order making final the $28,000.00 interim payment that the court originally awarded in August 2006, identifying the funds as part of the Compromise Settlement. The bankruptcy court also approved the Compromise Settlement between the parties. As part of the Compromise Settlement, the bankruptcy court directed the Trustee to pay Earwood full reimbursement for his legal fees of $23,237.85, which he had incurred when opposing the bankruptcy. The court also directed the estate's Trustee to pay Earwood his liquidator fees, but at an hourly rate significantly less than that set forth by the state court, ultimately granting him a reimbursement of $17,237.53. In October 2007, the bankruptcy court revised its ***668** September order and stipulated which fees came out of the interim payment and which fees remained to be paid. The second order also increased Earwood's liquidator fees to $21,449.00, and added reimbursement for expenses of $549.78, for a total of $21,999.68. This resulted in a total award for Earwood and his counsel of $45,227.53, which remains the amount in controversy.

Szwak appealed the bankruptcy court's orders approving the Compromise Settlement to the district court for the Western District of Louisiana. In his appeal, Szwak argued that the bankruptcy court legally erred by refusing to apply the "Direct Benefit Rule," a doctrine "which would have required Earwood [and his counsel] to show that their services and expenditures benefitted the estate as a prerequisite to approval of their requests for compensation and reimbursement of expenses." Szwak also argued that the bankruptcy court failed to consider all the necessary factors pursuant to Fifth Circuit precedent when approving the Compromise Settlement. In March 2009, the district court affirmed the bankruptcy court's orders.

II.

[1] [2] [3] [4] When reviewing a district court order that itself reviews a bankruptcy court order, an appellate court applies the same standard of review as did the district court. *In re San Patricio County Cmty. Action Agency.*[2] Findings of fact are reviewed for clear error.[3] Issues of statutory interpretation are reviewed de novo. *In re Nowlin.*[4] Mixed questions of law and fact are also reviewed de novo.[5] When reviewing a bankruptcy court's approval of a compromise settlement, an appellate court reviews for abuse of discretion. *In re Foster Mortgage Corp.*[6]

III.

Before reaching the merits of the case, we address Earwood's argument that events subsequent to the bankruptcy court's approval of the Compromise Settlement have rendered this case moot. We hold that they have not.

[5] [6] The doctrine of equitable mootness "is a prudential, not a constitutional, doctrine that evolved in response to the particular necessities surrounding consummation of confirmed [Chapter 11] bankruptcy reorganization plans." *In re Hilal.*[7] "An appeal is equitably moot when a plan of reorganization has been so substantially consummated that a court cannot order effective relief even though a live dispute remains among some parties to the bankruptcy case."[8] When determining whether to declare a case equitably moot, the court applies the following three factors: (1) whether a stay has been obtained, (2) whether the bankruptcy reorganization plan has been "substantially consummated," and (3) whether the relief requested would affect either the rights of parties not before the court or the success of the plan.[9] It is questionable whether the doctrine ***669** of equitable mootness applies to Chapter 7 bankruptcy liquidations.[10] However, even if equitable mootness applies in some Chapter 7 bankruptcies, it does not do so here.

[7] Neither party contests that Szwak has failed to obtain a stay. Thus, the first factor is satisfied in favor of mootness. Moreover, the Partnership has been fully liquidated and all funds disbursed, thus appearing to satisfy the second factor in favor of mootness.[11] However, as part of the final liquidation of the Partnership, Szwak and Winchell—who were the final remaining creditors of the Partnership—entered into a comprehensive compromise settlement

wherein all issues regarding the Partnership were settled between them and with the estate, except the instant litigation. Specifically, the Szwak–Winchell Agreement stated:

> Any other provisions or references notwithstanding, Szwak shall retain the right to pursue and to receive as a portion of this settlement compromise any recovery that might result for the benefit of this bankruptcy estate or for the benefit of Szwak or Winchell from In the Matter of: Bodenheimer, Jones, Szwak, & Winchell L.L.P., Debtor, David A Szwak, Appellant, V.[sic] Dale C. Earwood; Mary E. Winchell, Appellee, currently pending before the United States Court of Appeal [sic] for the Fifth Circuit. It is further agreed that no recovery in that matter shall be had against Winchell.

The Szwak–Winchell Agreement took place subsequent to the approval of the Compromise Settlement at issue in this appeal. However, when determining mootness, a court may review relevant evidence of subsequent events not available to the trial court.[12] Given Szwak's express reservation of rights to any assets of the Partnership that this appeal may affect, the fact that the liquidation has been "substantially consummated" does not militate in favor of mootness. Accordingly, the second factor does not ultimately favor mootness.

[8] However, even if the circumstances completely satisfied the first two mootness factors, case law demonstrates that Earwood's claim for mootness may still fail.[13] " 'The ultimate question to be decided [in a mootness inquiry] is whether the Court can grant relief without undermining the plan and, thereby, affecting third parties.' "[14] Currently, the only relevant party in interest not before the court is the liquidated estate, which is not truly a "third-party" in the bankruptcy but a central litigant whose assets remain at issue. Even though the case would have to be reopened and the Trustee reappointed if we were not to hold this case moot, the estate and its Trustee "are no strangers to the plan and ... have been on notice of this contingent exposure since early in the confirmation process."[15] Their renewed ***670** involvement in this case is therefore not the kind of circumstance the mootness doctrine appears designed to protect.[16] Earwood also argues that his full claim against the estate is larger than the amount he ultimately received in the Compromise Settlement, and that disturbing the Settlement would potentially expose the estate to liability that would require a redistribution of other awards. However, given our holding in this opinion that the bankruptcy court erred in awarding Earwood his claimed fees without first determining if his actions benefitted the estate, it is unlikely that any subsequent award on remand will be larger than the current amount in controversy.

In conclusion, reopening the bankruptcy case to redistribute improperly disbursed funds between the two current parties would not upset the liquidation plan or disturb the settled interests of parties not before the court. In any case, reopening the case is "not of the same nature or magnitude as the undoing of a complicated [Chapter 11] plan of reorganization," and therefore does not warrant a holding of equitable mootness.[17]

IV.

We now turn to the merits of the case. Szwak argues that the bankruptcy court committed legal error by approving the Compromise Settlement without first determining whether Earwood's services and expenses benefitted the estate. We agree.

A bankruptcy case may commence where, as here, a general partner of a firm files a petition for involuntary bankruptcy.[18] At that moment, Earwood's position and authority changed from state-law liquidator of a Partnership to a federally superseded custodian of a bankruptcy estate.[19] As superseded custodian, Earwood's authority and obligations were strictly circumscribed by statute. Once Earwood had knowledge of the commencement of the bankruptcy petition, he was specifically prohibited from

> mak[ing] any disbursement from, or tak[ing] any action in the administration of, property of the debtor, proceeds, product, offspring, rents, or profits of such property, or property of the estate, in the possession, custody, or control of such custodian, *except such action as is necessary to preserve such property.*[20]

***671** Earwood was also required to

> (1) deliver to the [Chapter 7] trustee any property of the debtor held by or transferred to such custodian, or proceeds, product, offspring, rents, or profits of such property, that is in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case; and

(2) file an accounting of any property of the debtor, or proceeds, product, offspring, rents, or profits of such property, that, at any time, came into the possession, custody, or control of such custodian.[21]

Once Earwood had performed these duties, the bankruptcy court was to "provide for the payment of reasonable compensation for services rendered and costs and expenses incurred ...."[22] A custodian's compensation for "services" and "actual, necessary expenses" are an administrative expense of the estate and are thereby entitled to priority in the bankruptcy proceedings.[23] In addition to compensation for services and "actual, necessary expenses," a superseded custodian's compensation may include "reasonable compensation for professional services rendered by an attorney" employed by the custodian to further an "allowed" expense, as well as that attorney's "actual, necessary expenses."[24]

[9] The record indicates that once Szwak had filed the involuntary petition for bankruptcy, Earwood focused his efforts on opposing the bankruptcy.[25] Indeed, all of his attorneys' fees, which comprise more than half of the amount in controversy, stem from opposing the bankruptcy. However, nowhere in the relevant bankruptcy statutes does it state that a superseded custodian is authorized to oppose a bankruptcy petition or to employ the estate's resources in doing so. Indeed, as mentioned above, the statute governing a superseded custodian's post-petition duties states explicitly that unless the custodian is expressly authorized by the bankruptcy court to continue in the administration of the estate, the custodian is restricted to delivering all property to the trustee and filing an accounting of all property that came into the custodian's possession.[26] Earwood was well aware of ***672** these obligations and the limits on his authority because his application for compensation, reimbursement, and attorneys' fees cited this section of the Bankruptcy Code as authority for his entitlement. Nevertheless, Earwood failed to relinquish control of the estate property until ordered to do so by the district court. Earwood also failed to file an accounting of the estate's property. For Earwood to claim that he is entitled to compensation for the ultra vires "service" of opposing the bankruptcy when he failed to first complete his statutorily-mandated service of winding up the estate borders on the absurd.[27] Indeed, Earwood has made no credible argument that his opposition to the bankruptcy was somehow "necessary" to preserve the property of the bankruptcy estate.[28] Accordingly, a request for compensation in this case that includes fees for opposing the bankruptcy cannot be considered "reasonable compensation" under § 543(c)(2). Nor can we consider Earwood's attorneys' fees to be derivative of an "allowable" expense under 503(b)(3)(E) and thus compensable under § 503(b)(4). As the bankruptcy court explicitly approved these fees as part of the Compromise Settlement, its decision to do so was legal error.

[10] [11] In addition, when reviewing Earwood's fee application, the bankruptcy court stated that it would not consider whether Earwood's services benefitted the estate. In doing so, the bankruptcy court once again erred. While pre-petition services are not governed by § 543, they are governed by § 503(b)(3)(E), which allows payment from the bankruptcy estate to pre-petition custodians for services and "actual, necessary expenses."[29] Earwood argues that because the words "benefit to the estate" are not in 503(b)(3)(E), no such requirement exists. However, we have interpreted the terms "actual" and "necessary" as requiring a benefit to the estate under a related provision of § 503, despite the fact that no corresponding language is found in that provision. *See In re Jack/Wade Drilling, Inc.*[30] As we have previously stated, "[t]he 'benefit' requirement has no independent basis in the Code, however, but is merely a way of testing whether a particular expense was truly 'necessary' to the estate: If it was of no 'benefit,' it cannot have been 'necessary.' "[31]

***673** Moreover, the "benefit to the estate" requirement for "services" of pre-petition liquidators and post-petition custodians is supported by long-established pre-Bankruptcy Code precedent. The "benefit to the estate" doctrine was first recognized in *Randolph & Randolph v. Scruggs,* where Justice Holmes, writing for a unanimous Court, held that a state-law assignee of a debtor's estate was entitled to seek payment for services that he undertook prior to the adjudication of the bankruptcy, inasmuch as those services benefitted the bankruptcy estate.[32] The Court added, however, that "[w]e are not prepared to go further than to allow compensation for services which were beneficial to the estate. Beyond that point we must throw the risk of his conduct on the assignee, as he was chargeable with knowledge of what might happen."[33] The Court also concluded that the assignee's decision to contest the bankruptcy once it had commenced did not appear to be a benefit to the estate, and therefore resulting fees were not allowable expenses entitled to priority.[34]

[12] Since the Supreme Court's decision in *Randolph,* Congress enacted the Bankruptcy Code.[35] Admittedly, Congress made no mention of the "benefit to the estate" rule

in the provisions of the Code governing the services of superseded custodians. However, "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.' " *Dewsnup v. Timm.*[36] Indeed, we must "not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Cohen v. de la Cruz.*[37] There is no indication that Congress intended to overturn the "benefit to the estate" doctrine when passing the statutes governing payment to superseded custodians. Indeed, the legislative history points to the contrary.[38]

Nevertheless, Earwood argues that by including language that expressly requires a bankruptcy court to employ a "benefit to the estate" analysis in other Code sections, Congress signaled that it had abandoned this pre-Code practice with regard to superseded custodians. Specifically, Congress has included "benefit to the estate" language in § 330(a)(4)(A) and (B) when addressing the services of an examiner, trustee under Chapter 11, and other professional person. Congress has also included "benefit to the estate" language in § 503(b)(3)(B) when determining the compensation to a creditor recovering property for the estate. However, none of these examples is dispositive of the issue. As stated above, the presumption regarding pre-Code practices and their continued viability ***674** runs counter to Appellee's argument; that is, these practices remain controlling unless explicitly superseded.[39] Moreover, the Court in *Randolph* specifically addressed the claims of a pre-petition assignee and his pre– and post-petition services.[40] However, the Court did not address claims from the parties and services found in §§ 330(a)(4)(A),(B) and 503(b)(3)(B). Accordingly, the *Randolph* ruling is not on point for parties and circumstances addressed in these statutes, and Congress may have needed to clarify in these sections whether a "benefit to the estate" analysis applied. At the very least, the fact that the *Randolph* Court specifically addressed the "benefit to the estate" test as it applies to a superseded custodian and his services makes its lack of inclusion in § 503(b)(3)(E) less conspicuous.

Finally, the "benefit-to-the-estate" doctrine remains a nearly universally-recognized interpretative scheme for § 503(b)(3)(E). Since the passage of the Bankruptcy Code, bankruptcy courts have almost unanimously held that *Randolph* controls custodian compensation, and they have interpreted § 503(b)(3)(E) to include the "benefit to the estate" doctrine regarding custodial services.[41] While this Court is not bound to follow any of these cases, the cases are instructive of the evolution of bankruptcy practice. We decline to upend decades of settled precedent in the bankruptcy courts absent a clear and compelling legal reason to do so.

In conclusion, the language of § 543 clearly circumscribes the actions of superseded custodians to those which are necessary to preserve the assets of the estate once a bankruptcy petition has been filed. Earwood cannot demonstrate that opposing the bankruptcy is an administrative expense to which he is entitled. Moreover, given our prior cases interpreting "actual" and "necessary" as the terms are used in the Bankruptcy Code, the Supreme Court precedent establishing pre-Code practice regarding superseded custodians, the legislative history of § 503(b)(3)(E), and the nearly uniform practice of the bankruptcy courts before and after the passage of the Bankruptcy Code, this Court would be predicted to interpret § 503(b)(3)(E) to require a "benefit to the estate" when awarding administrative expenses to a superseded custodian. Because the bankruptcy court explicitly refused to consider these standards when approving Earwood's compensation, the court committed legal error in approving the Compromise Settlement.

V.

Regardless of the bankruptcy court's errors, Earwood argues that the real issue is not whether the bankruptcy court properly applied the law, but whether it abused its discretion by approving the Compromise Settlement that the court ultimately found to be in the best interests of the estate.

***675** [13] [14] When reviewing a bankruptcy court's approval of a compromise settlement, the appellate court should ensure that the compromise settlement is " 'fair and equitable' and 'in the best interest of the estate.' " *In re Jackson Brewing Co.*[42] In making this determination we acknowledge that "[a] bankruptcy court is ordinarily in the best position, as the trial court and as the ongoing supervisory court for the bankruptcy proceeding, to determine whether a compromise is in the best interest of the estate and 'fair and equitable.' " *In re Emerald Oil Co.*[43] Nevertheless, a bankruptcy court abuses its discretion when it bases its decision on legally incorrect principles.[44]

Here, the bankruptcy court dictated the terms of the Compromise Settlement to the parties and specifically stated that it would only allow a settlement that included compensation to Earwood for his opposition to the bankruptcy. The bankruptcy court also refused to apply a "benefit to the estate" analysis regarding Earwood's services. In both pronouncements, the bankruptcy court erred as a matter of law. Accordingly, the bankruptcy court abused its discretion when it approved the Compromise Settlement.

VI.

The district court's order affirming the bankruptcy court's orders which approved the Compromise Settlement is VACATED. Similarly, the bankruptcy court's orders are REVERSED and the case is REMANDED to the bankruptcy court for further proceedings.

All Citations

592 F.3d 664, 52 Bankr.Ct.Dec. 157, Bankr. L. Rep. P 81,655

Footnotes

1 All references in this order to the "Trustee" are to the court-appointed Chapter 7 Trustee and not to the United States Trustee or its appointed agent overseeing the bankruptcy. *See* 11 U.S.C. § 323 (outlining role and capacity of an estate's trustee).

2 575 F.3d 553, 557 (5th Cir.2009).

3 *Id.*

4 576 F.3d 258, 261 (5th Cir.2009) (citing *United States v. Valle,* 538 F.3d 341, 344 (5th Cir.2008)).

5 *San Patricio County,* 575 F.3d at 557 (citing *In re Seven Seas Petroleum, Inc.,* 522 F.3d 575, 583 (5th Cir.2008)).

6 68 F.3d 914, 917 (5th Cir.1995).

7 534 F.3d 498, 500 (5th Cir.2008) (citing *In re Grimland, Inc.,* 243 F.3d 228, 231 (5th Cir.2001)); *see also In re Manges,* 29 F.3d 1034, 1038–39 (5th Cir.1994).

8 *Hilal,* 534 F.3d at 500 (citing *Grimland,* 243 F.3d at 231).

9 *Manges,* 29 F.3d at 1039 (citations omitted).

10 *See San Patricio County,* 575 F.3d at 558 ("It is certainly arguable that equitable mootness has no application to an appeal in a Chapter 7 liquidation."); *Grimland,* 243 F.3d at 231 n. 4 ("Equitable mootness normally arises where a Chapter 11 reorganization plan is at issue.").

11 *See Grimland,* 243 F.3d at 231 (recognizing the "substantially consummated" factor in a Chapter 7 bankruptcy satisfied when all of debtor's assets had been sold and proceeds distributed).

12 *Manges,* 29 F.3d at 1041 (citing, e.g., *Bd. of License Comm'rs v. Pastore,* 469 U.S. 238, 240, 105 S.Ct. 685, 686, 83 L.Ed.2d 618 (1985)).

13 *See Hilal,* 534 F.3d at 500–01; *Grimland,* 243 F.3d at 231–32.

14 *San Patricio County,* 575 F.3d at 558 (quoting *In re SI Restructuring, Inc.,* 542 F.3d 131, 136 (5th Cir.2008)).

15 *Hilal,* 534 F.3d at 500.

16 *See id.; San Patricio County,* 575 F.3d at 559–60; *see also* 11 U.S.C. § 350(b) ("A [bankruptcy] case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other cause.").

17 *See San Patricio County,* 575 F.3d at 559.

18 *See* 11 U.S.C. § 303.

19 Earwood was appointed liquidator of the partnership pursuant to La.Rev.Stat. Ann. § 12:142D (1994), which states:

> If the shareholders or incorporators do not authorize conduct of the liquidation out of court, the corporation shall file a petition with the court, praying that the corporation be liquidated and dissolved under the supervision of the court, whereupon the court shall appoint a liquidator, upon such conditions as to bond and compensation as it may deem proper. Thereafter the liquidation proceedings shall be conducted under the supervision and orders of the court.

The federal bankruptcy statutes define "custodian" as

> (A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;
> (B) assignee under a general assignment for the benefit of the debtor's creditors; or
> (C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

11 U.S.C. § 101(11).

20 11 U.S.C. § 543(a) (emphasis added).

21 *Id.* § 543(b).

22 *Id.* § 543(c)(2).

23 *Id.* § 503(b)(3)(E). This statute states, in relevant part:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including ... (3) the *actual, necessary expenses* ... incurred by ... (E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian[.]

(emphasis added).

24 *Id.* § 503(b)(4).

25 While Earwood submitted detailed records of his services between January 17, 2006 and April 3, 2006, he has submitted no record of his services after the commencement of the bankruptcy. Indeed, nothing in Earwood's timesheets submitted with his application for compensation indicates he was engaged in the authorized duties of a superseded custodian outlined in § 543(b)(1)-(2). However, Earwood expressly asserts in various places throughout the record that he engaged in what he called his "fiduciary duty" to oppose the bankruptcy. Therefore, absent any record to the contrary, we are left to assume that his actions post-petition were largely confined to opposing the bankruptcy.

26 *See* § 543(b). The bankruptcy court may excuse a custodian's compliance with subsections (a) and (b) if, after notice and hearing, it finds that it is in the best interests of the debtor or equity security holders that continued possession, custody, or control of the estate remain with the pre-petition custodian. *Id.* § 543(d)(1). In the instant case, however, the bankruptcy court made no such finding and gave Earwood no authorization to continue the administration of the estate post-petition.

27 *See. e.g., In re Posadas Assocs.,* 127 B.R. 278, 282 (Bankr.D.N.M.1991) (holding that "where the custodian incurs costs not for complying with the turnover provisions of the Code but for resisting turnover, the Court finds that prior court approval is necessary in order for the fees and costs to be considered for administrative expense priority").

28 *See* § 543(a).

29 While § 503 generally only accords an "administrative expense" priority status to claims for post-petition services, § 503(b)(3)(E) "expressly authorizes compensation for the prepetition services of a custodian or receiver superseded under 11 U.S.C. § 543 and is an exception to the general rule with respect to the allowance of compensation for exclusively postpetition activities as an administrative expense." *In re Snergy Props., Inc.,* 130 B.R. 700, 704 (Bankr.S.D.N.Y.1991) (citing *In re Hearth & Hinge, Inc.,* 28 B.R. 595, 597 (Bankr.S.D.Ohio 1983)); *see also In re Statepark Bldg. Group, Ltd.,* No. 04–33916–HDH–11, 2005 WL 2589179, at *2 (Bankr.N.D.Tex. June 29, 2005).

30 258 F.3d 385, 387 (5th Cir.2001) ("In order to qualify as an 'actual and necessary cost' under section 503(b)(1)(A), a claim against the estate must ... [be] a result of actions taken by the trustee *that benefitted the estate.*") (emphasis added) (citing *In re TransAmerican Natural Gas Corp.,* 978 F.2d 1409, 1416 (5th Cir.1992)); *see also In re H.L.S. Energy Co.,* 151 F.3d 434, 437 (5th Cir.1998); *NL Indus., Inc. v. GHR Energy Corp.,* 940 F.2d 957, 966 (5th Cir.1991) ("Courts have construed the words 'actual' and 'necessary' narrowly: the debt must *benefit [the] estate* and its creditors.") (citations omitted and emphasis added).

31 *H.L.S. Energy Co.,* 151 F.3d at 437 (citing Lawrence P. King, ed. , 4 COLLIER ON BANKRUPTCY ¶ 503.06[3][b] (15th rev. ed.1998)).

32 190 U.S. 533, 538–39, 23 S.Ct. 710, 712–13, 47 L.Ed. 1165 (1903).

33 *Id.* at 539, 23 S.Ct. at 713.

34 *Id.*

35 *See* Pub.L. No. 95–598, §§ 503, 543, 92 Stat. 2549 (1978).

36 502 U.S. 410, 419, 112 S.Ct. 773, 779, 116 L.Ed.2d 903 (1992) (citing *Emil v. Hanley,* 318 U.S. 515, 521, 63 S.Ct. 687, 690–91, 87 L.Ed. 954 (1943)).

37 523 U.S. 213, 221, 118 S.Ct. 1212, 1218, 140 L.Ed.2d 341 (1998) (quoting *Pa. Dept. of Pub. Welfare v. Davenport,* 495 U.S. 552, 563, 110 S.Ct. 2126, 2133, 109 L.Ed.2d 588 (1990)).

38 *See* 124 Cong. Rec. 32398 (1978) (statement of Rep. Edwards) ("Section 503(b)(3)(E) codifies present law in cases such as *Randolph v. Scruggs,* 190 U.S. 533, 23 S.Ct. 710, 47 L.Ed. 1165, which accords administrative expense status to services rendered by a prepetition custodian or other party to the extent such services actually benefit the estate."); 124 Cong. Rec. 33997 (1978) (statement of Sen. DeConcini) (same); *see also In re Miami Gen. Hosp.,* 101 B.R. 361, 364 n. 8 (Bankr.S.D.Fla.1989) ("Congress codified *Randolph* at 11 U.S.C. § 503(b)(3)(E)....").

39 *See Cohen,* 523 U.S. at 221, 118 S.Ct. at 1218.

40 *See Randolph & Randolph,* 190 U.S. at 535–36, 23 S.Ct. at 711.

41 *See, e.g., In re Pris-mm, LLC,* No. 08–16398–RAG, 2009 WL 2924166, at *3 (Bankr.D.Md. July 31, 2009); *In re Lake Region Operating Corp.,* 238 B.R. 99, 102 (Bankr.M.D.Pa.1999); *In re 245 Assocs.,* 188 B.R. 743, 748 (Bankr.S.D.N.Y.1995); *In re American Motor Club, Inc.,* 125 B.R. 79, 81–82 (Bankr.E.D.N.Y.1991); *In re Holden,* 101 B.R. 573, 576 (Bankr.N.D.Iowa 1989); *In re Kenval Mktg. Corp.,* 84 B.R. 32, 34 (Bankr.E.D.Pa.1988); *In re Valley Isle Broadcasting, Ltd.,* 56 B.R. 505, 506 (Bankr.D.Hawai'i 1985); *In re Jensen–Farley Pictures, Inc.,* 47 B.R. 557, 570–71 (Bankr.D.Utah 1985) (collecting cases that followed *Randolph* prior to enaction of Bankruptcy Code); *In re Marichal–Agosto, Inc.,* 12 B.R. 891, 894 (Bankr.N.Y.1981).

42 624 F.2d 599, 602 (5th Cir.1980) (quoting *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson,* 390 U.S. 414, 424, 88 S.Ct. 1157, 1163, 20 L.Ed.2d 1 (1968) ("*TMT Trailer*")).

43 807 F.2d 1234, 1239 (5th Cir.1987) (citing *TMT Trailer,* 390 U.S. at 432, 88 S.Ct. at 1163).

44 *See id.* (compromise agreement not "fair and equitable" when claim against the estate likely has no basis in law); *see also Kane v. Nat'l Union Fire Ins. Co.,* 535 F.3d 380, 384 (5th Cir.2008) (holding that a lower court abuses its discretion " 'when it makes an error of law' ") (quoting *In re Superior Crewboats, Inc.,* 374 F.3d 330, 334 (5th Cir.2004)).

End of Document

592 F.Supp.2d 532
United States District Court,
S.D. New York.

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,
v.
Steven BYERS, Joseph Shereshevsky, Wextrust Capital, LLC, Wextrust Equity Partners, LLC, Wextrust Development Group, LLC, Wextrust Securities, LLC, and Axela Hospitality, LLC, Defendants.

No. 08 Civ. 7104(DC).
|
Dec. 17, 2008.

Synopsis
Background: Securities and Exchange Commission (SEC) brought civil fraud enforcement action against companies and individual defendants arising out of alleged Ponzi scheme. Creditor committees filed motions to modify receiver orders. The District Court appointed receiver and receiver's counsel.

Holdings: The District Court, Chin, J., held that:

[1] Court could enjoin non-parties from filing involuntary bankruptcy petitions with respect to property in receivership;

[2] maintaining stay maintained status quo, and thus did not support lifting of preliminary injunction;

[3] where receiver had only just begun to investigate full extent of alleged Ponzi scheme, lifting of preliminary injunction was not warranted;

[4] receiver would automatically succeed to role of debtor-in-possession in event of bankruptcy filing; and

[5] showing of cause had to be made to justify preemptive withdrawal of case from bankruptcy court.

Motions denied.

West Headnotes (8)

[1] **Securities Regulation**🔑Receivership
Court could enjoin non-parties from filing involuntary bankruptcy petitions with respect to property in receivership, in civil fraud enforcement action brought by Securities and Exchange Commission (SEC) against companies and individual defendants arising out of alleged Ponzi scheme.

[2] **Securities Regulation**🔑In general; nature and form of remedy
Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy.

[3] **Receivers**🔑Injunction and stay
When determining whether an injunction against litigation should be lifted, a court considers: (1) whether refusing to lift the stay genuinely preserves the status quo or whether the moving party will suffer substantial injury if not permitted to proceed; (2) the time in the course of the receivership at which the motion for relief from the stay is made; and (3) the merit of the moving party's underlying claim.

26 Cases that cite this headnote

[4] **Securities Regulation**🔑Preliminary Injunction
Maintaining stay maintained status quo, and thus did not support lifting of preliminary injunction previously entered enjoining parties and non-parties alike from filing involuntary bankruptcy petition against property in receivership, in civil fraud enforcement action brought by Securities and Exchange Commission (SEC) against companies and individual defendants arising out of alleged Ponzi scheme, since receiver was charged with protecting investments of all investors and movant creditors were only concerned with recouping their own investments,

presumably even at expense of other investors.

7 Cases that cite this headnote

[5] **Securities Regulation**🔑Preliminary Injunction

Where receiver had only just begun to investigate full extent of alleged Ponzi scheme, lifting of preliminary injunction was not warranted which previously had been entered enjoining parties and non-parties alike from filing involuntary bankruptcy petition against property in receivership, in civil fraud enforcement action brought by Securities and Exchange Commission (SEC) against companies and individual defendants.

4 Cases that cite this headnote

[6] **Securities Regulation**🔑Receivership

Although preliminary injunction previously entered enjoining parties and non-parties alike from filing involuntary bankruptcy petition against property in receivership did not designate receiver as debtor-in-possession, receiver would automatically succeed to that role in event of bankruptcy filing, in civil fraud enforcement action brought by Securities and Exchange Commission (SEC) against companies and individual defendants arising out of alleged Ponzi scheme. 11 U.S.C.A. § 543.

7 Cases that cite this headnote

[7] **Bankruptcy**🔑Turnover by custodians

Because a receiver becomes a debtor-in-possession once a bankruptcy petition is filed, a debtor-in-possession is not a "custodian," and therefore is not required to deliver the debtor's assets to the trustee. 11 U.S.C.A. § 101(11).

[8] **Bankruptcy**🔑Withdrawal or transfer to district court

Showing of cause had to be made to justify preemptive withdrawal of case from bankruptcy court. 28 U.S.C.A. § 157.

1 Case that cites this headnote

Attorneys and Law Firms

***534** Alistaire Bambach, Esq., Neal Jacobson, Esq., Alex M. Vasilescu, Esq., Steven G. Rawlings, Esq., Danielle Sallah, Esq., New York Regional Office, New York, NY, for Plaintiff Securities and Exchange Commission.

Dewey & Leboeuf LLP, by Leo V. Gagion, Esq., Martin F. Bienenstock, Esq., Mark S. Radke, Esq., New York, NY, for Timothy J. Coleman, Receiver for Wextrust Entities and Affiliates.

Dechert LLP, by Shalom Jacob, Esq., Shumuel Vasser, Esq., New York, NY, for International Ad–Hoc Committee of Wextrust Creditors.

Brown Rudnick LLP, by Martin S. Siegel, Esq., Steven B. Smith, Esq., New York, NY, for International Consortium of Wextrust Creditors.

MEMORANDUM DECISION

CHIN, District Judge.

Before the Court are motions to modify a series of orders appointing a receiver in this complex securities fraud case. For the reasons set forth below, the motions are denied in part and granted in part.

BACKGROUND

On August 11, 2008, the Securities and Exchange Commission ("SEC") filed a complaint in this action against Steven Byers and Joseph Shereshevsky and five Wextrust entities (the "Wextrust Entities") for their role in a Ponzi scheme that purportedly defrauded more than one thousand investors of approximately $255 million. (SEC Opp. 2).[1] The SEC complaint alleged a massive fraud involving a complex web of some 240 Wextrust affiliates operating in the Middle East, Africa, and the United States. (SEC Opp. 2–3; Sordillo Decl. ¶ 3).

On August 11, 2008, this Court (Sullivan, J., sitting in Part I) entered an order (the "Receiver Order") appointing as temporary receiver Timothy Coleman (the "Receiver"). Pursuant to the Receiver Order, the Receiver was charged

with, *inter alia,* ascertaining the financial condition of the Wextrust Entities, including the extent of commingling of funds among the Wextrust Entities and the entities they control, and determining whether the Wextrust Entities and the entities under their control should file for bankruptcy.

The Receiver Order provided that:

> no person or entity, including any creditor or claimant against any of the Defendants, or any person acting on behalf of such creditor or claimant, shall take any action to interfere with the taking control, possession, or management of the ***535** assets, including, but not limited to, the filing of any lawsuits, liens, or encumbrances, or bankruptcy cases to impact the property and assets subject to this order.

(Receiver Order 4). This provision is being challenged by the International Ad–Hoc Committee of Wextrust Creditors and the International Consortium of Wextrust Creditors ("Movants").

On September 11, 2008, I entered an amended receiver order (the "Amended Receiver Order") that contained the following provision:

> [I]f in accordance with this order the Receiver determines that any of the Wextrust Entities and entities they own or control should undertake a bankruptcy filing, the Receiver, be and he hereby is, authorized to commence cases under title 11 of the United States Code for such entities in this district, and in such cases the Receiver shall prosecute the bankruptcy petitions in accordance with title 11 subject to the same parameters and objectives as a chapter 11 trustee and shall remain in possession, custody, and control of the title 11 estates subject to the rights of any party in interest to challenge such possession, custody, and control under 11 U.S.C. § 543 or to request a determination by this Court as to whether the Receiver should be deemed a debtor in possession or trustee, at a hearing, on due notice to all parties in interest, before the undersigned.

(Amended Receiver Order 10). Movants also challenge this provision.

On October 24, 2008, I entered an order imposing a preliminary injunction and other relief against defendants and the relief defendant, which incorporated the Receiver Order and Amended Receiver Order (collectively, the "Receiver Orders"). Movants challenge the two provisions quoted above. The SEC and the Receiver oppose any modifications, except in one respect, discussed below. I heard oral argument on the motions to modify on November 14, 2008, and reserved decision.

DISCUSSION

I. *Injunction Against Bankruptcy Petitions*

[1] The Movants' motion to modify the provision enjoining non-parties from filing involuntary bankruptcy petitions presents two issues: First, whether the Court has the authority to prevent non-parties from proceeding against defendants and their assets, and second, if so, whether the Court should continue to exercise its authority to do so. I conclude that I have such authority, and that I should continue to exercise that authority. I will, however, modify the Receiver Order in one respect, discussed below.

A. *Does This Court Have Authority to Enjoin Non–Parties From Filing Involuntary Bankruptcy Petitions?*

There is no case in the Second Circuit directly addressing the authority of a court to enjoin non-parties from filing involuntary bankruptcy petitions with respect to property in receivership. Consequently, Movants argue that I lack the authority to enter such an order. I am persuaded, however, by the sound reasoning of cases outside this Circuit that the Court indeed has the authority to prevent non-parties from filing involuntary bankruptcy petitions against the Wextrust entities.

In *SEC v. Wencke,* the Ninth Circuit upheld the district court's issuance of a stay prohibiting "all investors, creditors, and other persons," including non-parties, from "commencing, prosecuting, continuing or enforcing any suit" against the receivership ***536** entities except by leave of the court. 622 F.2d 1363, 1365 (9th Cir.1980). The Ninth Circuit reasoned that a district court's authority to issue such a stay "rests as much on its control over the property placed in receivership as on its jurisdiction over the parties to the securities fraud action." *Id.* at 1369. If the court could not control the receivership assets, the Ninth Circuit reasoned,

the receiver would be unable to protect those assets. *See id.* at 1369–70. This would effectively undermine the purpose of the receivership.

Similarly, the Sixth Circuit recently held that a district court has the authority to enjoin non-parties from instituting suits against assets subject to a receivership, provided the non-parties have notice of the injunction. *See Liberte Capital Group, LLC v. Capwill,* 462 F.3d 543, 552 (6th Cir.2006). The Sixth Circuit, citing *Wencke,* held that the district court's authority to issue such an injunction "arises from its power over the assets in question." *Id.*; *cf. Lankenau v. Coggeshall & Hicks,* 350 F.2d 61, 63 (2d Cir.1965) ("There is a substantial jurisdictional basis for allowing the federal court receiver to have and keep custody and control of the assets in question, and to obtain the relief needed to implement that custody.").

[2] The rulings of the Ninth and Sixth Circuits are, moreover, consistent with the rule in this Circuit that "[o]nce the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy." *SEC v. Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1103 (2d Cir.1972); *see also Eberhard v. Marcu,* 530 F.3d 122, 131 (2d Cir.2008) (noting that federal securities laws do not explicitly vest district courts with authority to appoint receivers, but that such authority exists because "[d]istrict courts possess broad power to remedy violations of federal securities laws").

The authority of this Court to issue such an injunction is also supported by the Second Circuit's decision in *United States v. Royal Business Funds Corp.,* 724 F.2d 12 (2d Cir.1983). There the Second Circuit affirmed an order enjoining a debtor from filing a bankruptcy petition where a receivership was already underway. *Id.* at 15 (holding that "a debtor subject to a federal receivership has no absolute right to file a bankruptcy petition"). The Court explicitly held that its ruling was not intended to disturb the general rule "that the pendency of an equitable receivership rarely precludes a petition in bankruptcy," but it nonetheless affirmed the order because, among other reasons, the "bankruptcy petition, which was filed by the debtor rather than by third-party creditors, will, so far as we can tell on this record, disrupt the receiver's attempts to improve the company's fortunes." *Id.*

In light of these decisions, I conclude that the Court has the authority to enjoin non-parties from filing involuntary bankruptcy petitions against any of the Wextrust Entities.

B. *Should the Court Lift the Injunction?*

[3] In a subsequent proceeding in *Wencke,* the Ninth Circuit set forth three factors to consider in determining whether an injunction against litigation should be lifted:

> (1) whether refusing to lift the stay genuinely preserves the status quo or whether the moving party will suffer substantial injury if not permitted to proceed; (2) the time in the course of the receivership at which the motion for relief from the stay is made; and (3) the merit of the moving party's underlying claim.

***537** *SEC v. Wencke,* 742 F.2d 1230, 1231 (9th Cir.1984) ("*Wencke II* "); *see also United States v. Acorn Tech. Fund, L.P.,* 429 F.3d 438, 442 (3d Cir.2005) (explicitly adopting *Wencke II* factors). Applying these factors to the facts of this case, I conclude that the injunction should stand.

[4] As to the first factor, maintaining the stay undeniably maintains the status quo. The Receiver is charged with protecting the investments of *all* the Wextrust Entities' investors. Movants, on the other hand, are only concerned with recouping their own investments, presumably even at the expense of other investors. (*See* 11/14/08 Tr. 20). This is not to impugn the motives of the Movants—it is perfectly rational that they want to recoup their investment—but only to point out that the Movants' interest *may* diverge from the interests of the investors as a whole. The Receiver is charged with protecting the investors as a whole, and thus the best way to maintain the status quo is to permit him to carry on with his investigation.

[5] As to the second factor, the Ninth Circuit held that "where the motion for relief from the stay is made soon after the receiver has assumed control over the estate, the receiver's need to organize and understand the entities under his control may weigh more heavily than the merits of the party's claim." *Wencke II,* 742 F.2d at 1231 (internal citation and quotations omitted); *accord Acorn Tech. Fund, L.P.,* 429 F.3d at 443–44 (holding that "very early in a receivership even the most meritorious claims might fail to justify lifting a stay given the possible disruption of the receiver's duties"). Here, the Receiver has only just begun to investigate the full

extent of the fraudulent scheme, and permitting some investors to file involuntary bankruptcy petitions would hinder the Receiver's investigation. (*See* Kahn Decl. ¶ 6 (CEO of real estate firm retained by Receiver stating that "uninformed decisions to file [bankruptcy] cases without a sufficient basis or strategic plan can adversely affect the properties and put a taint on the properties"); Sordillo Decl. ¶ 8 (partner in Deloitte, financial advisory firm retained by Receiver, stating that "[b]ankruptcy cases will be a burden on the resources of the estate")). The timing, therefore, also weighs against modifying the order.

As to the third factor, the Court does not have enough information about the merits of the Movants' claims to render a judgment. Even assuming the Movants' claims are strong, however, the other two *Wencke* factors weigh heavily against lifting the injunction.

For these reasons, I decline to lift the injunction previously entered enjoining parties and non-parties alike from filing an involuntary bankruptcy petition against any of the Wextrust Entities.

C. *Modification of the Receiver Order*

While the injunction against non-parties filing involuntary bankruptcy petitions stands, I hereby modify the Receiver Order to permit any party or non-party to apply to this Court on three days' notice for an order seeking permission to file an involuntary bankruptcy petition upon a showing that such a petition is appropriate and will benefit the receivership estate. I do this with the consent of the SEC (*see* SEC Opp. 15 n. 6). This modification will permit Movants, concerned that, *inter alia,* the Receiver lacks the authority to reorganize certain entities as opposed to merely liquidating them (*see* Mov. Reply 5), to pursue their claims in bankruptcy, but only if they can show that so doing will best serve the interests of the receivership, and not just their own self-interest.

I now turn to the second provision challenged by the Movants.

***538 II.** *Bankruptcy Procedure*

[6] The Amended Receiver Order provides that in the event the Receiver determines some or all of the Wextrust Entities should file for bankruptcy,

> the Receiver shall prosecute the bankruptcy petitions in accordance with title 11 subject to the same parameters and objectives as a chapter 11 trustee and shall remain in possession, custody, and control of the title 11 estates subject to the rights of any party in interest to challenge such possession, custody, and control under 11 U.S.C. § 543 or to request a determination by this Court as to whether the Receiver should be deemed a debtor in possession or trustee, at a hearing, on due notice to all parties in interest, before the undersigned.

(Amended Receiver Order 10). Movants argue that this provision violates two provisions of the Bankruptcy Code. First, they argue that it "circumvents the statutory provisions of the Bankruptcy Code dealing with appointment and selection of bankruptcy trustees." (Mov. Mem. 4–7). Second, they argue that it amounts to an improper assertion of jurisdiction over a case that is statutorily required to be heard by a bankruptcy court. (*Id.* 7). I address each argument in turn.

A. *Appointment and Selection of Bankruptcy Trustees*

Movants argue that the provision is improper because it "essentially allow[s] the Receiver to continue to act as a trustee post bankruptcy." (Mov. Mem. 5; *see* Mov. Reply 7). That is not the case. The Receiver will not serve in bankruptcy as a trustee, but rather as manager of the Wextrust entities, subject to the right of any party to challenge him under 11 U.S.C. § 543 or to seek appointment of a trustee pursuant to 11 U.S.C. § 1104.[2]

In *In re Bayou Group, LLC,* the Court upheld a challenge to a substantially similar provision based on its inherent equitable authority. 363 B.R. 674, 685 (S.D.N.Y.2007).[3] The court there held that preventing the receiver from exercising managerial control over the receivership assets once bankruptcy proceedings began would "frustrate the equitable power of this court to fashion what it deemed an appropriate remedy." *Id.*

[7] The court in *Bayou* also specifically addressed the argument, now advanced by Movants, that the order conflicts with ***539** 11 U.S.C. § 543, which provides that a "custodian" in possession of assets belonging to a bankruptcy debtor shall first deliver such assets to the trustee and then seek a hearing to excuse it from having to deliver

the assets. The *Bayou* court held that once the receiver filed the bankruptcy petition, his role as receiver terminated, but his role as *manager* of the bankrupt entities continued, and the "management of a bankrupt entity that files in Chapter 11 is automatically authorized to act as the debtor-in-possession, since under the Bankruptcy Code, the term 'debtor-in-possession' quite simply 'means debtor.' " 363 B.R. at 686 (citing 11 U.S.C. § 1101(1) and Black's Law Dictionary 412 (7th ed. 1999) (defining "debtor-in-possession" as a "Chapter 11 or 12 debtor that continues to operate its business as a fiduciary to the bankruptcy estate")). The fact that the receiver becomes, by operation of the Bankruptcy Code, a debtor-in-possession once a bankruptcy petition is filed is critical because a debtor-in-possession is not a "custodian" within the meaning of the Bankruptcy Code, *see* 11 U.S.C. § 101(11), and therefore is not required to deliver the debtor's assets to the trustee. *See Bayou* 363 B.R. at 685–87.

Here, while the Amended Receiver Order does not designate the Receiver as the debtor-in-possession, in the event of a bankruptcy filing, as noted by the *Bayou* court, the Receiver would automatically succeed to that role by operation of the Bankruptcy Code. There is no conflict, then, with 11 U.S.C. § 543, because a debtor-in-possession is not a custodian within the meaning of the statute.

While it is true that the *Bayou* court expressed regret over the inclusion of the debtor-in-possession reference in its order—insofar as making such a determination is "quintessentially the province of a bankruptcy judge"—it nonetheless upheld the order, *see id.,* and the court's reasoning for doing so is sound. Accordingly, I conclude that the Amended Receiver Order is not inconsistent with the Bankruptcy Code and decline to modify it.

B. *Improper Assertion of Jurisdiction*

[8] Movants argue that the provision of the Amended Receiver Order requiring this Court to hear disputes with respect to the Receiver's post-bankruptcy authority runs afoul of 28 U.S.C. § 157, which requires bankruptcy cases to be heard by bankruptcy judges. (Mov. Mem. 7). Section 157(d) provides that the Court can withdraw a case from the bankruptcy court's jurisdiction "for cause shown" if it "determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." Movants argue that no showing of cause has been made to justify a preemptive withdrawal of cases from the bankruptcy court. (Mov. Mem. 7).

I agree. Even assuming I have the authority to continue to exercise control over this case in the event a bankruptcy petition is filed, I decline to exercise that authority. If a bankruptcy petition is filed, the bankruptcy court will be well-equipped to ensure a fair and orderly process. If the parties disagree with any of the bankruptcy court's decisions, they are free to exercise their right to appeal. There is no reason to deviate from the usual procedures followed in bankruptcy court.

I therefore modify page ten of the Amended Receiver Order to strike the following language, which appears at the end of the disputed provision, after the reference to 11 U.S.C. § 543: "or to request a determination by this Court as to whether the Receiver should be deemed a debtor in ***540** possession or trustee, at a hearing, on due notice to all parties in interest, before the undersigned." In other words, if a bankruptcy petition is filed, the bankruptcy court will hear all disputes in the first instance, subject to the right of any party to appeal to the district court in accordance with the usual rules and procedures.

CONCLUSION

For the reasons set forth above, the Movants' motions to modify the Receiver Orders are denied, except that they are modified in the two respects indicated above.

SO ORDERED.

All Citations

592 F.Supp.2d 532

Footnotes

[1] Citations to "Mov. Mem." refer to the International Ad–Hoc Committee of Wextrust Creditors' motion to modify the receivership order, which was joined by the International Consortium of Wextrust Creditors. Citations to "Mov. Reply" refer to the International Ad–Hoc Committee's Reply. Citations to "SEC Opp." refer to the SEC's opposition brief. Citations to "Sordillo Decl." refer to the Declaration of John Sordillo filed in support of the Receiver's opposition brief. Citations to "Kahn Decl." refer to the Declaration of Mitchell P. Kahn filed in support of the Receiver's opposition brief. Citations to "11/14/08 Tr." refer to the Transcript of the hearing held on November 14, 2008.

[2] The SEC does not contest the Movants' right to seek appointment of a trustee under the legal standard set forth in 11 U.S.C. § 1104. (SEC Opp. 15 n. 6).

[3] The provision in *Bayou* read as follows:

> [The receiver shall] succeed to be the sole and exclusive managing member and representative of each of the Bayou Entities with the sole and exclusive power and authority to manage and direct the business and financial affairs of the Bayou Entities, including without limitation, the authority to petition for protection under the Bankruptcy Code, 11 U.S.C. §§ 101 et seq. (the "Code"), for any or all of the Bayou Entities and in connection therewith be and be deemed a debtor-in-possession for any or all of the Bayou Entities in proceedings under Chapter 11 of the Code, and prosecute such adversary proceedings and other matters as may be permitted under the Code and/or applicable law.

363 B.R. at 680. Similarly, the Amended Receiver Order, in addition to the provisions quoted above, authorizes the Receiver to "[s]ucceed to all rights to manage all properties owned or controlled, directly or indirectly, by the Wextrust [Entities] ... pursuant to the LLC and operating agreement relating to each entity." (Amended Receiver Order 5). Movants devote a great a deal of their briefs to differences between these two orders, but the reality is that, despite slight differences in language, both orders appoint the receiver to manage the affairs of the entities in receivership.

485 B.R. 650
United States Bankruptcy Court, D. Kansas.

In re BROOKE CORPORATION, Debtor. Christopher J. Redmond, Chapter 7 Trustee of Brooke Corporation, Brooke Capital Corporation (f/k/a Brooke Franchise Corporation), and Brooke Investments, Inc., Plaintiff, v. NCMIC Finance Corporation, Defendant.

Bankruptcy No. 08–22786.
|
Adversary No. 12–6043.
|
Jan. 15, 2013.

Synopsis
Background: In case converted from Chapter 11 to Chapter 7, Chapter 7 trustee brought adversary proceeding against entity that had, inter alia, provided commercial insurance premium financing to debtor, debtor franchisees, and insureds, seeking avoidance of allegedly constructively fraudulent transfers. Defendant filed counterclaim, seeking, for purposes of recoupment, offset, and/or administrative expense status, damages purportedly caused by tortious acts of custodian who was superseded by filing of debtor's initial Chapter 11 petition. Trustee filed motion to dismiss counterclaim.

Holdings: The Bankruptcy Court, Dale L. Somers, J., held that:

[1] those of defendant's counterclaims relating solely to prepetition conduct of the custodian were not entitled to administrative expense status as actual, necessary costs and expenses of preserving the estate;

[2] counterclaims relating to allegedly tortious conduct of special master were not entitled to administrative expense status as actual and necessary expenses incurred by a superseded custodian;

[3] alternatively, even if defendant's claims were viable administrative expense claims, they were barred as having been filed after the deadline to file administrative expense requests; and

[4] those counterclaims which arose prepetition could not be offset against trustee's postpetition fraudulent transfer claims.

Motion granted in part.

Procedural Posture(s): Motion to Dismiss; Motion to Dismiss for Failure to State a Claim.

West Headnotes (16)

[1] **Bankruptcy**🔑Priorities

Statutory priorities are to be narrowly construed because the presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among his creditors.

[2] **Bankruptcy**🔑Administrative expenses in general

Administrative expense priority generally is given to claims that satisfy two elements: (1) the claim resulted from a postpetition transaction, and (2) the claimant supplied consideration which was beneficial to the debtor-in-possession, or trustee, in the operation of the company's business. 11 U.S.C.A. § 503(b)(1)(A).

3 Cases that cite this headnote

[3] **Bankruptcy**🔑Administrative expenses in general
Bankruptcy🔑Time of accrual; prepetition claims

Pursuant to the Supreme Court's decision in *Reading*, the scope of the section of the Bankruptcy Code governing administrative expenses is expanded to encompass tort claims arising from postpetition conduct undertaken in the operation of the estate's business. 11 U.S.C.A. § 503(b)(1)(A).

5 Cases that cite this headnote

[4] **Bankruptcy**Time of accrual; prepetition claims

Those of adversary defendant's counterclaims against Chapter 7 trustee relating solely to prepetition conduct of custodian who was superseded by filing of debtor's initial Chapter 11 petition were not entitled to administrative expense status as actual, necessary costs and expenses of preserving the estate. 11 U.S.C.A. § 503(b)(1)(A).

1 Case that cites this headnote

[5] **Bankruptcy**Time of accrual; prepetition claims

Those of adversary defendant's counterclaims against Chapter 7 trustee relating to allegedly tortious conduct of special master who was superseded by filing of debtor's initial Chapter 11 petition were not entitled to administrative expense status as actual and necessary expenses incurred by a superseded custodian; tort claims based upon alleged prepetition misconduct by special master did not provide a benefit to the bankruptcy estate, nor did they arise from the operation of debtor's business under the protection of Chapter 11, such that there was no unfairness in giving adversary defendant's claims for tort damages the same status as other prepetition claims, and adversary defendant did not contend that it conferred a benefit on the estate but, instead, alleged that special master's wrongful acts in transferring certain funds benefited the estate. 11 U.S.C.A. §§ 101(11), 503(b)(3)(E).

1 Case that cites this headnote

[6] **Bankruptcy**Administrative expenses in general

Benefit requirement for administrative expenses is merely a way of testing whether a particular expense was truly necessary to the estate: if it was of no benefit, it cannot have been "necessary." 11 U.S.C.A. § 503(b)(1)(A), (b)(3)(E).

[7] **Bankruptcy**Administrative expenses in general
BankruptcyReorganization cases

Under the Bankruptcy Code's general administrative expense provision, administrative expense status requires that the consideration supporting the claimant's right to payment must have been beneficial to the trustee or debtor-in-possession. 11 U.S.C.A. § 503(b)(1)(A).

2 Cases that cite this headnote

[8] **Bankruptcy**Administrative expenses in general

Under the section of the Bankruptcy Code providing administrative expense status to the actual and necessary expenses incurred by a superseded custodian, the claimant must have benefited the estate. 11 U.S.C.A. § 503(b)(3)(E).

[9] **Bankruptcy**Time for Filing
BankruptcyExtension of Time; Excuse for Delay

Even if adversary defendant's counterclaims against Chapter 7 trustee arising from allegedly tortious acts of superseded custodian were viable administrative expense claims, they were barred as having been filed after the deadline to file administrative expense requests; custodian's failure to have promptly filed an accounting did not render the administrative claim bar date ineffective, and defendant failed to show cause for its untimely filing. 11 U.S.C.A. §§ 503(a), 543.

[10] **Bankruptcy**Turnover by custodians

Bankruptcy Code imposes three duties upon a custodian with knowledge of the commencement of a bankruptcy case: (1) not to take any action in the administration of the property of the debtor, (2) to deliver the property to the trustee, and (3) to file an accounting of any property of the debtor. 11 U.S.C.A. § 543.

[11] **Bankruptcy**Set-off or recoupment in general

Under the Bankruptcy Code, four elements are generally required for offset: (1) the creditor holds a claim against the debtor that arose before the commencement of the case, (2) the creditor owes a debt to the debtor that also arose before

the commencement of the case, (3) the claim and the debt are mutual, and (4) the claim and the debt are each valid and enforceable. 11 U.S.C.A. § 553.

1 Case that cites this headnote

[12] **Bankruptcy**🔑Mutuality; identity of right, person, and capacity

For debts to be "mutual," for purposes of offset, the parties must owe the debts to one another in the same capacities or relationships, and the debts must be of the same character. 11 U.S.C.A. § 553.

[13] **Bankruptcy**🔑Prepetition, post-petition, and unmatured debts

Those of adversary defendant's counterclaims which arose prepetition could not be offset against Chapter 7 trustee's claims under the Uniform Fraudulent Transfer Act (UFTA) and the Bankruptcy Code's fraudulent transfer section, which arose postpetition. 11 U.S.C.A. §§ 544(b), 550, 553; West's K.S.A. 33–204(a)(2), 33–205(a), 33–207.

1 Case that cites this headnote

[14] **Bankruptcy**🔑Set-off or recoupment in general

Offset is a universally recognized right grounded in principles of fairness that is not, with a few limited exceptions, affected by the Bankruptcy Code. 11 U.S.C.A. § 553.

[15] **Bankruptcy**🔑Set-off against claim

Claimant's failure to include all of its prepetition claims in its timely filed proof of claim did not preclude offset of Chapter 7 trustee's claims against the omitted claims. 11 U.S.C.A. § 553.

[16] **Bankruptcy**🔑Set-off or recoupment in general
Bankruptcy🔑Mutuality; identity of right, person, and capacity

In bankruptcy, the common law doctrine of recoupment is distinct from setoff; for "setoff," the mutual debts need not have arisen out of the same transaction, but for "recoupment," the same transaction requirement does apply. 11 U.S.C.A. § 553.

Attorneys and Law Firms

***652** John J. Cruciani, Michael D. Fielding, Husch Blackwell LLP, Kansas City, MO, for Plaintiff.

Brendan L. McPherson, Paul D. Sinclair, Polsinelli Shughart, P.C., Kansas City, MO, Jason L. Bush, Polsinelli Shughart PC, Overland Park, KS, for Defendant.

MEMORANDUM OPINION AND ORDER GRANTING IN PART THE PLAINTIFF'S MOTION TO DISMISS COUNTERCLAIM COMPLAINT

DALE L. SOMERS, Bankruptcy Judge.

Plaintiff Christopher J. Redmond, Chapter 7 Trustee (Trustee) of Debtors Brooke Corporation, Brooke Capital Corporation, and Brooke Investments, Inc., moves under Federal Rule of Civil Procedure 12(b)(6) and (c), made applicable to this proceeding by Federal Rule of Bankruptcy Procedure 7012(b), to dismiss the counterclaims asserted by Defendant NCMIC Finance Corporation (NCMIC or Defendant). The motion presents the question whether a creditor's claims for damages allegedly caused by the tortious acts of a custodian, who was superseded by the filing of a petition under Chapter 11 and the appointment of a Chapter 11 Trustee, are entitled to administrative priority under ***653** 11 U.S.C. § 503(b)(1)(A) or (b)(3)(E).[1] After carefully considering the pleadings and the oral arguments of counsel,[2] the Court finds that only the claims arising from postpetition conduct are eligible for administrative expense status, but that, except for the one claim that was asserted in NCMIC's proof of claim, administrative expense status for those claims is barred by a prior order of the Court. As to NCMIC's prayer that the counterclaims defeat the Trustee's fraudulent conveyance claims against it, the Court finds that only the counterclaims arising from postpetition conduct are eligible for offset under § 553 and that recoupment is not available for any of the counterclaims. Based on these rulings, the Trustee's motion is granted in part.

BACKGROUND FACTS.

The Brooke group of companies was involved in many aspects of insurance and insurance-related businesses, including a network of insurance franchisees and agents. The parent company was Debtor Brooke Corporation (Brooke Corp.). Debtor Brooke Capital Corporation (Brooke Capital), a majority-owned subsidiary of Brooke Corp., owned 100% of Brooke Capital Advisors, Inc. (BCA), which has not filed bankruptcy but was involved in events relevant to this proceeding. Brooke Capital also owned 100% of Debtor Brooke Investments, Inc. The three Brooke Debtors will be referred to collectively as Debtors.[3] Another relevant majority-owned subsidiary of Brooke Corp. was Brooke Credit Corporation, d/b/a Aleritas Capital Corporation (Aleritas), which has not filed bankruptcy. Aleritas was engaged in lending money to Brooke franchisees and other insurance agents.

Defendant NCMIC, which began its relationship with Brooke in 1998, initially fulfilled a "warehouse" financing role for Brooke agency franchise loans, holding the loans until they were securitized or sold to community banks. Later, NCMIC provided insurance premium financing and merchant credit card processing services to Brooke agents/franchisees. In addition, NCMIC purchased various participation interests in loans which Aleritas made to Brooke agents.

Brooke's business did not flourish. The Trustee alleges that the Brooke business model was unsustainable. On September 11, 2008, the Bank of New York Mellon, as trustee, filed an Emergency Motion for the Appointment of a Receiver with the United States District Court for the District of Kansas.[4] The Brooke defendants opposed the motion and sought the appointment of a Special Master instead. A hearing was held, and the parties agreed the District Court should enter a Consent Order Appointing a Special Master. Pursuant to that order, Albert A. Riederer (Riederer) was appointed Special Master of the "Special Master Entities," defined to be Brooke Capital, Brooke Corp., and BCA. The Special Master had authority to administer and manage the Special Master Estate, including the following power and authority:

> to take custody, control and possession of all records, assets, funds, bank accounts, brokerage accounts, premises and other materials of any kind in the ***654** possession of or under the direct or indirect control of the Special Master Entities related to the Special Master Estate, and to direct the application thereof as set forth in the agreements of the Special Master Entities and their subsidiaries governing the same.[5]

Brooke Corp. and Brooke Capital filed voluntary Chapter 11 petitions on October 28, 2008, and Brooke Investments, Inc., filed a voluntary petition under Chapter 11 on November 3, 2008. Riederer was appointed as Chapter 11 Trustee of the three Debtors. On June 29, 2009, the Chapter 11 proceedings were converted to Chapter 7. Riederer initially served as Chapter 7 Trustee. On November 3, 2011, Plaintiff Christopher J. Redmond was appointed as successor Chapter 7 Trustee.

The Trustee filed this adversary proceeding against NCMIC on May 5, 2012. His Complaint alleges five counts: Count I for avoidance of a security interest; Counts II and III for recovery of allegedly preferential transfers; and Counts IV and V for recovery of allegedly constructively fraudulent transfers.[6] Counts I, II, and III were dismissed by consent, after NCMIC filed a motion for summary judgment.[7] Defendant describes the Trustee's pending claims to avoid fraudulent transfers[8] as seeking recovery of the following: (1) $5.6 million in loan payments made by Aleritas on loans to franchisees that were assigned to NCMIC; (2) $17 million in loan payments to other lenders which allegedly benefitted NCMIC; and (3) $22.3 million in franchisees' operating expenses that were paid to third parties, such as landlords and utility companies, which allegedly benefitted NCMIC.[9] NCMIC responded to the Complaint with an answer denying the allegations and asserting its "Counterclaim for Purposes of Recoupment, Offset and/or Administrative Claim" (the Counterclaim Complaint).[10] Under various tort theories, NCMIC seeks compensation for multi-million dollar losses allegedly relating to the following described activities engaged in during the period that the Special Master was in charge of the Debtors' estates, plus limited claims for the conduct of Riederer as Chapter 11 Trustee.

Some of the claims asserted by NCMIC arise from NCMIC's relationship with CJD & Associates, LLC (CJD), a limited liability company which was a wholly-owned subsidiary of Brooke Brokerage Corporation, which, in turn, was wholly owned by Brooke Corp. On September 13, 2005, NCMIC purchased a 74.803% interest in a $2.525 million loan from Aleritas to CJD. In the spring of 2008, NCMIC loaned $2.5 million to Brooke Corp., secured by an assignment of Brooke Brokerage's 100% interest in CJD. NCMIC alleges that on September 17, 2008, the first day Riederer served as Special Master, unbeknownst to CJD and NCMIC, $1.38 million was transferred from CJD's bank account to Brooke

Corp., and that an additional $428,000 was transferred from CJD to Brooke on the following day. CJD's financial condition deteriorated, and Brooke Corp. defaulted on the CJD loan. On December 22, 2008, after Brooke Corp. filed for bankruptcy relief, Riederer, as Trustee, filed an emergency motion requesting permission to abandon the stock ***655** of CJD to NCMIC. The motion was granted. Thereafter, NCMIC entered into an "Agreement to Accept Collateral in Satisfaction of Obligations" and, in accord with that agreement, made two $25,000 payments to the Trustee and became the owner of CJD. In an effort to prop up CJD, NCMIC alleges it incurred obligations of approximately $2.94 million and also paid $25,000 to acquire the remaining 25.197% participation interest in the loan from Aleritas to CJD.

Some elements of NCMIC's counterclaim arise out its longstanding relationship in providing commercial insurance premium financing to Brooke Capital, Brooke franchisees, and insureds who dealt with Brooke franchisees. Under this arrangement, NCMIC advanced funds for premium payments, and the insureds assigned to NCMIC as security all unearned premiums and dividends which became payable under the financed policies. If financed policies were cancelled, NCMIC was entitled to the return of any unearned premiums and commissions. NCMIC claims that Riederer as Special Master wrongfully retained $178,541.20 in unearned premiums and $17,517.85 in unearned commissions. NCMIC also seeks to recover $170,724.86 as amounts which it advanced to Brooke for financed premiums but which it alleges Brooke failed to remit to the insurance carriers. In addition, NCMIC financed Brooke Capital's purchase of errors and omissions policies for its franchisees. Despite Brooke Capital's failure to make timely payment of the funds due to NCMIC under this arrangement, on September 25, 2008, upon receipt of partial payment, NCMIC alleges it honored Trustee Riederer's request not to cancel the policies and continued to make payments that allowed the policies to stay in effect until December 2008. NCMIC asserts a loss of $126,000 stemming from its financing of the E & O policies.

NCMIC also seeks to recover various payments made to Riederer as Special Master and as Chapter 11 Trustee. These include payments related to FTI Consulting, which was utilized by Riederer with respect to Brooke Corp. issues, and Silverman Consulting, which was utilized by Riederer with respect to Aleritas issues. In addition, NCMIC asserts a claim based upon its purchase of 100% participation interests in one loan from Aleritas to Midwest Funeral Real Estate Management Company and another to RKC Financial Corporation, a Brooke franchisee. As to the RKC loan, it is alleged that Riederer defaulted by failing to appear for an arbitration scheduled for October 21, 2008, thereby precluding NCMIC's collection from RKC based upon its participation interest.

The Trustee responded to the Counterclaim Complaint with a motion to dismiss, the matter which is the subject of this opinion. The Trustee's motion and supporting memorandum includes the following chart of NCMIC's counterclaims, which the Court has edited to remove notes commenting about the claims. The columns are self-explanatory, except for column three, labeled "counts." It identifies the legal theories of recovery for each claim using numbers defined as: (1) breach of fiduciary duty; (2) conversion; (3) fraudulent transfer; (4) negligence; (5) money had and received; and (6) unjust enrichment. The paragraph numbers in the "Description" column refer to paragraphs in the Counterclaim Complaint.

Claim	Amount	Counts	Description
CJD Loan Losses	$3,314,000.00	1, 4	Pre-petition debt obligation due to pre-petition loans made to CJD. *See* ¶¶ 29–36.
CJD Capital Infusions	$2,949,000.00	1, 4	Monies which NCMIC infuse d into CJD after NCMIC acquired the CJD stock from Brooke Brokerage. *See* ¶ 59. Note: NCMIC has not alleged in its Counterclaims that any of these moneies when to or for the benefit of the Debtors' estates.
CJD Consideration Payments	$ 50,000.00	1, 4	Monies transferred by NCMIC to the Debtors postpetition. *See* ¶ 44.
CJD Farmers Payment	$ 25,000.00	1, 4	Monies paid by NCMIC to Farmers and Merchants Bank of Hill City ("Farmers") to acquire the participated loan interest on which CJD was obligated. *See* ¶ 54. The Farmers participation interest related to a November 2003 loan. *See* ¶ 30.
CJD Transfers	$3,895,784.00	3	Pre-petition debt obligation stemming from the alleged transfer of funds from CJD to Brooke. *See* ¶ 58, 65, 164.
Wrongfully Withheld Unearned Premiums	$ 178,541.20	1, 2, 4	Pre-petition debt obligation stemming from Brooke's alleged failure to remit or turnover unearned premiums it had allegedly received from cancelled policies where NCMIC had provided premium financing. *See* ¶¶ 79–80.
Wrongfully Withheld Unearned Commissions	$ 17,517.85	1, 2, 4	Pre-petition debt obligation stemming from Brooke's alleged retention of unearned commissions due to unearned premiums that had been returned to NCMIC. *See* ¶¶ 86–87.
Wrongfully Withheld Financed Amounts	$ 170,724.86	1, 2, 4	Pre-petition debt obligation stemming from Brooke's receipt of financed premium which Brooke allegedly failed to remit to the appropriate carrier or general agent. *See* ¶¶ 93–94.
Unearned Premium E & O Loss	$ 126,000.00	5, 6	Pre-petition debt obligation stemming from an E & O policy which was financed pre-petition. *See* ¶¶ 101–109; 111–113; 117.

FTI Related Payment	$ 150,000.00	5, 6	Pre-petition debt obligation due to NFC's wire transfer of $150,000 to Brooke on October 10, 2008, with the monies being intended to begin winding down Brooke. *See* ¶¶ 110; 119–120.
Silverman Related Payment	$ 40,435.00	5, 6	Monies transferred on November 5, 2008, due to a request for funds "to keep Aleritas alive after the Debtors filed for bankruptcy." ¶ 122; *see also* ¶ 123.
Silverman Related Retention	$ 114,577.00	5, 6	Amounts allegedly owed by Aleritas to NCMIC for loan payments. *See* ¶¶ 124–125.
Midwest Funeral Proceeds	$ 105,511.89	2, 4	Amounts allegedly owed by Aleritas to NCMIC on a loan in which NCMIC held a participated interest, and on which Aleritas allegedly foreclosed and obtained gross sales proceeds in October 2008. *See* ¶¶ 127–131.
RKC Loss	$1,146,508.00	1, 4	Pre-petition debt obligation due to a 100% participated loan interest which NCMIC owned where the Brooke franchisee (i.e., the borrower) filed an arbitration proceeding against Brooke Corp., Aleritas (f/k/a Brooke Credit Corp.) and BASC and others, and obtained an arbitration award on October 21, 2008. *See* ¶¶ 133–146.
Merchant Fee Loss	$ 42,555.00	1, 2, 4	Pre-petition debt obligation which occurred in October 2008 due to fees and losses which Brooke was allegedly responsible to pay NCMIC due to rejected ACH transactions. *See* ¶¶ 148–156.

***656 ANALYSIS.**

A. NCMIC's counterclaims are for the purposes of recoupment, offset, and/or administrative expense status.

NCMIC asserts its counterclaims only for the purposes of recoupment, offset, and/or administrative expense status[11] as a means to defeat recovery on the Trustee's fraudulent transfer claims alleged in the Complaint. The Trustee's motion to dismiss is therefore directed at these purposes—the Trustee's primary position is *not* that the tort claims fail to state claims for which relief may be granted; rather, it is that NCMIC's tort claims are not entitled to administrative expense status, and ***657** further, that neither recoupment nor offset apply. The Trustee's motion to dismiss under Rule 12(b)(6) tests the legal sufficiency of NCMIC's allegations.

B. Whether any of NCMIC's counterclaims may be entitled to administrative expense status.[12]

1. Applicable Code provisions.

[1] Allowance of administrative expenses is addressed by § 503. Subsections (b)(1)(A) and (b)(3)(E) are relied upon by NCMIC. They provide in relevant part as follows:

> (b) After notice and a hearing, there shall be allowed administrative expenses ..., including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate ... [and]
>
> ...
>
> (3) the actual, necessary expenses ... incurred by—
>
> ...
>
> (E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian.

Under §§ 507(a)(1)(C) and (a)(2) and 726(a)(1), administrative expenses are entitled to priority. "Statutory priorities are to be narrowly construed '[b]ecause the presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among his creditors.' "[13] The question here is whether any of the tort claims alleged in the Counterclaim Complaint satisfy the foregoing definitions of administrative expenses.

2. With minor exceptions, NCMIC's claims are not administrative expenses under § 503(b)(1)(A).

[2] Generally, administrative expense priority under § 503(b)(1)(A) is given to claims that "satisfy two elements: (1) the claim resulted from a post-petition transaction, and (2) the claimant supplied consideration which was beneficial to the debtor-in-possession (or trustee) in the operation of the company's business."[14] "Thus at first blush, it would appear that postpetition tort claims could never gain administrative status because it is difficult to envision a tort 'benefiting' the bankruptcy estate."[15] However, in *Reading,*[16] a 1968 case decided under the Bankruptcy Act, the United States Supreme Court held that damages resulting from the negligence of a receiver appointed under Chapter XI acting within the scope of his authority as receiver gave rise to actual and necessary costs of administration in a Chapter XI arrangement, entitling the ***658** claim to priority. The Court reasoned as follows:

> Petitioner [the tort claimant whose property was destroyed by fire] suffered grave financial injury from what is here agreed to have been the negligence of the receiver and a workman. It is conceded that, in principle, petitioner has a right to recover for that injury from their 'employer,' the business under arrangement, upon the rule of respondeat superior.
>
> ....
>
> ... The 'master,' liable for the negligence of the 'servant' in this case was the business operating under a Chapter XI arrangement for the benefit of creditors and with the hope of rehabilitation. That benefit and that rehabilitation are worthy objectives. But it would be inconsistent both with the principle of respondeat superior and with the rule of fairness in bankruptcy to seek these objectives at the cost of excluding tort creditors of the arrangement from its assets, or totally subordinating the claims of those on whom the arrangement is imposed to the claims of those for whose benefit it is instituted.[17]

"Although *Reading* involved interpretation of § 64a of the Bankruptcy Act, subsequent decisions have recognized that *Reading's* analysis carries over to Code § 503(b)."[18]

The *Reading* rationale has been expanded to apply to statutory penalties incurred postpetition, in addition to tortious damages incurred postpetition.[19] But the Tenth Circuit has held that it does not extend to such claims when they arise from prepetition conduct. In *CF & I Fabricators,* the debtors sponsored a pension plan subject to the standards of the Internal Revenue Code and ERISA, but failed to meet their funding obligations before filing under Chapter 11. The Pension Benefit Guarantee Corporation asserted claims against the estate and sought priority status for them as tax claims or, alternatively, as administrative expenses. After rejecting the assertion that the claims were tax claims, the Tenth Circuit considered and rejected the position that the claims were entitled to administrative priority under the *Reading* rationale. "Even if we were to assume the contributions were statutory in nature [so that the *Reading* rationale applied], the *Reading* line of cases only allows administrative priority for post-petition expenses."[20] Because the claims were derived from pension credits relating to work performed prepetition, the postpetition requirement was not satisfied; for purposes of *Reading,* liabilities are not incurred postpetition simply because they become due postpetition. Other circuit courts of appeal also limit the *Reading* rationale to expenses arising from postpetition conduct.[21]

[3] To summarize, administrative expense status under § 503(b)(1)(A) is generally limited to claims which result from postpetition transactions which benefitted the debtor-in-possession (or trustee) in the operation of the company's business. Under *Reading,* which may be viewed as an ***659** exception to the benefit rule for purposes of § 503(b)(1)(A), the scope of § 503(b)(1)(A) is expanded to encompass tort claims arising from postpetition conduct undertaken in the operation of the estate's business.

[4] Under these standards, as a matter of law, most of NCMIC's claims are not administrative expenses under § 503(b)(1)(A). The only claims which relate to postpetition conduct are those seeking recovery of: (1) a postpetition payment to the Brooke estates of $50,000 as CJD-acquisition consideration, alleged to be damages for the Trustee's breach of fiduciary duty and negligence[22]; (2) the postpetition portion (which the Trustee contends is $16,772.99) of NCMIC's $178,541.20 claim for allegedly Wrongfully Withheld Unearned Premiums, as damages for the Trustee's breach of fiduciary duty, conversion, and negligence; and (3) the postpetition portion (which the Trustee contends is $913.59) of NCMIC's $17,517.85 claim for Wrongfully Withheld Premiums, as damages for the Trustee's breach of fiduciary duty, conversion, and negligence. All of the other claims are excluded from § 503(b)(1)(A) as a matter of law because they relate solely to prepetition conduct.

3. NCMIC's claims which relate to Riederer's prepetition conduct as Special Master are not entitled to administrative expense status under § 503(b)(3)(E).

[5] NCMIC's primary argument for administrative expense priority for the damages alleged to have been caused by the torts of Riederer as Special Master[23] relies upon § 503(b)(3)(E), quoted above. That provision defines administrative expenses to include the actual and necessary expenses incurred by a custodian superseded under § 543,[24] thereby including some claims arising from prepetition conduct within the definition of administrative expenses. But, as examined below, one requirement for such expenses is that they provided a benefit to the bankruptcy estate. The Court concludes that NCMIC'S claims based upon the allegedly tortious conduct of the Special Master fail to satisfy this requirement.

The concept of using estate funds to compensate a superseded custodian but limiting such expenses to those benefitting the estate has its origins in *Randolph &* ***660** *Randolph v. Scruggs,*[25] a 1903 decision of the Supreme Court, which allowed a bankruptcy claim for compensation for services rendered by a superseded assignee for the benefit of creditors which were beneficial to the bankruptcy estate. The Supreme Court stated:

> We are not prepared to go further than to allow compensation for services which were beneficial to the estate. Beyond that point we must throw the risk of his conduct on the assignee, as he was chargeable with the knowledge of what might happen.[26]

The legislative history of § 503(b)(3)(E) reflects an intent to codify *Randolph* by giving administrative expense status only "to the extent such services actually benefit the estate."[27]

[6] Courts generally require a benefit to the estate when finding that expenses of a superseded custodian are entitled to administrative expense status.[28] In addition to the legislative history, this construction is supported by the use

of the phrase "actual, necessary expenses" in § 503(b)(3)(E). The general administrative expense provision, § 503(b)(1)(A), uses the similar phrase "actual, necessary costs and expenses." The Tenth Circuit construes § 503(b)(1)(A) to require that the consideration supplied by the claimant was " 'beneficial to the debtor-in-possession in the operation of the business.' "[29] As the Fifth Circuit has found, the benefit requirement is " 'merely a way of testing whether a particular expense was truly "necessary" to the estate: If it was of no "benefit," it cannot have been "necessary." ' "[30] NCMIC's tort claims based upon alleged misconduct by the Special Master are not typical of claims arising from actions which benefitted the estate.

Nevertheless, according to NCMIC, such claims are "actual and necessary expenses" for purposes of § 503(b)(3)(E) under *Reading,* discussed above. Alternatively, NCMIC argues that the custodianship estate and, ultimately, the bankruptcy estate benefitted from the conduct at issue. The Court rejects these rationales for finding that damages allegedly caused by the tortious acts of the special master are eligible for administrative expense treatment.

The parties agree, and this Court's research has confirmed, that there are no cases applying *Reading* to allow administrative expense status to tort claims which arose prepetition. As discussed above, courts applying *Reading* for purposes of § 503(b)(1)(A) restrict administrative expense treatment to claims based upon postpetition conduct. Further, contrary to NCMIC's arguments, the Court finds the rationale of *Reading* does not support the expansion of administrative expense status ***661** to tort claims arising from prepetition conduct of a superseded custodian. The primary rationale of *Reading* was recognition of the benefit to creditors from reorganization and the unfairness of subordinating the claims of those injured as a result of the operation of a debtor's business to the claims of creditors for whose benefit the reorganization was instituted. Therefore, under *Reading,* "[i]n order for a tort damage or other similar claim to be accorded administrative priority, it should arise from the operation of the debtor's business."[31] But NCMIC's tort claims alleged against the Special Master did not arise from the operation of Brooke's business under the protection of Chapter 11. There is no unfairness in giving NCMIC's claims for tort damages the same status as other prepetition claims. To argue benefit to the estate based upon the operation of Brooke's business by the Special Master would move the line of demarcation created by the filing of a Chapter 11 proceeding from the date of filing to the date of the appointment of the superseded custodian. If this is to be the law, Congress, not a court, would be the proper body to so provide, and Congress has not done so.

[7] [8] Further, the Court rejects NCMIC's alternative contention that benefit to the estate for purposes of § 503(b)(3)(E) is present based upon the specific Special Master transactions which are the basis for the tort claims. For example, NCMIC argues that the Special Master estate, and therefore the bankruptcy estate, benefitted when the Special Master allegedly tortiously transferred funds from CJD to Brooke. It is true that the estate allegedly received the funds, but NCMIC's focus is misdirected. Under § 503(b)(1)(A), administrative expense status requires that the *consideration supporting the claimant's right to payment* must have been beneficial to the trustee or debtor-in-possession.[32] Similarly, under § 503(b)(3)(E), the claimant must have benefitted the estate. Here NCMIC is not claiming that it conferred a benefit on the estate; it is alleging the Special Master's wrongful acts benefitted the estate. NCMIC is claiming it was injured, and is attempting to recover from the Trustee the losses that it alleges it suffered because of the acts of the Special Master. Whether those acts benefitted the Special Master estate or ultimately the bankruptcy estate is not the issue.

For the foregoing reasons, the Court finds that the claims asserted by NCMIC against the estate are not entitled to administrative expense status under § 503(b)(3)(E). There is no precedent extending the *Reading* rule allowing administrative expense status under § 503(b)(1)(A) for damage claims for torts committed by a bankruptcy trustee during the operation of the debtor's business to § 503(b)(3)(E) for expenses incurred by a superseded custodian. Further, apart from *Reading,* NCMIC has not shown that its claims arise from its own, in contrast to the Special Master's, prepetition activities which conferred a benefit on the estate, as required for administrative expense status under § 503(b)(3)(E).

4. Administrative expense status of NCMIC's Counterclaims is barred by a prior order of the Court.

[9] Alternatively, the Trustee argues that even if NCMIC's claims were viable administrative expense claims, NCMIC ***662** would not be entitled to judgment for any administrative expense claims against the Debtors' estates because NCMIC's purported administrative expense claims

have been barred and discharged by a prior order of the Court. On October 13, 2009, an order was entered in the main bankruptcy case establishing November 30, 2009, as the bar date for all holders of any Chapter 11 administrative expense claims.[33] The order provided in part:

> Any person or entity that is required, but fails, to file an Administrative Expense Request for its Chapter 11 Administrative Expense in accordance with the procedures set forth in this Order on or before the Administrative Bar Date (a) shall be forever barred, estopped, and enjoined form asserting any Chapter 11 Administrative Expense against the Debtors and the Debtors shall be forever discharged from any and all indebtedness or liability with respect to such Chapter 11 Administrative Expenses, and (b) shall not be permitted to receive payment from the Debtors' estates or participate in any distribution in the Debtors' Chapter 7 cases on account of such Chapter 11 Administrative Expense.[34]

On October 16, 2009, a Notice of Deadline to File Administrative Expense Requests was filed.[35] It is undisputed that NCMIC received both the October 13, 2009, order and the October 16, 2009, notice. NCMIC did not file an administrative expense claim in accordance with the orders by the November 30, 2009, bar date. The administrative claims were asserted in the Counterclaim Complaint filled on June 25, 2012. The Trustee contends the estates are therefore discharged from any liability for the administrative claims asserted by NCMIC.

NCMIC responds that the argument fails because: (1) the claims arising from Riederer's acts or omissions as Special Master are viable because Riederer as a superseded custodian has not filed a § 543 accounting; (2) there are numerous exceptions to claim bar dates and proofs of claim may be amended; and (3) the administrative bar date does not apply. Of course, the Trustee argues none of NCMIC's positions are valid.

[10] Section 543 imposes three duties upon a custodian with knowledge of the commencement of a bankruptcy case: (1) not to take any action in the administration of the property of the debtor; (2) to deliver the property to the trustee; and (3) to file an accounting of any property of the debtor. Bankruptcy Rule 6002(a) provides that the custodian shall "promptly" file a report and account, and transmit it to the United States Trustee. Subsection (b) provides that after the report and account is filed and an examination has been made into the superseded administration, "after notice and a hearing, the court shall determine the propriety of the administration, including the reasonableness of all disbursements."

The only authority provided by NCMIC in support of its position that Riederer's failure to promptly file an accounting renders the administrative claim bar date ineffective is *American Bridge Products*.[36] The court in that case held that under state law, the statute of limitations did not ***663** begin to run on a bankruptcy trustee's claims to impose personal liability on the debtor's prebankruptcy state court receiver for negligence and breach of duty until the receiver had rendered a final accounting or been discharged in either state or federal court. But *American Bridge Products* does not address a bar date established by the bankruptcy court; it is concerned with tolling of the state law limitation period on state law causes of action asserted by a bankruptcy trustee. Likewise, neither the Code nor bankruptcy rules provide any basis for finding that a failure to promptly file an accounting affects the enforcement of a bar date for claiming administrative expense status for claims against a bankruptcy estate as the successor to the official-capacity liability of a superseded custodian.

Second, NCMIC points out that its proof of claim, claim number 1073, was filed on November 2, 2009, before the administrative claim bar date. It included a claim for $178,541.20 for conversion of Wrongfully Withheld Unearned Premiums, and a statement that a portion of this claim might be entitled to administrative expense priority. NCMIC argues that creditors may amend proofs of claim and those amendments generally relate back so they are deemed timely filed. Contemporaneously with filing its objection to the Trustee's motion to dismiss, NCMIC filed an amended proof of claim which includes a priority claim of $8,430,370.80, comprised of all the claims alleged in the Counterclaim Complaint. It therefore asserts its administrative claims were timely filed.[37]

But NCMIC's argument overlooks § 503(a), which provides: "An entity may timely file a request for payment of an administrative expense, or may tardily file such request if permitted by the court for cause." NCMIC has failed to show cause for its untimely filing. Although the Court does not doubt that NCMIC did not seriously evaluate the possibility it might have claims against the estate until after it was sued by the Trustee on May 5, 2012, this circumstance does not

constitute cause for allowing an untimely filing of an administrative claim.

Finally, NCMIC argues that the administrative bar date order is ineffective to discharge the estate's liability for NCMIC's claims because the definition of an administrative expense included in the October 16, 2009, notice of the October 13, 2009, order relates only to those claims arising from the date of filing to the date of conversion to Chapter 7. The only claims which the Court has found not to be precluded from administrative expense status as a matter of law arose during the defined period and are therefore included within the scope of the order. As discussed above, the remaining claims, those arising from allegedly wrongful acts of the Special Master, even though arguably outside of the time frame to which the order applies, are nevertheless barred from administrative expense status as a matter of law.

The only counterclaim arising postpetition which is not excluded from administrative expense status by the prior order is the postpetition portion of the claim for Wrongfully Withheld Unearned Premiums.

C. Most of NCMIC's Counterclaims are not eligible to be offset against the Trustee's claims.

1. NCMIC's counterclaims which arose prepetition may not be offset against the Trustee's claims against NCMIC.

NCMIC's Counterclaim Complaint seeks a judicial determination that it has the ***664** right to offset the amount of its alleged injuries against any monies that the Trustee may recover from it. The Trustee argues this relief must be denied because under § 553, the Code section addressing offset, NCMIC's prepetition claims may not be offset against the Trustee's postpetition claims.

[11] [12] [13] The parties agree that under § 553, four elements are generally required for offset: (1) the creditor holds a claim against the debtor that arose before the commencement of the case; (2) the creditor owes a debt to the debtor that also arose before the commencement of the case; (3) the claim and the debt are mutual; and (4) the claim and the debt are each valid and enforceable.[38] For debts to be mutual, "[t]he parties must owe the debts to one another in the same capacities or relationships and the debts must be of the same character."[39] The controversy in this case is about the second and third elements. The Trustee asserts mutuality is lacking because NCMIC's claims (its counterclaims) are prepetition and its debts (the Trustee's Uniform Fraudulent Transfer Act (UFTA) claims[40]) are postpetition. NCMIC responds that since the Trustee is asserting fraudulent conveyance claims under state law by stepping into the shoes of prepetition creditors of NCMIC, the Trustee's claims arose prepetition.

Courts generally hold that a prepetition claim against the debtor may not be set off against a trustee's preferential transfer or fraudulent transfer claim.[41] With respect to preferential transfer claims, the Fifth Circuit Court of Appeals in a 1924 case stated:

> The reason is, to permit this to be done would defeat the right to recover the preference and render the statute futile. In such a case the transaction is single, and results in a depletion of the fund that would otherwise have gone to creditors to the extent of the preferential payments. Allowing the creditor to set off the debt due him against the payments received by him would leave the preference unremedied. In this class of cases, the right to offset is denied, because the estate has been depleted to the detriment of creditors of like class, and to allow the right of set-off would perpetuate the depletion.[42]

It applied the same reasoning to a claim of fraudulent transfer under the 1898 Bankruptcy Act.[43] In 1991, the Ninth Circuit Court of Appeals agreed the rule applied to a fraudulent conveyance claim under § 548 of the Code,[44] and in 1994, applied it to a fraudulent conveyance claim under state law.[45]

Nevertheless, NCMIC asserts it may offset its prepetition claims against any recovery on the Trustee's UFTA claims. NCMIC would have this Court rule that, although preferential transfer claims under § 547 and fraudulent transfer claims ***665** under § 548 arise postpetition for purposes of § 553, state law fraudulent conveyance claims asserted under § 544(b) do not.[46] According to NCMIC, this is so because the state law UFTA claims arose entirely separately and independently of the bankruptcy and, under § 544, the Trustee steps into the shoes of an actual creditor who, prepetition, could have brought the alleged fraudulent transfer claim against NCMIC.

The Court rejects NCMIC's attempt to distinguish claims under §§ 547 and 548 from claims under § 544. NCMIC

cites no case authority and no commentators supporting its position. The Trustee's rights under § 544, just like his rights under §§ 547 and 548, did not exist until the bankruptcy was filed. Section 544 "creates a status and allows applicable nonbankruptcy law to determine the rights that accrue as a result of the created status."[47] Although generally, § 544(b) confers upon the trustee no greater rights of avoidance than a creditor would have had if it were asserting invalidity on its own behalf, there are exceptions.[48] For example, the trustee is not denied relief because of the prepetition wrongful conduct of the debtor.[49] Also, the trustee may avoid the entire transfer for the benefit of the estate, without regard to the size of the claim of the creditor whose rights and powers the trustee is asserting.[50] And § 502(d) specifically requires disallowance of any claim of an entity from which property is recoverable under a Chapter 5 cause of action, including claims under § 544. It would render § 502(d) meaningless if a setoff of prepetition claims could be effectuated as a defense against Chapter 5 causes of action.

The Court therefore rejects NCMIC's contention that its counterclaims which arose prepetition can be offset against the Trustee's UFTA claims. The Trustee's motion to dismiss should be granted on this issue.

2. NCMIC's counterclaims which arose postpetition are not as matter of law precluded from offset.

NCMIC's only counterclaims which relate to postpetition conduct seek recovery of: (1) the CJD-consideration payment of $50,000 as damages for the Trustee's alleged breach of fiduciary duty and negligence; (2) the postpetition portion (which the Trustee contends is $16,772.99) of the $178,541.20 claim for allegedly Wrongfully Withheld Unearned Premiums, as damages for breach of fiduciary duty, conversion, and negligence; and (3) the postpetition portion (which the Trustee contends is $913.59) of the $17,517.85 claim for Wrongfully Withheld Premiums, as damages for breach of fiduciary duty, conversion, and negligence. The Trustee does not argue that these claims as a matter of law are outside the offset allowed by § 553.

3. NCMIC's failure to include all of its prepetition claims in its timely filed proof of claim does not preclude offset of the Trustee's claims against the omitted claims.

The Trustee argues that most of NCMIC's prepetition claims are time ***666** barred. On July 20, 2009, the Court entered on order establishing November 9, 2009, as the deadline for filing claims against the Debtors' estates. On November 2, 2009, NCMIC filed a proof of claim, but it included only a small portion of the claims asserted in the Counterclaim Complaint. In response to the Trustee's motion to dismiss, NCMIC filed an amended proof of claim and argues that amendments of claims are freely granted and that such amendments relate back.

[14] [15] Both parties have overlooked the rule in the Tenth Circuit that "timely filing of a proof of claim is not a prerequisite to asserting a right of setoff under 11 U.S.C. § 553."[51] This rule is based on the fact that offset is "a universally recognized right grounded in principles of fairness that [is] not, with a few limited exceptions, affected by the Bankruptcy Code."[52] The Court therefore finds that NCMIC's failure to file a timely proof of claim for all of the damages alleged in the Counterclaim Complaint does not provide a basis for denial of offset.

D. Recoupment is not a legally valid defense to the Trustee's claims.

[16] The Counterclaim Complaint seeks a court determination that NCMIC is entitled to use the doctrine of recoupment to defeat recovery on the Trustee's claims against it. In bankruptcy, the common law doctrine of recoupment is distinct from setoff. For setoff, the mutual debts need not have arisen out of the same transaction, but for recoupment, the same transaction requirement does apply.[53] When moving to dismiss, the Trustee argues that none of NCMIC's counterclaims arise out of the same transactions as the estate's claims. When responding to the motion, NCMIC agrees. The Trustee is entitled to dismissal of NCMIC's allegation that recoupment is available as a defense to the Trustee's claims.

CONCLUSION.

For the foregoing reasons, the Court grants the Trustee's motion to dismiss in part. NCMIC's tort claims which arise from prepetition conduct of the Special Master are not entitled to administrative expense status under § 503(b)(1)(A) or (b)(3)(E). NCMIC's counterclaims which relate to postpetition conduct of the Chapter 11 Trustee are not precluded from administrative expense status under §

503(b)(1)(A) as a matter of law. They seek recovery of: (1) the CJD-consideration payment of $50,000 as damages for the Trustee's alleged breach of fiduciary duty and negligence; (2) the postpetition portion (which the Trustee contends is $16,772.99) of the $178,541.20 claim for allegedly Wrongfully Withheld Unearned Premiums, as damages for breach of fiduciary duty, conversion, and negligence; and (3) the postpetition portion (which the Trustee contends is $913.59) of the $17,517.85 claim for Wrongfully Withheld Premiums, as damages for breach of fiduciary duty, conversion, and negligence. However, except for the postpetition portion of the claim for Wrongfully Withheld Unearned Premiums, administrative expense status of these counterclaims is barred by the Court's administrative bar date order. As to offset, as a matter of law, none of NCMIC's counterclaims, except the three claims which arise from postpetition conduct, as enumerated above, ***667** are eligible to be set off against the Trustee's claims. Recoupment is not a valid defense to the Trustee's claims. In short, the only counterclaims which are not subject to dismissal under Rule 12(b)(6) and (c) are the ones for offset of the postpetition counterclaims; as to those claims, administrative expense status is precluded as a matter of law for all except the one for Wrongfully Withheld Unearned Premiums.

IT IS SO ORDERED.

All Citations

485 B.R. 650

Footnotes

1 Future references to Title 11 in the text shall be to the section number only.

2 The Trustee appears by Michael D. Fielding of Husch Blackwell LLP. NCMIC appears by Paul D. Sinclair of Polsinelli Shughart PC.

3 The bankruptcies of the three Debtors are being jointly administered. *In re Brooke Corp.,* Case no. 08–22786, is the lead case.

4 *Bank of New York Mellon v. Aleritas Capital Corp.,* D. Kan. Case no. 2:08–cv–02424–JWL.

5 Case no. 2:08–cv–02424–JWL, Dkt. 23 at 4.

6 Adv. no. 12–6043, Dkt. 1.

7 Dkt. 8.

8 The claims are asserted under 11 U.S.C. §§ 544, 548(a)(1)(B), and 550 and K.S.A. 33–204(a)(2), 33–205(a), and 33–207. Dkt. 1.

9 Dkt. 9 at 2–3.

10 Dkt. 5.

11 Dkt. 5.

12 As an alternative to the position that none of the counterclaims are administrative expenses of the Debtors' estates, the Trustee argues that certain claims, identified as third-parry claims, fail to state claims against the estates. The counterclaims included in this category are: CJD Capital Infusions; CJD Farmers Payment; Silverman Related Payment; Silverman Related Retention; and Midwest Funeral Proceeds. The Court does not address this issue because doing so would be mere dicta, in light of the Court's resolution of the other issues.

13 *Isaac v. Temex Energy, Inc. (In re Amarex, Inc.),* 853 F.2d 1526, 1530 (10th Cir.1988) (quoting *Trustees of Amalgamated Ins. Fund v. McFarlin's,* 789 F.2d 98, 100 (2d Cir.1986)).

14 *Peters v. Pikes Peak Musicians Ass'n (In re Colorado Springs Symphony Orchestra Ass'n),* 462 F.3d 1265, 1268 (10th Cir.2006).

15 3 William L. Norton, Jr., and William L. Norton III, *Norton Bankruptcy L. & Prac.3d,* § 49:25 at 49–169 (Thomson Reuters/West 2012).

16 *Reading Co. v. Brown,* 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968).

17 *Id.* at 477–79, 88 S.Ct. 1759.

18 3 *Norton Bankruptcy L. & Prac.3d,* § 49:25 at 49–171.

19 *In re CF & I Fabricators of Utah, Inc.,* 150 F.3d 1293, 1298 (10th Cir.1998).

20 *Id.* at 1299.

21 E.g., *In re Hemingway Transport, Inc.,* 954 F.2d 1, 6–7 (1st Cir.1992); *Pension Benefit Guaranty Corp. v. Sunarhauserman, Inc. (In re Sunarhauserman, Inc.),* 126 F.3d 811, 817 (6th Cir.1997); *In re Jartran, Inc.,* 732 F.2d 584, 588–90 (7th Cir.1984); *In re Abercrombie,* 139 F.3d 755, 758 (9th Cir.1998).

22 The Court does not address the Trustee's contention that to allow the counterclaim to recover $50,000 paid to the Debtors' estates postpetition would result in NCMIC receiving a double recovery at the expense of other creditors. The motion to dismiss can be resolved without addressing this fact-based question.

23 As to the liability of the estate for the torts of the Special Master, NCMIC relies on *McNulta v. Lochridge,* 141 U.S. 327, 12 S.Ct. 11, 35 L.Ed. 796 (1891), which allowed, under nonbankruptcy law, a claim for negligence against the current receiver of a railroad when the wrong had occurred while the railroad was in the possession of a former receiver. When moving to dismiss the

Counterclaim Complaint, the Trustee does not challenge the position that the Brooke estates have liability for wrongs of the Special Master.

24 The Trustee does not challenge NCMIC's position that Riederer is a superseded custodian under the Code. "Custodian" is defined by § 101(11) to include a "receiver or trustee for any of the property of the debtor, appointed in a case or proceeding not under this title." Although the Trustee points out that Riederer was appointed as a special master under the authority of Federal Rule of Civil Procedure 53(a)(1)(A) and not as a receiver under the authority of Federal Rule of Civil Procedure 66, he fails to identify any limitation on the Special Master's authority which would remove him from the Code's definition of custodian.

25 190 U.S. 533, 23 S.Ct. 710, 47 L.Ed. 1165 (1903).

26 *Id.* at 539, 23 S.Ct. 710.

27 *In re Kenval Marketing Corp.,* 84 B.R. 32, 34 (Bankr.E.D.Pa.1988) (quoting 124 Cong. Rec. H 11094–95 (daily ed. Sept. 28,1978) (remarks of Rep. Edwards); S 17411 (daily ed., Oct. 6, 1978) (remarks of Sen. DeConcini)).

28 4 *Collier on Bankruptcy* ¶ 503.10[6] (Alan N. Resnick & Henry J. Sommer, eds.-in-chief, 16th ed. 2012).

29 *Amarex,* 853 F.2d at 1530(quoting *Trustees of Amalgamated Ins. Fund v. McFarlin's,* 789 F.2d 98, 101 (2d Cir.1986), which was quoting *In re Mammoth Mart, Inc.,* 536 F.2d 950, 954 (1st Cir.1976)).

30 *Szwak v. Earwood (In re Bodenheimer, Jones, Szwak, & Winchell, L.L.P.),* 592 F.3d 664, 672 (5th Cir.2009) (quoting *In re H.L.S. Energy Co.,* 151 F.3d 434, 437 (5th Cir.1998)).

31 Daniel Morman, *The Legacy of Reading Co. v. Brown[:] Claims Arising from Trustee or DIP Misconduct,* 23 Am. Bankr.Inst. J. 1, 40 (2004).

32 *In re Amarex,* 853 F.2d at 1530.

33 Case no. 08–22786, Dkt. 831, Order (I) Establishing Administrative Bar Date and Procedures for Filing Administrative Expense Requests and (II) Approving Form and Manner of Notice of the Bar Date.

34 *Id.* at ¶ 10.

35 Case no. 08–22786, Dkt. 854.

36 *Riley v. Decoulos (In re American Bridge Products, Inc.),* 599 F.3d 1 (1st Cir.2010).

37 The Court at this time does not address whether the amended proof of claim relates back for purposes other than the filing of administrative claims.

38 5 *Collier on Bankruptcy* at ¶ 553.01[1].

39 4 *Norton Bankruptcy L. & Prac.3d,* § 73:5 at 73–35 to 73–36.

40 These claims are asserted under 11 U.S.C. §§ 544(b) and 550, and K.S.A. 33–204(a)(2), 33–205(a), and 33–207.

41 5 *Collier on Bankruptcy* at ¶ 553.03[3][e][v]; 4 *Norton Bankruptcy L. & Prac.3d,* § 73:4 at 73–31 to 73–33.

42 *Walker v. Wilkinson,* 296 F. 850, 852 (5th Cir.1924).

43 *Mack v. Newton,* 737 F.2d 1343, 1366 (5th Cir.1984).

44 *Wyle v. C.H. Rider & Family (In re United Energy Corp.),* 944 F.2d 589, 597 (9th Cir.1991).

45 *Acequia, Inc. v. Clinton (In re Acequia, Inc.),* 34 F.3d 800, 817 (9th Cir.1994).

46 In addition to asserting state law fraudulent conveyance claims under § 544, the Trustee also cites § 548(a)(1)(B), the Bankruptcy Code's constructive fraudulent transfer provision, as a statutory basis for recovery. NCMIC presents no argument that such claims arose prepetition.

47 4 *Norton Bankruptcy L. & Prac.,* ¶ 63:7 at 63–36 to 63–37.

48 5 *Collier on Bankruptcy,* ¶ 544.06[3].

49 *Id.*

50 5 *Collier on Bankruptcy,* ¶ 544.06[4].

51 *Davidovich v. Welton (In re Davidovich),* 901 F.2d 1533, 1539 (10th Cir.1990) (citing *Turner v. United States (In re G.S. Omni Corp.),* 835 F.2d 1317, 1317 (10th Cir.1987)).

52 *Id.*

53 *Id.* at 1537.

KeyCite Yellow Flag
Distinguished by RMB Fasteners, Ltd. v. Heads & Threads Intern., LLC, N.D.Ill., January 25, 2012

425 B.R. 26
United States Bankruptcy Court, D. Massachusetts.

In re TYS, INC., Debtor.

No. 07–10531–JNF
|
Feb. 5, 2010.

Synopsis
Background: Attorney who had served as assignee under prepetition assignment for benefit of creditors of corporate Chapter 7 debtor filed requests for compensation, pursuant to bankruptcy statute providing for payment of reasonable compensation to custodians of estate property, and trustee objected.

Holdings: The Bankruptcy Court, Joan N. Feeney, J., held that:

[1] attorney who accepted prepetition assignment for benefit of creditors of debtor-corporation, after having previously served as corporate counsel, was suffering from irreconcilable conflict of interest, of kind which prevented him from recovering any compensation for his services as assignee, and

[2] compensation was also barred based on lack of any benefit to creditors or to bankruptcy estate from attorney's services.

Compensation denied.

West Headnotes (6)

[1] **Bankruptcy**Turnover by custodians

Attorney who accepted prepetition assignment for benefit of creditors of debtor-corporation, after having previously served as corporate counsel, was suffering from irreconcilable conflict of interest, of kind which prevented him from recovering any compensation for his services as assignee under bankruptcy statute providing for payment of reasonable compensation to custodians of estate property; this conflict was underscored by attorney's conduct, in his capacity as assignee, in presenting to creditors, as fait accompli, a sale of corporation's assets to newly formed entity created by corporation's principals without any marketing or solicitation of higher offers and without disclosing either the prospective purchaser's relationship to corporation or fact that he had previously served as corporation's attorney. 11 U.S.C.A. § 543(c)(2).

[2] **Creditors' Remedies**Administration of assigned estate

Assignee for benefit of creditors stands in fiduciary capacity to creditors of debtor.

[3] **Corporations and Business Organizations**Assignment for Benefit of Creditors

As assignee for benefit of creditors, former counsel to corporate debtor had duty to debtor's creditors to maximize sales price for its assets, a duty that he breached by facilitating, endorsing, and implementing “back-room deal” for sale of corporation's assets to newly created entity formed by corporation's principals, without any marketing or solicitation of higher offers, and without disclosing to creditors the relationship which existed between corporate seller and purchasing entity.

1 Case that cites this headnote

[4] **Creditors' Remedies**Appointment, qualification, and tenure of assignee or trustee
Creditors' Remedies Administration of assigned estate

Assignee for benefit of creditors is equivalent of Chapter 7 trustee, and assignee's employment is subject to same sort of requirements governing Chapter 7 trustee. 11 U.S.C.A. §§ 101(14), 327(a), 701(a)(1).

[5] **Bankruptcy**Turnover by custodians

Same principle that prevents Chapter 7 debtor's

lawyer from serving as trustee or trustee's counsel because he has materially adverse interest, and which denies him compensation if he does serve, also controls question of compensation of assignee for benefit of creditors, under bankruptcy statute providing for payment of reasonable compensation to custodians of estate property, if assignee previously served as debtor's attorney. 11 U.S.C.A. § 543(c)(2).

[6] **Bankruptcy**Turnover by custodians

Assignee for benefit of creditors could not obtain any compensation for his services when order for relief under the Bankruptcy Code was later entered against corporate debtor, pursuant to bankruptcy statute providing for payment of reasonable compensation to custodians of estate property, where assignee's services, in facilitating, endorsing and implementing "back-room deal" for sale of corporation's assets to newly created entity formed by corporation's principals, without any marketing or solicitation of higher offers, and without disclosing to creditors the relationship which existed between corporate seller and purchasing entity, did not confer any benefit on corporate creditors, but served only to benefit corporation's principals, and did not benefit bankruptcy estate but merely delayed its administration. 11 U.S.C.A. § 543(c)(2).

Attorneys and Law Firms

***27** Brian E. Donovan, Law Offices of Brian E. Donovan, Quincy, MA, for Debtors.

MEMORANDUM

JOAN N. FEENEY, Bankruptcy Judge.

I. INTRODUCTION

The matters before the Court are three requests for compensation made by Michael B. Feinman, Esq. ("Attorney Feinman") pursuant to 11 U.S.C. § 543(c)(2) relating to his services as Assignee for the Benefit of Creditors of TYS, Inc. (the "Debtor" or "TYS"). In total, Attorney Feinman seeks $30,653.76[1] The Chapter 7 Trustee objected to all requests for compensation.

***28** The Court conducted an evidentiary hearing on November 30, 2009 at which Attorney Feinman testified and ten exhibits were introduced into evidence, including "Stipulated Facts Requiring No Further Proof." Following the trial, the parties submitted post-trial briefs.[2]

The Court now makes the following findings of fact and conclusions of law in accordance with Fed. R. Bankr.P. 7052.

II. FACTS

TYS was a Massachusetts corporation formerly engaged in the business of the retail sale of fireplace and barbecue equipment, as well as the wholesale and retail distribution of propane, with locations in Massachusetts, Maine and New Hampshire. Beginning in April 2006, Eugene Harris ("Harris"), was the president, treasurer and clerk, and a director, of the Debtor. Harris's wife, Phyllis Ryan ("Ryan"), was the assistant treasurer, and is alleged to have been a director. From at least April 2006 until January 4, 2007, Harris and Ryan exercised exclusive control over the overall management of the business and finances of the Debtor, as well as the day-to-day operations of the Debtor.

Between January 2006 and July 2006, Harris and Ryan advanced nearly $600,000 to the Debtor to fund the continuing operations of its business. On or about October 31, 2006, WEH Business Trust ("WEH"), a Massachusetts business trust which held 100% of the stock of the Debtor and for whom Harris and Ryan served as two of three trustees,[3] caused to be sold a ***29** portion of a separately incorporated business held by it, namely its wholesale and retail propane distribution business-to a third party, Ferrellgas, for the sum of approximately $3.8 million (the "Ferrellgas Sale"). Following the payment of the secured creditor of WEH from the proceeds of the Ferrellgas Sale, there was approximately $1 million in cash available from that sale. Moreover, after the Ferrellgas Sale, TYS had unsecured debts in excess of $1.3 million, together with contingent liabilities on real estate leases, in addition to the amounts allegedly advanced by Harris and Ryan.

On or about November 7, 2006, Harris and Ryan met with Attorney Feinman, who practices in the area of bankruptcy and insolvency law, for the purpose of seeking insolvency related advice. They had never met Attorney Feinman, and he had never represented either of them individually or the Debtor. Rather, Charles Nierman, Esq. had represented TYS. Attorney Nierman's office was a referral source for Attorney Feinman for clients with insolvency problems, and Attorney Nierman referred TYS to him.

During the course of their introductory meeting, Harris and Ryan described in general terms the financial condition of TYS and its affiliates. Attorney Feinman advised Harris and Ryan that he required a retainer, as well as documents pertaining to TYS's finances in anticipation of a possible Chapter 11 petition for TYS.

On or about November 17, 2006, Harris and Ryan, on behalf of TYS, returned to Attorney Feinman's office and engaged him as attorney for TYS for the purpose of obtaining recommendations about a possible workout or commencement of a Chapter 11 case, as well as related financial issues. Attorney Feinman requested, and was paid, a $5,000 retainer, identified as an advance deposit on fees, pursuant to an Engagement Agreement executed by Harris as president of TYS on that date. He also obtained copies of leases and an accounts payable aging.

Pursuant to the Engagement Agreement, Attorney Feinman represented that he would provide legal services to TYS and bill for services and expenses, including "such things as conferences with others on your behalf, legal research necessary to properly advise you, preparation of documents and correspondence, discussions and negotiations with other parties, interoffice conferences with lawyers and staff and travel time." Additionally the Engagement Agreement provided: "We [attorneys associated with Feinman Law Offices] can terminate our services at any time so long as you give us written notice. We can discontinue our services if you do not pay us or if we feel we can no longer properly represent you for any reason."

Attorney Feinman testified about one telephonic conference with Harris:

> Mr. Harris explained to me that he had a very—he was very upset with his brother, how his brother had managed the company into its financial condition. He had indicated to me that a part of any plan of reorganization for the company, that he wanted to form a new company to buy out the business. I indicated to him that he needed to get separate counsel to address those issues. I specifically told him I could not wear two hats, I could not serve his interests and the interests of the company.

***30** As a result of Attorney Feinman's advice, Harris retained Thomas Raftery, Esq. ("Attorney Raftery") to represent him with respect to personal financial issues. On or about December 15, 2006, Attorney Raftery formed a corporation known as NEFP, Inc. ("NEFP"), whose president and sole shareholder was Ann Lynch ("Lynch"), Ryan's sister and Harris's sister-in-law. NEFP's principal place of business was identified as 140 South Main Street, Middleton, Massachusetts, the same address at which TYS was then maintaining its principal place of business.

TYS never sent Feinman Law Offices written notice terminating its services, and Attorney Feinman never sent TYS a termination notice with respect to their attorney/client relationship. Attorney Feinman's itemization of professional services does not reveal that Feinman Law Offices formally discontinued its service, and, as will be discussed below, Attorney Feinman did not exhaust the $5,000 retainer obtained by his firm.

On or about January 4, 2007, Harris, as the owner of fifty-two percent of the shares of the Debtor, representing his interest in WEH Business Trust, purportedly authorized the Assignment for the Benefit of Creditors (the "Assignment"), pursuant to which all of the assets of the Debtor were assigned to Attorney Feinman as Assignee.[4] The Assignment, which was executed by Harris as president of TYS and by Attorney Feinman, provided: "The Assignee, *primarily in the interest of creditors,* shall hold and manage the Trust Property, receive and collect the rents, income and proceeds thereof, and convert the Trust Property into money as rapidly as he may think expedient, and in such manner as he may think best." (emphasis supplied). It also provided that the Assignee was to pay claims in the order of priority set forth in the Bankruptcy Code with "any balance remaining to the Debtor."

Attorney Feinman submitted his first invoice to TYS on or around January 3, 2007, one day before the execution of the Assignment. The invoice contained time entries beginning on November 17, 2006 and ending on December 14, 2006. On

December 9, 2006, Attorney Feinman charged TYS $687.50 for "Compile assignment; vote and assent forms for review by debtor and Thomas Raftery. [sic]" On December 14, 2006, he charged TYS $330 for "Review of documents; Telephonic conference call with Thomas Raftery and Richard Erricola [the appraiser engaged to value the business and assets of TYS] concerning execution of assignment."[5] In total, Attorney Feinman, who was the sole attorney involved in matters relating to TYS, sought a total of $3,685 from TYS, leaving a balance of $1,315. Thus, at the time of the execution of the Assignment for the Benefit of Creditors, Attorney Feinman owed the Debtor $1,315 resulting from the unused portion of his firm's retainer.

On January 5, 2007, one day after the execution of the Assignment for the Benefit of Creditors, Attorney Feinman, as Assignee, sold substantially all of the remaining assets of the Debtor to NEFP. NEFP continued to operate the same retail business ***31** which the Debtor had operated under the name "Yankee Fireplace," in the same locations in Middleton, Massachusetts and Arundel, Maine, and Harris and Ryan managed its day-to-day operations. NEFP purchased the Debtor's assets for a stated consideration of $800,000, of which $80,000 was paid by NEFP as a deposit, with the remaining $720,000 to be paid over five years in monthly installments of approximately $6,000, pursuant to a promissory note (the "Note") payable to the Assignee. That Note was secured by the assets of the business. Under the terms of the Note, a balloon payment in excess of $550,000 was due at the conclusion of the five-year term. There was not evidence that Attorney Feinman conducted any due diligence with respect to NEFP. Because NEFP was making payments to the Assignee over a five year period, it was incumbent upon him to ascertain its financial capabilities and its ability to pay and the identity and experience of its officers, directors, and management. In view of the absence of that information, Attorney Feinman undoubtedly knew that NEFP was an entity through which Harris could maintain control of the business of TYS.

Attorney Feinman did not advertise the sale of TYS's assets or solicit other offers or counteroffers. Indeed, while he was negotiating the sales price, he shared the appraised value of the business with Attorney Raftery, who represented both Harris, who had expressed a wish to maintain control of the business, and NEFP, the buyer.

Prior to the execution of the Assignment for the Benefit of Creditors, Harris and Ryan received a total of at least $579,987.44 from the Debtor, in repayment of amounts they claimed to have advanced to the Debtor (the "Payments"). They received at least $497,000 from the assets of TYS between November 13, 2006 and December 28, 2006, a period spanning the period when Attorney Feinman represented TYS. Prior to the January 4, 2007 Assignment for the Benefit of Creditors, Harris and Ryan used a portion of the assets of TYS to purchase a substantial quantity of new inventory, which was ultimately sold to NEFP pursuant to the Assignment, to the benefit of NEFP and to the detriment of the Debtor's creditors.

The initial payment of $80,000 to the Assignee for the purchase of the assets of the Debtor was not funded by NEFP or Lynch, as its sole shareholder; rather, it constituted a portion of the Payments received by Harris and Ryan, who paid at least $80,000 of such funds to capitalize NEFP. These funds, in turn, were paid by NEFP to Attorney Feinman, as Assignee, to acquire the assets of the Debtor.

Attorney Feinman testified that he did not learn of any of the Payments until October of 2007 when the Chapter 7 Trustee conducted an examination of him pursuant to Fed. R. Bankr.P.2004.

Attorney Feinman testified that he did not discuss the sale price for TYS's assets until he had obtained an appraisal from Richard Erricola ("Erricola"). He testified that he had one meeting in his office with Harris and Attorney Raftery, but subsequent negotiations were with Attorney Raftery by telephone or e-mail. Attorney Feinman indicated that he rejected Harris's initial offer of the liquidation value for the assets. He stated that he "indicated [to Harris] that I would not accept it and would not handle the assignment at that price." Although Attorney Feinman had a telephone conference with Attorney Raftery and Erricola on December 14, 2006, it is unclear precisely when Erricola was employed and by whom. Although the sale of TYS's assets to NEFP was negotiated in December of 2006 and finalized on January 5, 2007, Erricola was paid ***32** by Attorney Feinman, as Assignee, on January 26, 2007.

Attorney Feinman, in his March 15, 2007 itemization of professional services as Assignee, disclosed that, on January 4, 2007, he reviewed documentation and appraisals. On January 9, 2007, he again reviewed information from the appraiser and had a conference with Erricola. He testified that Erricola provided him with a liquidation value for TYS's assets of $240,343 and that he shared that number with

Attorney Raftery, adding that he did not obtain a copy of the appraisal from Erricola until after the physical appraisal of the assets. From the sequence of events, it would appear that Attorney Feinman was purporting to act as Assignee prior to the actual execution of the Assignment for the Benefit of Creditors.

One day after Attorney Feinman sold the assets of TYS to NEFP, he sent a letter to all of the creditors of TYS as well as parties in interest. The letter provided in pertinent part the following:

> Pursuant to the terms and provisions of the Assignment, as Assignee, I have partially liquidated the assets of the company, and will continue to do so in order to make distribution to creditors on the terms and conditions set forth in the assignment for the benefit of creditors. The Assignment for the Benefit of Creditors executed by the Debtor provides for distribution to creditors as would normally be provided for in a bankruptcy proceeding commenced on January 4, 2007, using the same priority provisions of the Bankruptcy Code....
>
> As of the present date, I have sold the Debtor's physical assets and certain contractual rights to a third party. A Purchase and Sale Agreement, Bill of Sale and related documents have been executed for the sale of the physical assets of TYS, Inc. for the sum of $800,000.00. The sale does not include funds on hand in the Debtor's bank accounts, nor does the sale include causes of action available to the Debtor against third parties....

* * *

> Finally, in handling this Assignment for the Benefit of Creditors, as Assignee, I represent the interests of the creditor body as a whole, and do not represent the interests of any particular creditor....

Although Attorney Feinman represented in his January 5, 2007 letter that he sold the assets of TYS to a "third party," he did not disclose that NEFP was a newly created entity whose president was Ryan's sister and Harris's sister in law—an insider as that term is defined in the Bankruptcy Code. *See* 11 U.S.C. § 101(31)(B)(vi). He also did not disclose that NEFP's principal place of business and address were the same as those of TYS. Additionally, he did not disclose that Harris was going to be managing NEFP. With respect to his own involvement, Attorney Feinman did not disclose that he had acted as counsel to TYS beginning on November 17, 2006. Finally, he did not disclose that he had taken no steps whatsoever to advertise or otherwise market the assets of TYS or solicit counteroffers for its assets.

An involuntary petition for bankruptcy relief was filed by certain unsecured, unpaid creditors of the Debtor on January 29, 2007. On March 13, 2007, an Order of Relief was entered, and the Trustee was appointed.

Attorney Feinman cooperated fully with the Trustee and promptly turned over his records, provided assistance, and provided an accounting to the Trustee. On March 15, 2007, he filed his "Final Account by ***33** Assignee for the Benefit of Creditors." He stated that "[a]s of March 4, 2007, total funds on hand were $150,376.80. Of all funds received by me as Assignee, only one administrative expense was paid in the amount of $5,817.50 to Richard Erricola for an inventory and appraisal of physical assets of the Debtor which were anticipated to be sold." As noted above, the account showed that Erricola was paid on January 26, 2007.

Attorney Feinman filed a Motion for Allowance and Reimbursement of Legal Fees and Expenses on March 15, 2007 to which he attached an itemization of his services beginning on January 2, 2007 and ending on March 15, 2007. Through his Motion, he sought $14,295 for services and $471.64 for expenses. Between January 2, 2007 and January 29, 2007, the date the involuntary petition was filed, Attorney Feinman incurred fees totaling $9,022.50 and expenses totaling $450.49. His itemization reveals that he sought compensation for filing a Reply to the involuntary petition. In that Reply, which was filed on February 12, 2007, he stated:

> The pre-assignment relationship between various principals of the Debtor entity was acrimonious, and accordingly, in the absence of further information, as assignee seeking to liquidate the assets of the Debtor and to make payments upon creditors [sic], I have concern about the nature of these proceedings. In the absence of such further information, as assignee I am unable to recommend to the Court to enter an order for relief as requested by the petitioning creditors.[6]

Upon motion by the Debtor and by Order dated July 27, 2007, the Court converted the Debtor's bankruptcy case from a Chapter 7 proceeding to Chapter 11, and the Trustee was appointed Chapter 11 Trustee on August 2, 2007. Following a settlement of certain claims against Harris, Ryan and others, the Debtor's Chapter 11 case was converted back to a Chapter 7 proceeding, and the Trustee was again appointed Chapter 7 Trustee of TYS.

On July 15, 2009, Attorney Feinman submitted a Second Supplemental Request for Compensation seeking $6,480 in fees for professional services and $5,023.12 in expenses. His itemization set forth a balance forward of $20,483.76 and an adjustment of $1,333.12. The disbursements included $5,000 for a deductible with respect to his professional liability insurance. As set forth above, he seeks a total of $30,653.76.

From the Stipulated Facts, as supplemented with reference to the documentary evidence and testimony, it is unclear when Attorney Feinman ceased to represent the Debtor and agreed in principle to accept the Assignment for the Benefit of Creditors. In other words, between December 14, 2006 and January 2, 2007, who did he represent? Attorney Feinman testified that he thought about declining the Assignment, "but the problem was is [sic] that I had only had involvement with Mr. Harris for about two weeks, maybe three weeks at most. I felt that I could proceed with it without any conflict issues. I didn't recommend the assignment. I didn't pursue it...." He added that, if he had known that there were insider transfers taking place, he likely would have declined the Assignment. Additionally, he testified that although Harris told him about preferences to trade creditors he did not tell him about the ones TYS made to him and Ryan, stating that because he was Assignee for only a short period of time, he did ***34** not have the opportunity to perform a preference analysis.

III. POSITIONS OF THE PARTIES

Attorney Feinman maintains that the issue before the Court is whether there is a bright line rule that bars an attorney from acting as an assignee for the benefit of creditors if the attorney-client privilege has attached. He distinguishes the case relied upon by the Trustee, namely *In re Colony Press, Inc.,* 83 B.R. 862 (Bankr.D.Mass.1988). Attorney Feinman argues that he played an "exceedingly limited role in both scope and time" as counsel to TYS before Harris chose to obtain separate counsel to pursue an assignment for the benefit of creditors. He also emphasizes that he had no *actual* conflict of interest or *actual* knowledge of any conduct on the part of the Debtor's principals that was later challenged by the Chapter 7 Trustee.

The Chapter 7 Trustee, also relying upon *In re Colony Press, Inc.,* objects to the payment of any fees incurred by Attorney Feinman due to his prior service as counsel to the Debtor. Additionally, he maintains that the services rendered did not benefit the estate or its creditors because they were performed exclusively to benefit the principals of the Debtor and NEFP. The Trustee asserts that Attorney Feinman's professional obligation to maintain the confidences of TYS, as disclosed to him by Harris, was at odds with his duty to make full disclosure to TYS's creditors as Assignee. The Trustee maintains that Attorney Feinman knew, or should have known, if proper inquiry had been made, that the Assignment for the Benefit of Creditors had the effect of having nearly $500,000 paid to the Debtor's principals rather than to its creditors within six weeks of the date of the Assignment—a period in which Attorney Feinman was serving as counsel to TYS. Further, the Trustee states that, had Attorney Feinman obtained knowledge of preferential transfers during the attorney-client relationship, such knowledge would constitute a client confidence that would have precluded him from serving as Assignee. The Trustee adds that Harris's expressed wish to remain in control was sufficient to create a conflict of interest.

With respect to his argument that Attorney Feinman's services did not benefit the estate, the Trustee points to his failure to disclose that the "third party" to whom he sold the assets of TYS was NEFP, a newly formed corporation owned by Harris's sister-in-law, as well as his failure to disclose that Harris was going to continue to manage the business of NEFP, and his failure to disclose that NEFP was going to continue to operate TYS's business from the same location.

The Trustee specifically objects to any fees and costs incurred by Attorney Feinman between April 3, 2008 and July 30, 2009. The Trustee maintains that fees and expenses incurred by Attorney Feinman, including a $5,000 deductible to his professional liability carrier, did not benefit the estate. The Trustee also notes that Attorney Feinman failed to account for $1,315, representing the balance of the retainer provided to him by TYS.

IV. DISCUSSION

A. *Conflict of Interest*

[1] The first issue that the Court must resolve is whether Attorney Feinman had a conflict of interest with respect to his representation of the Debtor and his status as a fiduciary to its creditors as Assignee. Based upon the evidence presented, Massachusetts Rule of Professional Conduct 1.7, and the decision in *Colony Press,* the Court concludes that Attorney Feinman, in fact, had a conflict of interest when he accepted the Assignment for the ***35** Benefit of Creditors, despite his testimony to the contrary. Attorney Feinman's dual role as counsel to TYS and as Assignee created an irreconcilable conflict of interest due to the adverse interests of the corporation and the constituency of creditors. *See In re Colony Press, Inc.,* 83 at 865. In that case, the court explained the conflicting roles of an assignee and a debtor's attorney. It stated:

> For example, if Petitioner had learned in confidence from the Debtor of a preference or fraudulent transfer made by the Debtor, he would not be permitted to disclose this information even though it could be crucial in the creditors' decision on whether or not to assent to the Assignment. See Mass. Sup. Jud. Ct. R. 3:07, DR 4–101. Petitioner's obligation to be diligent in his duties under the Assignment would likely require some "policing" of the Debtor to be sure that the Debtor was not holding out on the inclusion of any property in the Assignment. But the necessity of such policing appears to require him to have declined the Assignment, because under the Canons he must decline any proffered employment that is likely to adversely affect his exercise of independent professional judgment in behalf of a client. *See* Mass. Sup. Jud. Ct. R. 3:07, DR 5–105.
>
> Beyond those considerations, the very terms of the Assignment create potential conflict. It grants the Debtor the right to receive back the excess of the value of unencumbered property over the total claims of assenting creditors. Any questions concerning the amount of a claim, or whether a creditor should be permitted to assent, therefore bear directly upon the existence or not of surplus going back to the Debtor. Petitioner's understandable inclination to favor the Debtor as his client would likely cloud his decisions as Assignee concerning these matters. So we appear to have yet another violation of Petitioner's professional obligations, the obligation to avoid even the appearance of professional impropriety. *See* Mass. Sup. Jud. Ct. R. 3:07, Canon 9.

83 B.R. at 865–66.[7]

Attorney Feinman's conflict of interest is highlighted by the *fait accompli* he presented to the creditors of TYS in the form of the sale of TYS's assets to NEFP without any marketing or solicitation of higher offers, by his failure to disclose pertinent information about the ownership and management of NEFP to the creditors of TYS, and by his failure to disclose information about his role as counsel to the Debtor.

[2] Massachusetts Rules of Professional conduct address conflicts of interest. In pertinent part, the Rule 1.7 provides:

> (a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:
>
> (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
>
> (2) each client consents after consultation.
>
> ***36** (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

Mass. R. Prof. Conduct 1.7. Even if Attorney Feinman may have believed that he could act as Assignee, less than three weeks after the last time entry for which he charged TYS for his services, namely December 14, 2006, he should have formally terminated his representation of TYS, and, more importantly, disclosed his involvement as counsel to TYS to its creditors in his January 5, 2007 letter. Although he was not acting as an attorney to the beneficiaries of the Assignment, as Assignee, he was acting in a fiduciary capacity to the creditors of the Debtor.[8] *See* Mike C. Buckley and Gregory Sterling, What Banks Need to Know About ABCs, 120 Banking L.J. 48 (Jan. 2003) ("The basic job of an Assignee is to fulfill the responsibilities of a prudent

fiduciary."); Geoffrey L. Berman and Robert J. Keach, "The Receivership Alternative" A Response, 20 Am. Bankr.Inst. J. 26 (July/Aug. 2001). Thus, his role as Assignee was sufficiently similar to the role of an attorney to warrant reference to Rule 1.7.

In *In re Colony Press, Inc.,* the court stated:

> As a trustee, the Petitioner was required to administer the trust diligently in accordance with its terms and in the sole interest of the assenting creditors. His position of trust and confidence also mandated full disclosure to the assenting creditors of all material facts known to him which related to their right under the trust.

83 B.R. at 865 (citing Restatement (Second) of Trusts §§ 170, 173 comment d, and 174).

Attorney Feinman's omissions in the January 5, 2007 letter were so glaring as to suggest, at best, willful ignorance or, at worst, collusion with Harris and NEFP so that Harris could maintain control of the business of TYS. In this regard, although Attorney Feinman testified that he recommended the filing of a Chapter 11 petition to Harris, as president of TYS, he failed to elicit basic information from him about officer loans, transfers outside the ordinary course of business, and he inexplicably failed to advise TYS not to make payments that might be considered preferential and avoidable by a bankruptcy trustee or an assignee. Thus, while he was counsel to TYS, TYS made payments of $497,000 to Harris and Ryan who used that money to boost inventory which was purchased by NEFP, whose sole shareholder was an insider. Had Attorney Feinman made even minimal inquiry before accepting the Assignment, he would have learned that as Assignee, he would have to sue Harris and Ryan, a circumstance that undoubtedly would have unraveled ***37** the very sale he effected and recommended to creditors as Assignee.

[3] As Assignee, Attorney Feinman had a duty to the Debtor's creditors to maximize the sales price for its assets. He failed in the performance of that duty by facilitating, endorsing, and implementing a "back-room deal." Not only did he share Erricola's appraisal with Attorney Raftery, he hastily and without any proffered justification, sold the assets of TYS to NEFP, a newly created entity, with a minimal cash down payment and a five year payout. In *Colony Press,* a case Attorney Feinman attempts to distinguish, the bankruptcy court disallowed compensation to an assignee who, though conflicted, at least advertised a scheduled auction by placing ads in The Worcester Telegram, The Boston Globe and The Providence Journal. *See In re Colony Press, Inc.,* 83 B.R. at 863.

[4] [5] An Assignee is the equivalent of a Chapter 7 trustee. According to one commentator,

> [T]he assignee is the analogous equivalent to the Chapter 7 trustee. An ABC's purpose is to provide the assignor's creditors with an equal distribution of the assignor's estate in proportion to their claims. Once the trust agreement is created, the assignee stands in the debtor's shoes and can protect him or her from creditors because the assignee now possesses legal and equitable title to all assets. In other words, because the debtor no longer has title to his or her assets, the creditor cannot attach or execute on the property transferred to the assignee.

Jonathan T. Edwards, The Crossroads: The Intersection of State Law Remedies and Bankruptcy, 18 J. Bankr.L. & Prac. 2, Art. 4 (2009). Given the similar status of assignees and trustees, this Court finds that an assignee's employment is subject to the same requirements. *See* 11 U.S.C. §§ 101(14), 327(a) and 701(a)(1); *see also In re Colony Press, Inc.,* 83 B.R. at 866. This Court agrees with the court in *Colony Press,* a case in which the assignor also served as counsel to the debtor, that "the principle which prevents the debtor's lawyer from serving as trustee or trustee's counsel because he has a materially adverse interest, and which denies him compensation if he does serve, also controls the question of an assignee's compensation under § 543." *Id.* at 868. Thus, based upon the weight of the credible evidence, the Court finds that Attorney Feinman was conflicted and failed to satisfactorily perform his duties as Assignee. The principles set forth in the Bankruptcy Code dictate the conclusion that Attorney Feinman is precluded from receiving compensation for his services as assignee because of the material adverse interest he had resulting from his representation of TYS and the interest of its creditors as Assignee.

B. *Benefit to the Estate*

[6] Section 543(c) of the Bankruptcy Code provides that "[t]he court, after notice and a hearing, shall—... provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such

custodian....” 11 U.S.C. § 543(c). According to the United States Court of Appeals for the Fifth Circuit,

> A custodian's compensation for “services” and “actual, necessary expenses” are an administrative expense of the estate and are thereby entitled to priority in the bankruptcy proceedings. In addition to compensation for services and “actual, necessary expenses,” a superseded custodian's compensation may include “reasonable compensation for professional services rendered by an attorney” employed by the custodian to ***38** further an “allowed” expense, as well as that attorney's “actual, necessary expenses.”

In re Bodenheimer, Jones, Szwak & Winchell L.L.P., 592 F.3d 664, 671 (5th Cir.2009). The Fifth Circuit in *Bodenheimer* also observed that prepetition services of a custodian are governed by 11 U.S.C. § 503(b)(3)(E) which provides that the actual, necessary expenses, other than compensation and reimbursement specified for professional services of an attorney or accountant to a custodian require benefit to the estate. 592 F.3d at 672. It stated: “[t]he ‘benefit’ requirement has no independent basis in the Code, however, but is merely a way of testing whether a particular expense was truly ‘necessary’ to the estate: If it was of no ‘benefit,’ it cannot have been ‘necessary.’ ” *Id.* (citing *In re H.L.S. Energy Co.*, 151 F.3d 434, 437 (5th Cir.1998)) (footnote omitted). The Fifth Circuit explained:

> [T]he “benefit to the estate” requirement for “services” of pre-petition liquidators and post-petition custodians is supported by long-established pre-Bankruptcy Code precedent. The “benefit to the estate” doctrine was first recognized in *Randolph & Randolph v. Scruggs*, where Justice Holmes, writing for a unanimous Court, held that a state-law assignee of a debtor's estate was entitled to seek payment for services that he undertook prior to the adjudication of the bankruptcy, inasmuch as those services benefitted the bankruptcy estate. The Court added, however, that “[w]e are not prepared to go further than to allow compensation for services which were beneficial to the estate. Beyond that point we must throw the risk of his conduct on the assignee, as he was chargeable with knowledge of what might happen.” The Court also concluded that the assignee's decision to contest the bankruptcy once it had commenced did not appear to be a benefit to the estate, and therefore resulting fees were not allowable expenses entitled to priority.
>
> Since the Supreme Court's decision in *Randolph*, Congress enacted the Bankruptcy Code. Admittedly, Congress made no mention of the “benefit to the estate” rule in the provisions of the Code governing the services of superseded custodians. However, “[w]hen Congress amends the bankruptcy laws, it does not write ‘on a clean slate.’ ” *Dewsnup v. Timm*. Indeed, we must “not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.” *Cohen v. de la Cruz*. There is no indication that Congress intended to overturn the “benefit to the estate” doctrine when passing the statutes governing payment to superseded custodians. Indeed, the legislative history points to the contrary.

592 F.3d at 672–73 (footnotes omitted). Thus, the Fifth Circuit concluded that “the language of § 543 clearly circumscribes the actions of superseded custodians to those which are necessary to preserve the assets of the estate once a bankruptcy petition has been filed.” 592 F.3d at 674.

In view of the foregoing, the Court agrees with the Chapter 7 Trustee that Attorney Feinman's services and the disbursements for which he seeks reimbursement, provided no benefit to the bankruptcy estate. For the reasons set forth in the discussion concerning his conflict of interest, the Court concludes that his services and disbursements not only failed to benefit the bankruptcy estate but delayed its administration.

V. CONCLUSION

In view of the foregoing, the Court shall enter an order denying Attorney Feinman's ***39** requests for compensation in this case.

All Citations

425 B.R. 26, 63 Collier Bankr.Cas.2d 414, 52 Bankr.Ct.Dec. 212

Footnotes

1 Attorney Feinman seeks reimbursement for attorney's fees. The record does not reflect that he employed himself as counsel in his capacity as Assignee. Thus, the Court shall construe his requests for compensation in his capacity as a custodian only. *See* 11 U.S.C. § 101(11) ("The term 'custodian' means ... assignee under a general assignment for the benefit of the debtor's creditors....").

2 Following the trial, Attorney Feinman filed a Motion to Strike Portions of the Chapter 7 Trustee's Post Trial Memorandum. Upon consideration of the Motion and the Trustee's Opposition, the Court shall enter an order denying the Motion to Strike. Attorney Feinman specifically objected to a footnote in which the Trustee referenced a "question of law as to whether the assignment was properly authorized;" a reference to the expenses incurred by the Trustee with respect to undoing the Assignment for the Benefit of Creditors and references to the sale of assets to NEFP and a discussion relating to the sale and other adversary proceedings, which ostensibly were not introduced into evidence. The Trustee responded, noting that the Court can take judicial notice of its own docket. *See In re Hyde,* 334 B.R. 506, 508 n. 2 (Bankr.D.Mass.2005). The Court agrees with the position espoused by the Trustee. Nevertheless, the portions of the Trustee's Memorandum to which Attorney Feinman objected are not dispositive of the issues before the Court, and the Court has relied almost exclusively on the parties Stipulated Facts and Attorney Feinman's testimony, rather than the contents of the briefs.
Additionally, the Court denies Attorney Feinman's request to introduce his affidavit and that of Thomas Raftery, Esq. set forth in his Motion to Strike. The Court sustained the Trustee's objection to admission of the affidavits as hearsay, and Attorney Feinman proffered no reason to reconsider that ruling.

3 The parties failed to identify WEH in the Stipulated Facts. The Court takes judicial notice that on March 21, 2008 the Chapter 7 Trustee commenced an action against Feinman in which he alleged that Attorney Feinman committed:

> attorney malpractice stemming from his conflict of interest arising from his simultaneous and mutually exclusive representation of the Debtor and the interests of its principals, by which he facilitated the preferential repayment of the inside principal of monies advanced to the corporation, and subsequent repurchase of the business of the Debtor as a turnkey operation from Attorney Feinman, acting as assignee for the benefit of creditors, through a new corporation, using the very funds that had been preferentially transferred to them.

In conjunction with that litigation, the parties filed a Joint Pretrial Memorandum in which they stipulated to facts relating to the identity and ownership of WEH. The Court takes further judicial notice that the Chapter 7 Trustee and Attorney Feinman compromised the claims set forth in the adversary proceeding. The Stipulation of Settlement, which this Court approved, specifically did not "constitute an admission of liability in any manner or fashion on the part of [Attorney] Feinman, and [Attorney] Feinman expressly denie[d] any liability for the claims raised in the Adversary Proceeding." *See generally In re Harmony Holdings, LLC,* 393 B.R. 409, 413 (Bankr.D.S.C.2008); *In re Hyde,* 334 B.R. 506, 508 n. 2 (Bankr.D.Mass.2005).

4 As noted in note one above, Attorney Feinman objected to the Trustee's reference to the issue of whether the Assignment was properly authorized. The parties, however, used the word "purportedly" in their Stipulated Facts.

5 This was the first mention of Richard Erricola in Attorney Feinman's itemization of his services to TYS. Additionally, the itemizations suggest that Attorney Feinman was billing TYS for services he was performing, or intended to perform, as Assignee beginning on December 9, 2006.

6 Only the debtor, or a general partner in a partnership debtor that did not join in the petition may file an answer to an involuntary petition. *See* 11 U.S.C. § 303(d).

7 The court added:

> These considerations appear to have prompted some states to pass legislation which either prohibits a debtor from naming his lawyer as assignee or gives creditors the power to replace the assignee named by the debtor. FN2 Massachusetts, whose regulation on the subject of assignments is minimal (See Mass.G.L. ch. 203, §§ 40–42), has imposed no such restriction. But Congress has done so with respect to the analogous situation involving the appointment of a trustee under the Bankruptcy Code *Id.* at 866.

8 Additionally, to the extent TYS was insolvent, Harris and Ryan owed fiduciary duties to the creditors of TYS. *See* Mike C. Buckley and Gregory Sterling, What Banks Need to Know About ABCs, 120 Banking L.J. 48 (Jan.2003). It was incumbent upon

Attorney Feinman in undertaking fiduciary duties as Assignee to ascertain whether the principals of the corporation for which he was appointed Assignee had satisfied those duties with respect to their conduct involving the creation of and sale of TYS's assets to NEFP. *Id.*

End of Document

185 B.R. 575
United States Bankruptcy Appellate Panel
of the Ninth Circuit.

In re SIERRA PACIFIC BROADCASTERS, Debtor.
INDUSTRIAL COMMISSION OF ARIZONA, Appellant,
v.
Alan R. SOLOT, Chapter 11 Trustee; Edward P. Bolding, Appellees.

BAP No. AZ–94–2510–RMAs.
|
Bankruptcy No. 88–0543–TUC–LO.
|
Argued and Submitted July 21, 1995.
|
Decided Aug. 10, 1995.

Synopsis
Industrial Commission of Arizona (ICA) filed application for administrative expense priority for its claim for reimbursement of workers' compensation benefits paid to uninsured Chapter 11 debtor's employee injured in postpetition industrial accident. The United States Bankruptcy Court for the District of Arizona, Lawrence Ollason, J., denied application. ICA appealed. The Bankruptcy Appellate Panel, Russell, J., held that: (1) dismissal of underlying bankruptcy case did not render appeal moot; (2) claim for reimbursement of workers' compensation benefits was not entitled to priority as excise tax; and (3) claim arising from postpetition industrial accident and postpetition reimbursement of workers' compensation award was entitled to administrative expense priority.

Reversed and remanded.

Procedural Posture(s): On Appeal.

West Headnotes (9)

[1] **Bankruptcy**🔑Moot Questions
Ordinarily, dismissal of bankruptcy case on appeal may render appeal moot.

2 Cases that cite this headnote

[2] **Bankruptcy**🔑Moot Questions
Appeal from denial of application by Industrial Commission of Arizona for administrative expense priority for claim for reimbursement of workers' compensation paid to uninsured Chapter 11 debtor's employee injured in postpetition industrial accident was not moot, even though underlying bankruptcy case had been dismissed, where remedy existed whereby, if ordered, administrative claimant could return any distributions wrongfully received to estate to be shared pro rata among other administrative claimants. Bankr.Code, 11 U.S.C.A. § 503(b)(1).

4 Cases that cite this headnote

[3] **Bankruptcy**🔑Conclusions of Law; De Novo Review
Bankruptcy appellate panel reviews issues of statutory interpretation as questions of law reviewed de novo.

4 Cases that cite this headnote

[4] **Bankruptcy**🔑Discretion
Bankruptcy appellate panel reviews for abuse of discretion bankruptcy court's award or denial of administrative claims. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

1 Case that cites this headnote

[5] **Bankruptcy**🔑State and Local Government Claims
Claim of Industrial Commission of Arizona (ICA) for reimbursement of workers' compensation benefits paid to uninsured Chapter 11 debtor's employee injured in postpetition industrial accident was not entitled to priority status as excise tax, where payments by ICA resulted from debtor's voluntary decision not to provide insurance so that ICA's assessment should be regarded as fee rather than tax. Bankr.Code, 11 U.S.C.A. § 507(a)(7)(E); A.R.S.

§§ 23–901 to 23–1091, 23–907, subds. A–C.

3 Cases that cite this headnote

[6] **Bankruptcy**Governmental Claims; Taxes, Etc

Claim of Industrial Commission of Arizona (ICA) for reimbursement for workers' compensation paid to uninsured Chapter 11 debtor's employee injured in postpetition industrial accident was entitled to administrative expense priority as actual, necessary cost of preserving estate. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A); A.R.S. §§ 23–901 to 23–1091, 23–907, subds. A–C.

3 Cases that cite this headnote

[7] **Bankruptcy**Administrative Expenses in General

Expenses of preserving estate, entitled to administrative expense priority, include liabilities that arise out of trustee's or debtor-in-possession's actual and necessary costs of administering estate. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

5 Cases that cite this headnote

[8] **Bankruptcy**Administrative Expenses in General

In order to recover expenses of preserving estate as administrative claim, claimant is not required to prove that claim benefitted estate; rather than requiring actual benefit to estate, provision only requires that conduct involved in attempting to preserve estate must be for benefit of estate as opposed to benefit of some other entity. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

2 Cases that cite this headnote

[9] **Bankruptcy**Administrative Expenses in General

Postpetition expenses which benefit third party are not entitled to administrative expense priority as expense necessary to preserve estate. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

5 Cases that cite this headnote

Attorneys and Law Firms

***576** Lawrence D. Hirsch, Phoenix, AZ, for appellant Industrial Com'n of Arizona.

Scott D. Gibson, Tucson, AZ, for appellee Alan R. Solot.

Before RUSSELL, ASHLAND and McMANUS,[1] Bankruptcy Judges.

OPINION

RUSSELL, Bankruptcy Judge:

This appeal arises from the denial of an application for an administrative expense priority pursuant to § 503(b)(1)[2] for a claim arising from a postpetition industrial accident and a postpetition worker's compensation award. We REVERSE and REMAND.

I. FACTS[3]

[1] [2] On March 10, 1988, the debtor, Sierra Pacific Broadcasters, Ltd. ("Sierra") filed a voluntary chapter 11 petition. Sierra, as debtor in possession, operated a radio station in Arizona. In early 1990, the appellee, Alan R. Solot was appointed the chapter 11 trustee ("chapter 11 trustee").

Sometime prior to the time the chapter 11 trustee was appointed, Sierra, as debtor in possession, allowed its worker's compensation insurance to lapse. For some unknown reason, the chapter 11 trustee did not reinstate ***577** the worker's compensation insurance at the time of his appointment.

On January 2, 1992, Richard L. Mize ("Mize"), an employee of Sierra, was injured in an industrial accident. Since there was no insurance available to compensate Mize for his work-related injuries, the appellant, Industrial Commission of Arizona ("ICA") paid benefits to Mize pursuant to Arizona law.[4]

On July 15, 1992, ICA filed an application for payment of a $50,000 administrative claim against Sierra for reimbursement of the compensation benefits paid to Mize.

On February 2, 1994, ICA filed an amended proof of claim asserting an administrative claim of $75,000.

Although the chapter 11 trustee originally agreed to the $75,000 claim, he later filed an objection to ICA's claim. The chapter 11 trustee was joined in his objection by the Internal Revenue Service and the appellee, Edward P. Bolding, who was the sole shareholder of Sierra.

On July 26, 1994, the bankruptcy court held a hearing on ICA's application for payment of the alleged administrative expense. On October 27, 1994, the bankruptcy court denied ICA's application.

On November 2, 1994, ICA filed a motion for reconsideration. The bankruptcy court denied ICA's motion.

ICA timely filed its notice of appeal.

II. ISSUES

A. Whether a claim for reimbursement of worker's compensation benefits is entitled to priority status as an excise tax under § 507(a).

B. Whether a claim arising from a postpetition industrial accident and postpetition reimbursement of a worker's compensation award is entitled to an administrative expense priority under § 503(b)(1)(A).

III. STANDARD OF REVIEW

[3] The BAP reviews issues of statutory interpretation as questions of law reviewed *de novo*. *In re Sun Runner Marine, Inc.,* 134 B.R. 4, 5 (9th Cir. BAP 1991).

[4] The BAP reviews for an abuse of discretion the bankruptcy court's award or denial of administrative claims pursuant to § 503(b)(1)(A). *In re Hanna,* 168 B.R. 386, 388 (9th Cir. BAP 1994).

IV. DISCUSSION

A. *Priority Status as an Excise Tax under § 507(a)*

[5] ICA argues that its claim for reimbursement of the worker's compensation benefits paid to Mize was entitled to priority status as an excise tax pursuant to § 507(a)(7)(E).[5] We disagree.

Recently, the BAP was presented with a very similar argument involving ICA and whether its claim for reimbursement of a worker's compensation benefit was an excise tax entitled to priority status under § 507(a)(7)(E)(ii).[6] *See In re Camilli,* 182 B.R. 247 (9th Cir. BAP 1995).

In *Camilli,* the ICA asserted that its claim was nondischargeable as an excise tax. The BAP concluded that ICA's claim was not an ***578** excise tax entitled to priority under § 507(a), and thus was dischargeable. *Id.* at 252.

More specifically, the BAP stated:

> The Bankruptcy Code generally does not give priority to claims resulting from injuries suffered by a debtor's employee. If a private insurer had paid [the injured worker's] claim, the debtor would have had no obligation to reimburse the insurer for the claim and the insurer's claim for any insurance premiums owed would not be given priority in bankruptcy. The payments to [the injured worker] by the ICA resulted from [the debtor's] voluntary decision not to provide insurance, and therefore the ICA's assessment should be regarded as a fee.
>
> ....
>
> Because in Arizona an employer may elect not to use insurance provided by the State, charges assessed by the State are in the nature of fees rather than taxes.

Id. at 251 (citation omitted).

The only difference between *Camilli* and the instant case is the fact that ICA's claim in *Camilli* arose prepetition. That fact alone, however, would not affect the conclusion that ICA's claim is not an excise tax entitled to priority under § 507(a)(7).[7]

Because ICA's claim is not an excise tax, we need not decide whether ICA would be entitled to an administrative expense priority pursuant to § 503(b)(1)(B)(i) (allowing administrative expense priority for taxes incurred by the estate).

B. *Administrative Expense Priority under § 503(b)(1)(A)*

[6] ICA also argues that its claim is entitled to an administrative expense priority under § 503(b)(1)(A). The chapter 11 trustee contends that ICA submitted no proof that its claim benefitted the estate.

[7] Section 503(b)(1)(A) defines administrative claims to include "the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case...." 11 U.S.C. § 503(b)(1)(A). These expenses include the liabilities that arise out of the trustee or debtor in possession's actual and necessary costs of administering the estate. *Reading Co. v. Brown,* 391 U.S. 471, 483, 88 S.Ct. 1759, 1766, 20 L.Ed.2d 751 (1968).

In *Reading,* the Supreme Court held that satisfaction of a tort liability incurred by the receiver during an arrangement proceeding under the Bankruptcy Act of 1898 would be granted administrative priority, since the liability arose within the scope of the receiver's authority.[8] The liability was thus chargeable against the estate as an actual and necessary cost of administration because it occurred postpetition.

The Supreme Court has made it clear that "[t]he plain meaning of legislation should be conclusive, except in the 'rare case [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.' " *United States v. Ron Pair Enters., Inc.,* 489 U.S. 235, 242, 109 S.Ct. 1026, 1031, 103 L.Ed.2d 290 (1989) (quoting ***579** *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 571, 102 S.Ct. 3245, 3250, 73 L.Ed.2d 973 (1982)).

[8] A review of § 503(b)(1)(A) does not indicate that a claimant is required to prove that a claim *benefitted* the estate. The chapter 11 trustee relies on *In re Palau Corp.,* 18 F.3d 746 (9th Cir.1994) and *In re Dant & Russell, Inc.,* 853 F.2d 700 (9th Cir.1988) for the proposition that ICA's claim does not represent a cost or expense that benefitted the estate.

In *Palau,* an employee sought approval of an administrative priority claim arising from a backpay award which accrued postpetition to an employee who was terminated prepetition. The crucial issue focused on whether the backpay award represented services *rendered* after the commencement of the case. The Ninth Circuit concluded that the employee was not entitled to an administrative expense priority pursuant to § 503(b)(1)(A) because the claim was not for postpetition services rendered. 18 F.3d at 750–51.

[9] In *Dant & Russell,* the Ninth Circuit stated, "[t]he statute is explicit. Any claim for administrative expenses must be the actual and necessary costs of preserving the estate for the *benefit* of its creditors." *Id.* at 706 (emphasis added). The reference to the "benefit of its creditor" is not in § 503(b)(1)(A). Rather than requiring an actual benefit to the estate, the language only requires that the conduct involved in attempting to preserve the estate must be for the "benefit" of the estate as opposed to the benefit of some other entity. For example, postpetition expenses which benefitted a third party would not be entitled to an administrative expense. *See e.g. In re Leedy Mortgage Co., Inc.,* 111 B.R. 488, 493 (Bankr.E.D.Pa.1990) (stating that the cost incurred to benefit the claimants' own interest is not entitled to administrative priority).

In *Dant & Russell,* the issue involved a claim for an administrative expense priority by the debtor's lessor for environmental cleanup costs on property which had been leased by the debtor. The lease was rejected by the debtor in possession shortly after bankruptcy pursuant to § 365(g). Since the effect of rejection under § 365(g) is to treat the breach of an unexpired lease as occurring prepetition, the Ninth Circuit concluded that the damages also occurred prepetition. Thus, the claim was not entitled to an administrative expense priority. The Ninth Circuit did note, however, that the result would be different if the contaminated property were property of the estate. 853 F.2d at 709. In that case, the claimant would have been entitled to an administrative expense priority.

This case differs from *Palau* and *Dant & Russell* in that the injury and the claim both arose *postpetition.* For example, Mize's injury occurred postpetition as well as the compensation benefits paid on Sierra's behalf to Mize.

We disagree with the chapter 11 trustee's assertion that *Reading* only involves cases where the trustee engages in tortious conduct. Clearly, the estate is liable for any actual and necessary costs of administration arising from postpetition claims of worker's compensation benefits arising from postpetition injuries. *See Reading,* 391 U.S. at 482, 88 S.Ct. at 1765 (stating that it was natural and just that those injured by the operation of a business during arrangement recover ahead of those creditors for whose benefits the business is continued).

V. CONCLUSION

The ICA's claim is not entitled to priority status under § 507(a) because it is not an excise tax. Because the claim was an actual and necessary cost of administration the bankruptcy court abused its discretion in denying ICA's claim as an administrative expense priority pursuant to § 503(b)(1)(A).

Accordingly, we REVERSE and REMAND for the bankruptcy court to enter an order allowing the claim as an administrative expense.

All Citations

185 B.R. 575, 27 Bankr.Ct.Dec. 880, Bankr. L. Rep. P 76,623, 95 Cal. Daily Op. Serv. 7049, 95 Daily Journal D.A.R. 11,763

Footnotes

[1] Hon. Michael S. McManus, Bankruptcy Judge for the Eastern District of California, sitting by designation.

[2] Unless otherwise indicated, all Chapter, Section and Rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1330 and to the Federal Rules of Bankruptcy Procedure, Rules 1001–9036.

[3] One day prior to oral argument, the debtor/appellee informed this Panel that the underlying bankruptcy case had been dismissed. Ordinarily, the dismissal of a bankruptcy case on appeal may render an appeal moot. *See In re Universal Farming Indus.,* 873 F.2d 1334, 1335 (9th Cir.1989) ("When the issue being litigated directly involves the debtor's reorganization, the case is mooted by the dismissal of the bankruptcy."). However, in this case, the appeal is not moot because a remedy exists whereby, if ordered, the administrative claimant can return any distributions wrongfully received to the estate to be shared *pro rata* among other administrative claimants. *See In re Vista Del Mar Assoc., Inc.,* 181 B.R. 422, 423–24 (9th Cir. BAP 1995) (stating general rule of mootness "focusses on an [appellate] court's ability to fashion meaningful relief."); *In re Baker & Drake, Inc.,* 35 F.3d 1348, 1351–52 (9th Cir.1994) (discussing rules of mootness).

[4] Arizona's worker's compensation statutes are codified at Ariz.Rev.Stat.Ann. §§ 23–901 to 23–1091 (West 1994). Under Arizona law, an employer who fails to procure worker's compensation insurance can be held liable to an injured worker in a legal action. Ariz.Rev.Stat.Ann. § 23–907.A. The injured worker may either file a civil action against the employer or apply for compensation benefits with the ICA. Ariz.Rev.Stat.Ann. § 23–907.B. Payments of these benefits "act as a judgment against the employer." Ariz.Rev.Stat.Ann. § 23–907.C.

[5] We note that under the Bankruptcy Reform Act of 1994, § 507(a)(7)(E) has been redesignated as § 507(a)(8)(E). *See* Pub.L. No. 103–394, 108 Stat. 4106 (1994), *reprinted in,* 1994 U.S.C.C.A.N. 3340.

[6] Section 507(a)(7)(E)(ii) provides the following expenses and claims have priority in the following order: "(7) allowed unsecured claims of governmental units, only to the extent that such claims are for— ... (E) an excise tax on— ... (ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition." 11 U.S.C. § 507(a)(7)(E)(ii).

[7] Because the facts of the very recently decided BAP case are so closely related to this appeal, we are bound by that decision. Of course, this is not to say that the result would have been different in this appeal had the BAP not recently decided the issue. *See Bank of Maui v. Estate Analysis, Inc.,* 904 F.2d 470, 472 (9th Cir.1990) (O'Scannlain, J., concurring) (explaining that the goal of creating the BAP was making BAP decisions binding on all bankruptcy courts in the circuit); *In re Ball,* 185 B.R. 595 (9th Cir. BAP 1995) (stating that a Panel should not overrule a prior ruling "unless a Ninth Circuit Court of Appeals decision, Supreme Court decision or subsequent legislation has undermined those rulings."); *In re Windmill Farms, Inc.,* 70 B.R. 618, 622 (9th Cir. BAP 1987), *rev'd on other grounds,* 841 F.2d 1467 (9th Cir.1988) (stating any decision not concluding that BAP decisions are binding throughout the entire circuit are in error).

[8] Section 503(b) replaced § 64(a) of the Bankruptcy Act of 1898. The two sections are virtually identical. Section 64(a) provides that "to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate...." 11 U.S.C. § 64(a) (repealed 1978).

19 B.R. 9
United States Bankruptcy Court, D. Rhode Island.

In re Alfred GOMES, Debtor.

Bankruptcy No. 8100106.
|
April 2, 1982.

Synopsis
Attorney filed application for services rendered and expenses incurred as state court wage earner receiver. The Bankruptcy Court, Arthur N. Votolato, Jr., J., held that: (1) attorney's position as state court-appointed state wage earner receiver qualified him as "custodian," and his compensation therefore constituted administrative expense of estate, and (2) record established that attorney was entitled to award as custodian of $1,000, which was less than five percent of total payments to be made into debtor's Chapter 13 plan.

Judgment accordingly.

West Headnotes (4)

[1] **Bankruptcy**Professional Services; Attorney Fees

Attorney's position as state court-appointed state wage earner receiver qualified him as "custodian," and his compensation therefore constituted administrative expense of estate. Bankr.Code, 11 U.S.C.A. §§ 101(10)(A), 1301 et seq.; R.I.Gen.Laws 1956, § 10–18–1 et seq.

6 Cases that cite this headnote

[2] **Bankruptcy**Expenditures in General

As matter of comity, Bankruptcy Court may recognize presumption in favor of reasonableness of state court allowance, but the Bankruptcy Court ultimately must exercise its independent judgment whenever determining compensation payable to custodian out of estate being administered by the Bankruptcy Court. Bankr.Code, 11 U.S.C.A. §§ 503, 503(b)(3)(E), 543, 543(c)(2).

[3] **Bankruptcy**Time of Accrual; Prepetition Claims

With regard to Bankruptcy Court's duty to award receivers reasonable compensation, prerequisite to any such allowance is judicial determination that amount allowed is reasonable in view of quality and extent of services performed. Bankr.Code, 11 U.S.C.A. § 543(c)(2).

2 Cases that cite this headnote

[4] **Bankruptcy**Trustee as Attorney

Record established that attorney, who was appointed by state court as State Wage Earner Receiver and who performed services similar to, although not as extensive as, those routinely performed by Chapter 13 Trustees, was entitled to award as custodian of $1,000, which was less than five percent of total payments to be made into debtor's Chapter 13 plan. Bankr.Code, 11 U.S.C.A. §§ 101(10)(A), 701 et seq., 1301 et seq., 151326(b); R.I.Gen.Laws 1956, § 10–18–1 et seq.

8 Cases that cite this headnote

Attorneys and Law Firms

***10** Leo D. Covas, State Court Receiver, Connors & Kilguss, Providence, R. I., for Alfred C. Gomes.

Russell D. Raskin, Providence, R. I., for debtor.

John Boyajian, Boyajian, Coleman & Harrington, Providence, R. I., Trustee.

Opinion

ARTHUR N. VOTOLATO, Jr., Bankruptcy Judge.

Heard on the Application for Allowance by Leo D. Covas, Esq. in the amount of $2,621.23 for services rendered and expenses incurred as State Court Wage Earner Receiver, and on the Debtor's objection to the amount of said application.

The undisputed facts of this case are as follows: Attorney Covas was appointed State Wage Earner Receiver by a

justice of the Rhode Island Superior Court on August 1, 1978, and a plan of payment was formulated to settle the Debtor's financial obligations.[1] Gomes made a number of payments, but he was apparently unable to continue funding the plan after March 20, 1980. Because of Gomes' inability to make payments, the Superior Court terminated the receivership on October 20, 1980 and allowed the Receiver a fee in the amount of $2,500, although there were apparently no funds available from which the allowance could be paid. The Debtor filed a Chapter 13 petition in this Court on February 19, 1981, and Mr. Covas filed the instant application, contending that the Bankruptcy Court is bound by and must award the same fee granted by the State Court.

[1] Covas also requests the Court to determine that he is a custodian within the definition of 11 U.S.C. s 101(10)(A)[2] and to authorize payment of his fees and expenses as an administrative expense of the estate. 11 U.S.C. s 503(b)(3)(E).[3] Covas' position ***11** as court-appointed State Wage Earner Receiver certainly qualifies him as a custodian,[4] and his compensation therefore constitutes an administrative expense.

[2] The issues before the Court are: (1) whether the State Court award is res judicata, and (2) if not, what is the reasonable value of the services in question. The fact that Covas' services were of benefit to the estate is undisputed. However, it is also clear that the amount of compensation to which the Receiver is entitled is a matter for determination by the Bankruptcy Court. 11 U.S.C. s 543(c)(2).[5] As a matter of comity, the Court may recognize a presumption in favor of the reasonableness of the State Court allowance, but this Court ultimately must exercise its independent judgment whenever determining compensation payable out of an estate being administered in the Bankruptcy Court. Hume et al. v. Meyers et al. (In re Piedmont Manganese Corp.), 242 F. 827, 830-31 (4th Cir. 1917). See also In re India Wharf Brewery, Inc., 96 F.2d 710 (2nd Cir. 1938); In re Left Guard of Madison, Inc., 11 B.R. 238, 7 BCD 974 (Bkrtcy.W.D.Wis.1981).

An analogy can be made to the Bankruptcy Court's inherent authority to consider evidence extrinsic to the judgment and record of a prior state suit, when determining whether a debt previously reduced to judgment is dischargeable. In Brown v. Felsen, 442 U.S. 127, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979), the Supreme Court held that the Bankruptcy Court is not confined to a review of the judgment and record in the prior state court proceeding when determining the dischargeability of a debt if no judicial inquiry has been made into the facts affecting the issue before the Court.

[3] Similarly, with regard to the Court's duty under s 543(c)(2) to award receivers reasonable compensation, a prerequisite to any such allowance is a judicial determination that the amount allowed is reasonable in view of the quality and extent of services performed. Here, the Applicant has not shown that the State Court award was based upon any judicial inquiry into the quality and/or extent of services performed. See generally Dunson v. Lewis (In re Lewis), 17 B.R. 341 (Bkrtcy.S.D.Ohio, 1982); Citibank, N.A. v. Friedenberg (In re Friedenberg), 12 B.R. 901, 8 BCD 69 (Bkrtcy.S.D.N.Y.1981); Murray v. Day (In re Day), 4 B.R. 750 (D.C.S.D.Ohio 1980), appeal dismissed 633 F.2d 214 (6th Cir. 1980). Accordingly, the Receiver's objection to review by the Bankruptcy Court is overruled, and the application will be considered here on the merits.

[4] The applicant has advanced none, and I see no reason why the compensation of state court appointed people should exceed the compensation allowed in the Bankruptcy Court for the same or similar services. The compensation of officials appointed by either court should be based upon the same criteria, i.e., the time expended, the intricacy of work involved, the size of the estate, and the benefit of the services to the estate. See In re Marichal-Agosto, Inc., 12 B.R. 891 (Bkrtcy.S.D.N.Y.1981); In re Left Guard of Madison, Inc., supra. In this case, the services performed by Mr. Covas in the State Court were similar to, although not as extensive as those routinely performed by the Chapter 13 Trustee in Bankruptcy. 11 U.S.C. s 151326(b) provides that a private ***12** trustee supervising a Chapter 13 case may be awarded up to 5 percent of the total payments into the plan. If the instant Chapter 13 case is fully consummated, the maximum fee for the Trustee will amount to $1,675.[6] The Court, of course, in its discretion may reduce this amount. The Attorney for the Debtor requested an allowance in the amount of $1,310. He was awarded $750, payable as follows: one-third forthwith, one-third when the plan accumulates funds sufficient to satisfy one-third of all accepted claims, and the balance upon consummation of the plan.[7] In Chapter 13, where economy is essential, basic fairness and common sense require that the compensation of state appointed court officers should bear some reasonable relationship to that of persons doing the same work in the Federal courts.

Attorney Covas' request of $2,500 exceeds 20 percent of the assets collected and disbursed in the State Court proceeding. Based upon the entire record, together with what I consider to be the applicable law, the maximum value of the services performed by Attorney Covas is $1,000. He is also allowed $121.23 in expenses.

All Citations

19 B.R. 9, 8 Bankr.Ct.Dec. 1401

Footnotes

1 Rhode Island law provides for a state version of a Chapter 13 wage earner petition. See R.I.Gen.Laws s 10-18-1 et seq.

2 Section 101(10)(A) defines custodian as a "receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title."

3 s 503. Allowance of administrative expenses.

> ....
> (b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including-
> ....
> (3) the actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by-
> ....
> (E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian;

4 The definition of custodian includes those functions which are substantially similar to those of a state receiver or trustee. See note 2, supra; House Report No. 95-595, 95th Cong. 1st Sess. (1977) 309, 310, U.S.Code Cong. & Admin.News 1978, p. 5787.

5 s 543. Turnover of property by a custodian.

> ....
> (c) The court, after notice and a hearing, shall-
> ....
> (2) provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such custodian;

6 Approximately $33,504 is scheduled to be paid into the plan, and the Trustee is responsible for the proper administration and distribution of that sum.

7 Although that order is a departure from the normal practice, I believe that staggered payments are justified by the circumstances. The Trustee has moved to convert the case to Chapter 7 on several occasions because timely payments have not been made. Although I have serious doubt about the plan's eventual consummation, it has been allowed to continue because creditors would probably receive nothing in liquidation, and counsel for the Debtor vigorously represents that mortgage and other arrearages will be made up, and that future installments will be paid in a timely fashion. Since the creditors have been required to endure inordinate delay based on Mr. Raskin's vigorous opposition to conversion of this proceeding, it is equitable that payment of his fee should also be contingent upon the accuracy of his representations.

32 Cal.App.5th 648
Court of Appeal, Second District, Division 3, California.

CITY OF SIERRA MADRE, Plaintiff and Respondent,
v.
SUNTRUST MORTGAGE, INC., Defendant and Appellant;
David J. Pasternak, Real Party in Interest and Respondent.

B284550
|
Filed 2/26/2019

Synopsis

Background: Following residential landowners' refusal to abate nuisance, 2018 WL 6787331, city brought action against landowners and mortgage lender and sought appointment of receiver to undertake remediation, and receiver sought approval for super-priority lien. The Superior Court, Los Angeles County, No. GC046442, William D. Stewart, J., granted the lien, and mortgage lender appealed.

Holdings: The Court of Appeal, Lavin, J., held that:

[1] receiver appointment statute authorized super-priority lien, and

[2] court appropriately exercised its discretion when authorizing super-priority lien.

Affirmed.

Procedural Posture(s): On Appeal; Judgment.

West Headnotes (18)

[1] **Appeal and Error** Effect of delay or lapse of time in general

When, pending an appeal from the judgment of a lower court, and without any fault of the defendant, an event occurs which renders it impossible for the appellate court, if it should decide the case in favor of plaintiff, to grant him any effectual relief whatever, the court will not proceed to a formal judgment, but will dismiss the appeal.

[2] **Action** Moot, hypothetical or abstract questions

The pivotal question in determining if a case is moot is whether the court can grant the plaintiff any effectual relief; if events have made such relief impracticable, the controversy has become "overripe" and is therefore moot.

More cases on this issue

[3] **Appeal and Error** Substantive questions and issues

Mortgage lender's failure to obtain stay pending appeal, and receiver's act in obtaining loan to fund remediation of nuisance property secured by super-priority lien and completion of remediation, did not render mortgage lender's appeal of lien priority moot, as court could resolve the issue concerning the relative priority of the lien and mortgage, and, even if the property had been sold and the funds improperly dispersed, mortgage lender might still have a remedy in equity.

More cases on this issue

[4] **Receivers** Representation by receiver of court and of parties

The function of the receiver is to aid the court in preserving and managing the property involved in a particular lawsuit for the benefit of those to whom it can ultimately be determined to belong. Cal. Civ. Proc. Code § 568.

2 Cases that cite this headnote

[5] **Receivers** Representation by receiver of court and of parties
Receivers Authority of receiver in general

A receiver is an officer of the court and is subject to the court's continuing control, and only has those powers granted to it by statute or an order

of the court. Cal. Civ. Proc. Code § 568.

2 Cases that cite this headnote
More cases on this issue

[6] **Receivers**Representation by receiver of court and of parties

Receiver, acting for the court, is not the agent of any party but acts for the benefit of all holding an interest in the receivership property. Cal. Civ. Proc. Code § 568; Cal. Rules of Court, rule 3.1179(a).

1 Case that cites this headnote

[7] **Receivers**Authority of receiver in general

A receiver has the power, with court authorization, to take possession of property, receive rents, collect debts, borrow money, and sell real or personal property in receivership pursuant to court order. Cal. Civ. Proc. Code §§ 568, 568.5.

1 Case that cites this headnote
More cases on this issue

[8] **Receivers**Title or right acquired by receiver in general
ReceiversRepresentation by receiver of court and of parties

The receiver acquires no title in the property but instead acts as an officer of the court, and title remains vested in those persons or entities in whom it was vested when the receiver was appointed. Cal. Civ. Proc. Code § 568; Cal. Rules of Court, rule 3.1179(a).

[9] **Receivers**Discretion of court

Most matters related to receiverships rest in the sound discretion of the trial court.

4 Cases that cite this headnote

[10] **Courts**Rules of Property

Considerable deference is afforded to court decisions that are drastic enough to extinguish an owner's interest in property and to decisions regarding the demolition or rehabilitation of substandard structures.

[11] **Receivers**Discretion of court

The amount of compensation paid to a receiver is within the court's discretion.

3 Cases that cite this headnote

[12] **Receivers**Discretion of court

Although the receiver's compensation is typically paid from the receivership estate, the court has considerable discretion to determine who must ultimately bear the cost of the receivership.

1 Case that cites this headnote

[13] **Receivers**Loans and advances to receiver, and securities therefor
ReceiversPower to authorize issue

Courts have substantial discretion to authorize a receiver to borrow money to fund the preservation and management of property in the receivership estate, particularly where the estate does not produce income; in that circumstance, the receiver may ask the court to authorize the issuance of a receiver's certificate to the lender as security for money loaned to the estate.

3 Cases that cite this headnote

[14] **Receivers**Lien and priorities

Use of super-priority liens in the context of money loaned to a receivership estate should be infrequent because the disturbance of preexisting liens may bring harsh consequences.

2 Cases that cite this headnote

[15] **Receivers**Lien and priorities

Generally applicable receivership statute under which receiver was appointed authorized issuance of super-priority lien in connection with loan to remediate nuisance property, even if second statute under which receiver was appointed, authorizing appointment of receivers to remedy building code violations, did not specifically mention a super-priority lien. Cal. Civ. Proc. Code §§ 564, 568; Cal. Health & Safety Code § 17980.7.

2 Cases that cite this headnote
More cases on this issue

[16] **Mortgages and Deeds of Trust**🔑Government Claims and Liens
Receivers🔑Lien and priorities

Trial court appropriately exercised its discretion when authorizing a super-priority lien in favor of receiver for nuisance property which took priority over mortgage; homeowners refused to abate the nuisance they created on their property, mortgage lender chose to take no action against them even though they were plainly in breach of the deed of trust, lender did not object to appointment of receiver to abate nuisance, neither homeowners nor lender were willing to fund the costly remediation such that receiver had to borrow money in order to proceed, and no lender would loan money to the receiver unless the loan was secured with a super-priority lien on the property. Cal. Civ. Proc. Code §§ 564, 568.

1 Case that cites this headnote
More cases on this issue

[17] **Receivers**🔑Lien and priorities

Imposition of a super-priority lien by receiver for nuisance property did not substantially prejudice mortgage lender, which was senior lienholder, as, prior to the remediation, property had minimal or negative value and mortgage lien was unlikely to be repaid.

More cases on this issue

[18] **Mortgages and Deeds of Trust**🔑Waste

Although a mortgage lender is generally barred from suing its borrower to recover the balance of a mortgage loan when the value of the property is inadequate to satisfy the loan, a lender may bring an action against a borrower for bad faith waste in appropriate circumstances. Cal. Civ. Proc. Code § 580b.

Witkin Library Reference: 6 Witkin, Cal. Procedure (5th ed. 2008) Provisional Remedies, § 454 [Possession and Control of Property.]

****120** APPEAL from an order of the Superior Court of Los Angeles County, William D. Stewart, Judge. Affirmed. Los Angeles County Super. Ct. No. GC046442.

Attorneys and Law Firms

Wright, Finlay & Zak, Jonathan D. Fink, Newport Beach, and Ruby J. Chavez for Defendant and Appellant.

Dapeer, Rosenblit & Litvak and William Litvak, Los Angeles, for Plaintiff and Respondent.

Pasternak, Pasternak & Alsbrook, David J. Pasternak and Blake C. Alsbrook, Los Angeles, for Real Party in Interest.

Michael N. Feuer, City Attorney (Los Angeles), Wilfredo R. Rivera, Assistant City Attorney, Christina V. Tusan, Jeremy Berzon and Rebecca Morse, Deputy City Attorneys for The People of the State of California as Amici Curiae on behalf of Plaintiff and Respondent and Real Party in Interest.

LAVIN, J.

***651 INTRODUCTION**

This is the second appeal before us involving a public nuisance created by Jeffrey ****121** M. and Taryn N. Hildreth (the Hildreths) on their residential property in Sierra Madre. (See ***652** *City of Sierra Madre v. Hildreth* (Dec. 26, 2018, B281729), 2018 WL 6787331 [nonpub. opn.].) Because the Hildreths refused to abate the nuisance, the City of Sierra Madre (City) brought the present action against them and their mortgage lender, appellant SunTrust Mortgage, Inc. (SunTrust), and sought the appointment of a receiver to undertake the remediation. SunTrust did not object to the appointment of the receiver or the remediation plan, but when the receiver borrowed $250,000 to fund the remediation work, SunTrust objected to the issuance of the lien securing that loan because it had priority over SunTrust's preexisting lien. The receiver and real party in interest in this appeal sought approval for the super-priority lien because no lender would loan funds without it. SunTrust appeals the court's order authorizing the super-priority lien.

SunTrust's primary argument is that Health and Safety Code section 17980.7—a statute authorizing the appointment of a receiver in cases involving remediation of substandard buildings—does not explicitly provide that a court may issue a super-priority lien which displaces previously existing

liens. We reject this argument because the use of super-priority liens has been approved in California since at least 1915. SunTrust's remaining arguments are without merit. We therefore affirm the order.

FACTS AND PROCEDURAL BACKGROUND

1. Over the course of more than 10 years, the Hildreths undertake several unpermitted construction projects on their residential property.

In July 1998, the Hildreths purchased a small home in Sierra Madre. The home was in substantial disrepair and the Hildreths began a complete remodel—without the benefit of any permits from the City. In October 1998, after the City issued a stop work order due to the absence of permits, the Hildreths requested and obtained permits for plumbing, building, electrical, and mechanical work relating to the renovation. Although the Hildreths eventually completed the work contemplated by the permits and moved into the home, they never notified the City the work was completed or requested a final inspection.

Around the time the Hildreths began the renovation, they decided they wanted to develop the home and the property for commercial use—specifically, a wine tasting and sales business. In September 1999, the Hildreths applied for a conditional use permit describing their proposed business operation, but the City never issued the requested permit. The Hildreths, however, proceeded to develop the property for their proposed wine business. In 2005, the City discovered the Hildreths had excavated a large pit on the eastern side of their property which caused a portion of an adjacent alley to collapse. The City immediately issued a stop work order and ***653** required the Hildreths to work with a licensed engineer and a licensed shoring contractor, together with the City Building Department, to install temporary shoring. The Hildreths later constructed an unpermitted cement structure in the pit.

Then, in early 2009, the City discovered the Hildreths had—again without permits—excavated the western portion of their property to a depth of 12 feet below ground level, including the area underneath the western side of the house. The excavated area ran the entire length of the property and extended east to the unpermitted subterranean cement structure. In ****122** June 2009, the City issued another stop work order. It appears SunTrust refinanced the Hildreths' mortgage during this time, as a deed of trust evidencing a mortgage loan of $276,000 was recorded in March 2009.

In 2010, apparently undeterred by the City's prior warnings, the Hildreths erected a large, unpermitted deck in their front yard that extended over the public sidewalk adjacent to their property. In late October 2010, after receiving complaints from City residents, the City inspected the property and issued another stop work order.

2. The City files a nuisance action naming the Hildreths and SunTrust as defendants.

On December 1, 2010, the City filed the present action against the Hildreths and SunTrust seeking declaratory relief and asserting claims for public nuisance, municipal code violations, and state housing law violations. The following month, in January 2011, the court issued a preliminary injunction identifying a minimum of 30 violations of state and local building codes and prohibiting the Hildreths from performing any additional work or residing in the home without required permits, inspections, and approvals by the City. The court also ordered the Hildreths to submit the requisite applications, plans, documents, and fees to the City regarding the outstanding violations and, upon approval by the City, to remediate the home and the property.

3. After the Hildreths fail to remediate the property, the court appoints a receiver. SunTrust does not object to the appointment.

The Hildreths refused to cooperate with the City or comply with the preliminary injunction. In August 2012, more than a year and a half after the court issued the preliminary injunction, the City asked the court to appoint a receiver to take custody and control of the Hildreths' property. SunTrust did not object to the appointment. Citing the Hildreths' continuing obstruction, the court granted the City's request and appointed David J. Pasternak to act ***654** as the receiver. Because the Hildreths obstructed the receiver's work, the City and the receiver agreed to postpone the remediation until after the court entered judgment in the nuisance action.

4. Following a lengthy bench trial, the court finds in favor of the City on all claims and enters judgment accordingly. SunTrust does not participate in the trial.

The court conducted a 27-day bench trial during the spring of 2016. SunTrust did not participate in the trial but reserved the right to challenge the issuance of any lien that would displace its position as first lienholder.

The court issued a lengthy and thorough statement of decision in support of its judgment in favor of the City on all claims. As pertinent here, the court found the unpermitted and unapproved construction constituted a public nuisance under the City's municipal code as well as under state law, and injunctive relief to abate the nuisance was appropriate. The court entered judgment in the City's favor in January 2017.

Also, and as part of the judgment, the court ordered the previously-appointed receiver to oversee remediation of the property. The court found the Hildreths would not be willing or able to remediate the property if given the opportunity to do so. The Hildreths were required to pay the receiver's costs, however.

****123 5. The receiver presents a remediation plan, which the court adopts. SunTrust objects to the proposed super-priority lien for the lender funding the remediation but does not object to the plan.**

In early April 2017, the receiver provided his remediation report to the court. The property needed extensive and costly work performed. Specifically, a contractor would need to fill the excavated portion of the lot with slurry, increase the home's structural support, and remove the large deck encroaching on the public sidewalk. The lowest of the three contractor bids was approximately $250,000 and the bulk of the expense related to filling in the pit under the Hildreths' home.

The receiver also advised the court that the value of the property after remediation would be $175,000 to $200,000 as a vacant lot and $465,000 to $495,000 with the rehabilitated home. Because the cost to remediate the home was relatively small and the increase in value was substantial, the receiver recommended rehabilitating, rather than demolishing, the home.

To fund the remediation, the receiver proposed borrowing funds from South County Bank (bank), one of very few institutional lenders willing to ***655** provide such funding. The bank would require, however, its loan to be secured by a receiver's certificate with first priority, i.e., a senior lien on the property ahead of all other recorded liens and encumbrances (i.e., super-priority lien). The receiver indicated no lender would loan money to the receiver unless it received a super-priority lien. The property as it then existed had no equity in light of the SunTrust lien. And even after remediation, the property value would be insufficient to satisfy the SunTrust lien, the substantial attorney's fees and cost award to the City (approximately $875,000), and the receiver's costs of administration. In other words, according to the receiver, a lender would not be repaid unless it had a super-priority lien on the property.

SunTrust objected to the receiver's proposed remediation plan but only to the extent it provided a super-priority lien for the bank that would displace SunTrust as the senior lienholder. SunTrust did not challenge the receiver's approach or the cost of the remediation.

6. The court authorizes the receiver to borrow funds as proposed. SunTrust appeals.

On July 5, 2017, the court granted the receiver's request in large part.[1] Specifically, the court authorized the receiver to borrow $250,000 from the bank in exchange for a receiver's certificate in the amount of the loan with first priority ahead of all other encumbrances if SunTrust opted not to fund the remediation. SunTrust opted not to do so and appealed from the July 5, 2017 order.

DISCUSSION

SunTrust contends the trial court erred in authorizing the receiver to issue a receiver's certificate with first priority over all other liens and encumbrances.

1. The appeal is not moot.

We first address, and reject, the City's contention that the present appeal is moot.

[1] [2] " ' "[W]hen, pending an appeal from the judgment of a lower court, and without any fault of the defendant, an ****124** event occurs which renders it impossible for this court, if it should decide the case in favor of plaintiff, to grant him any effectual relief whatever, the court will not proceed to a formal ***656** judgment, but will dismiss the appeal." '

[Citations.]" (*Panoche Energy Center, LLC v. Pacific Gas & Electric Co.* (2016) 1 Cal.App.5th 68, 95–96, 205 Cal.Rptr.3d 39.) " 'The pivotal question in determining if a case is moot is ... whether the court can grant the plaintiff any effectual relief. [Citations.] If events have made such relief impracticable, the controversy has become "overripe" and is therefore moot.' [Citation.]" (*Id.* at p. 96, 205 Cal.Rptr.3d 39.)

[3] The City contends SunTrust's appeal is moot because the receiver, in accordance with the order appealed by SunTrust, obtained a loan from South Coast Bank to fund the remediation of the Hildreths' property and secured that loan with a super-priority lien. Essentially, the City contends SunTrust forfeited the right to challenge the court's July 5, 2017 order authorizing the receiver to provide a super-priority lien because SunTrust did not obtain a stay of the order pending appeal. We disagree. Although it appears the remediation is complete at this point, that fact does not prevent us from resolving the issue presented here concerning the relative priority of liens on the Hildreths' property. And even if the property had been sold and the funds improperly dispersed, SunTrust might still have a remedy in equity against the recipient of those funds.

2. The court did not abuse its discretion in authorizing a super-priority lien to secure the loan taken by the receiver to fund remediation of the Hildreths' property.

2.1. Legal Principles

[4] [5] [6] The function of the receiver is to aid the court in preserving and managing the property involved in a particular lawsuit for the benefit of those to whom it can ultimately be determined to belong. (*Free Gold Mining Co. v. Spiers* (1901) 135 Cal. 130, 132, 67 P. 61; *City of Santa Monica v. Gonzalez* (2008) 43 Cal.4th 905, 930, 76 Cal.Rptr.3d 483, 182 P.3d 1027 (*Gonzalez*); *City of Chula Vista v. Gutierrez* (2012) 207 Cal.App.4th 681, 685, 143 Cal.Rptr.3d 689 (*Chula Vista*).) A receiver is an officer of the court and is subject to the court's continuing control; a receiver only has those powers granted to it by statute or an order of the court. (*Gonzalez*, p. 930, 76 Cal.Rptr.3d 483, 182 P.3d 1027; Code Civ. Proc., § 568.) The receiver, acting for the court, is not the agent of any party but acts for the benefit of all holding an interest in the receivership property. (*Gonzalez*, p. 930, 76 Cal.Rptr.3d 483, 182 P.3d 1027; Cal. Rules of Court, rule 3.1179(a).)

[7] [8] A receiver has the power, with court authorization, to take possession of property, receive rents, collect debts, borrow money, and sell real or personal property in receivership pursuant to court order. (Code Civ. Proc., §§ 568, 568.5.) The receiver acquires no title in the property but instead acts as an officer of the court, and title remains vested in those persons or entities in ***657** whom it was vested when the receiver was appointed. (*North v. Cecil B. De Mille Productions, Inc.* (1934) 2 Cal.2d 55, 58, 39 P.2d 199; *Kaura v. Stabilis Fund II, LLC* (2018) 24 Cal.App.5th 420, 433, 234 Cal.Rptr.3d 265.)

[9] [10] [11] [12] Most matters related to receiverships rest in the sound discretion of the trial court. As our Supreme Court noted in *Gonzalez*, for example, considerable deference is afforded to "court decisions that are drastic enough to extinguish an owner's interest in property" and to decisions regarding the demolition or rehabilitation ****125** of substandard structures. (*Gonzalez, supra*, 43 Cal.4th at p. 931, 76 Cal.Rptr.3d 483, 182 P.3d 1027.) Similarly, the amount of compensation paid to a receiver is within the court's discretion. (*People v. Riverside University* (1973) 35 Cal.App.3d 572, 587, 111 Cal.Rptr. 68 ["It is settled that fees awarded to receivers are in the sound discretion of the trial court and in the absence of a clear showing of an abuse of discretion, a reviewing court is not justified in setting aside an order fixing fees."].) And although the receiver's compensation is typically paid from the receivership estate, the court has considerable discretion to determine who must ultimately bear the cost of the receivership. (See, e.g., *Ephraim v. Pacific Bank* (1900) 129 Cal. 589, 592, 62 P. 177 [noting "the general rule that the costs of a receivership are primarily a charge upon the fund in his possession" but that " 'it may sometimes happen that a direct liability is imposed upon the parties to the action, or upon some of them, for the remuneration of the receiver' " due to " 'irregularity of the appointment, or from the insufficiency of the fund, or out of the agreement between the parties' "]; *Baldwin v. Baldwin* (1947) 82 Cal.App.2d 851, 855, 187 P.2d 429 [" 'As a general proposition the costs of a receivership are primarily a charge upon the property in the receiver's possession and are to be paid out of said property. *However, this is not an invariable rule*. In many cases a direct liability is imposed upon the parties to the action, or upon some of them, for the remuneration of the receiver.' "].) Here, as noted, the court imposed the cost of the receivership on the Hildreths. SunTrust has not challenged that determination.

[13] [14] Courts also have substantial discretion to authorize a receiver to borrow money to fund the preservation and management of property in the receivership estate, particularly where, as here, the estate does not produce income. In that circumstance, the receiver may ask the court to authorize the issuance of a receiver's certificate to the lender as security for money loaned to the estate. Typically, such a receivership certificate will have priority over all other liens—even preexisting liens. (See, e.g., 12 Miller & Starr, Cal. Real Estate (4th ed. 2018) § 41.12, p. 41-33 ["Receivership certificates are then issued as evidence of the indebtedness and become liens on the subject property when issued under the direction and control of the court, usually with priority over all other liens, including preexisting liens."].) This too is a matter committed to the sound discretion of the court. (*Title Ins. & Trust Co. v. California Development Co.* (1915) 171 Cal. 227, 233, 152 P. 564 ["The questions here ***658** involved, i.e., whether receiver's certificates should be issued and whether those certificates when issued should be given priority over the other indebtedness of the defendant, rested largely in the discretion of the court below. That court, upon a consideration of all the facts, determined that the certificates should equitably be given priority over the bonds, and we think its conclusion should not be interfered with."]; 12 Miller & Starr, *supra*, pp. 41-33 to 41-34 ["Whether receiver's certificates should be issued, and whether those certificates when issued should be given priority over the other indebtedness already of record against the property, are decisions that rest largely in the discretion of the court."].) But as the receiver points out, use of super-priority liens should be infrequent because the disturbance of preexisting liens may bring harsh consequences. (See 2 Clark on Receivers (3d ed. 1959) § 463, pp. 760–761 ["The authority to disturb existing liens should be exercised with great caution, and should be carried ****126** no further than actually necessary to attain the desired protection to the res."].)

2.2. SunTrust's arguments are without merit.

Notwithstanding the well-settled authority just discussed, SunTrust claims the court had no authority to give the bank a super-priority lien, thereby displacing SunTrust as the senior lienholder. SunTrust's arguments are not persuasive.

[15] SunTrust first argues no statute authorizes the issuance of a super-priority lien. Here, the receiver was appointed under Code of Civil Procedure section 564 (a generally applicable receivership statute) and Health and Safety Code section 17980.7 (authorizing appointment of receivers to remedy building code violations). SunTrust's primary argument is that Health and Safety Code section 17980.7 does not explicitly authorize the issuance of a super-priority lien. That section specifically identifies the powers of a receiver appointed under the Health and Safety Code and provides, in pertinent part, that a receiver appointed to take control of a substandard building[2] has the power "[t]o borrow funds to pay for repairs necessary to correct the conditions cited in the notice of violation and to borrow funds to pay for any relocation benefits authorized by paragraph (6) and, with court approval, secure that debt and any moneys owed to the receiver for services performed pursuant to this section with a lien on the real property upon which the substandard building is located. The lien shall be recorded in the county recorder's office in the county within which the building is located." (Health & Saf. Code, § 17980.7, subd. (c)(4)(G).) As SunTrust notes, that section makes no mention of a super-priority lien. And SunTrust urges us to infer from the plain language of the statute (i.e., the absence of language authorizing a super-priority lien) and the legislative history of section 17980.7 that the ***659** Legislature intended to *prohibit* super-priority liens when it adopted this statute in 1990 and amended it in 2001.

We conclude it is unnecessary to engage in a lengthy statutory analysis of Health and Safety Code section 17980.7 because, as noted, the receiver was also appointed under Code of Civil Procedure section 564. Section 568 of the Code of Civil Procedure—first enacted in 1872—gives a receiver appointed under section 564 very broad powers: "The receiver has, under the control of the Court, power to bring and defend actions in his own name, as receiver; to take and keep possession of the property, to receive rents, collect debts, to compound for and compromise the same, to make transfers, and generally to do such acts respecting the property as the Court may authorize." (Code Civ. Proc., § 568.) As already noted, the California Supreme Court long ago concluded a court may authorize a receiver to issue a super-priority lien in appropriate circumstances. (*Title Ins. & Trust Co. v. California Development Co.*, *supra*, 171 Cal. at p. 233, 152 P. 564.) And Health and Safety Code section 17980.7, subdivision (c)(4)(H),[3] specifically gives a receiver appointed under that section the powers of a receiver appointed under Code of Civil Procedure section 564.

SunTrust also contends *Chula Vista*, *supra*, does not support the issuance of a ****127** super-priority lien. (207 Cal.App.4th

at p. 681, 143 Cal.Rptr.3d 689.) Specifically, SunTrust argues "courts may impose the costs [of the receiver] on the party who sought the appointment of the receiver or apportion them among the parties." That is true, as noted *ante*. And here the court has assigned the costs of the receivership to the Hildreths. That issue is distinct, however, from SunTrust's apparent concern that it might be unable to collect the debt owed by the Hildreths if it is not paid from the proceeds of sale of the property due to the new super-priority lien created by the receiver.

In any event, *Chula Vista* is of no assistance to SunTrust. There, a receiver was appointed under Health and Safety Code section 17980.7 to cure code violations in a residential building. (*Chula Vista, supra*, 207 Cal.App.4th at p. 684, 143 Cal.Rptr.3d 689.) The court approved the receiver's request for a lien to secure his fees, but the receiver never recorded the lien. (*Id*. at p. 685, 143 Cal.Rptr.3d 689.) Eventually, the lender (and senior lienholder) foreclosed and conveyed the property to a bona fide purchaser. (*Ibid*.) Several years later, the receiver filed an action against the lender seeking payment of his fees under a theory of unjust enrichment. (*Ibid*.) The issue on appeal was whether the lender "benefited" from the receiver's services. (*Id*. at pp. 685–687, 143 Cal.Rptr.3d 689.) As that issue is not remotely relevant to the present proceeding, we address it no further.

***660** Finally, SunTrust points out that under the Health and Safety Code, the receiver may look to numerous sources for payment of receivership costs. For example, SunTrust notes the receiver could create a junior lien to secure a loan under Health and Safety Code section 17980.7, subdivision (c)(4)(G). Further, a receiver may look to the rents and profits produced by a property to pay for the cost of the receivership. (Health & Saf. Code, § 17980.7, subd. (c)(4)(E), (F).) Alternatively, the court could have appointed as receiver a nonprofit organization or community development corporation which would have been eligible to apply for grants to assist in the rehabilitation of the property. (Health & Saf. Code, § 17980.7, subd. (c)(2).) SunTrust also suggests the Hildreths, as owners, or the City, as the party that requested the receiver, should pay the costs of the receivership.

SunTrust correctly states the provisions of the statute at issue. But the fact that the court had a variety of options to choose from when it authorized the receiver to obtain funding for the needed remediation is beside the point. SunTrust cites no authority suggesting—and does not even argue—the court abused its discretion by authorizing a super-priority lien after considering all the facts and balancing the equities.

[16] In any event, we would find no abuse of discretion on this record. The Hildreths refused to abate the nuisance they created on their property. SunTrust chose to take no action against the Hildreths, despite the fact the Hildreths were plainly in breach of the deed of trust.[4] Accordingly, the court properly appointed a receiver to abate the nuisance and, notably, SunTrust did not object. Because neither the Hildreths nor SunTrust was willing to fund the costly remediation and the property did not produce any income, the receiver had to borrow money in order to proceed with the remediation. And as no ****128** lender would loan money to the receiver unless the loan was secured with a super-priority lien on the property, the only way to effect the remediation was to authorize the receiver's request to issue such a receiver's certificate. In short, the court did not abuse its discretion.

In closing, we note SunTrust repeatedly argues its interest in the Hildreths' property was inequitably displaced by the lender's super-priority lien. For example, SunTrust urges "[i]t is inequitable to allow [its] lien to be essentially stripped to nothing for a receivership that it did not request and which, as it will eat up most if not all the equity in the property, offers little to no benefit to [SunTrust]. It was not [SunTrust]'s duty to protect against and monitor the Hildreths' use of the property that they owned subject to a loan [t]hat was current or the City's related neglect. Therefore, [SunTrust]'s priority lien should not be sacrificed to pay for the remediation."

***661** [17] [18] The critical point, unmentioned by SunTrust, is that its lien on the Hildreths' property was worthless (or nearly so) well before the court authorized the receiver to issue a super-priority lien.[5] The Hildreths persisted with unpermitted excavation and construction on the property and created the public nuisance that required remediation so costly it exceeded the value of the unimproved land. As a result, SunTrust had an inadequately secured loan and, due to California's anti-deficiency statutes, also had an extremely limited ability to obtain payment from the Hildreths directly.[6] Stated differently, the imposition of a super-priority lien by the receiver did not substantially prejudice SunTrust because prior to the remediation, SunTrust was the senior lienholder on a property with minimal (or perhaps negative) value and was unlikely to be repaid in any event. SunTrust's contention

that it should remain the senior lienholder—and benefit from the increased property value provided by the remediation while bearing none of the cost—is simply untenable.

DISPOSITION

The July 5, 2017 order authorizing the receiver to issue a receiver's certificate with first lien priority is affirmed. The City of Sierra Madre shall recover its costs on appeal.

and Egerton, J., concurred.

Appellant's petition for review by the Supreme Court was denied May 22, 2019, S255087.

All Citations

32 Cal.App.5th 648, 244 Cal.Rptr.3d 118, 19 Cal. Daily Op. Serv. 1764, 2019 Daily Journal D.A.R. 1591

Footnotes

1 The July 5, 2017 order substantially modified a June 2, 2017 order authorizing the receiver to proceed as he proposed. The court reconsidered that order, however, and the July 5, 2017 order is the court's final ruling.

2 A substandard building is defined in Health and Safety Code section 17920.3.

3 That portion of the statute states a receiver appointed under Health and Safety Code section 17980.7 has the power "[t]o exercise the powers granted to receivers under Section 568 of the Code of Civil Procedure."

4 We note, for example, that under the deed of trust, the Hildreths agreed to preserve, maintain, and protect the property, not to allow it to deteriorate, and not to commit waste on it.

5 As noted, the receiver concluded the property remediation would cost at least $250,000 and the value of the property after remediation would likely be $175,000 to $200,000 as a vacant lot and $465,000 to $495,000 with the rehabilitated home.

6 Although a mortgage lender is generally barred from suing its borrower to recover the balance of a mortgage loan when the value of the property is inadequate to satisfy the loan (see Code Civ. Proc., § 580b), a lender may bring an action against a borrower for " 'bad faith' " waste in appropriate circumstances. (*Cornelison v. Kornbluth* (1975) 15 Cal.3d 590, 604, 125 Cal.Rptr. 557, 542 P.2d 981.) As Miller & Starr explains: "To the extent that there has been a reduction in the value of the property by depressed market conditions, the trustor or other person liable on the debt cannot be held personally liable. However, when the reduction in value resulting from bad-faith waste is the result of intentional or malicious action by the owner or person in possession, they can be held personally liable despite the limitations against personal liability on a purchase-money obligation." (5 Miller & Starr, Cal. Real Estate, *supra*, § 13:313, p. 13-1322.)

Joshua A. del Castillo | Allen Matkins Leck Gamble Mallory & Natsis LLP

2026 CBF Receiverships and Bankruptcy Panel

Q: Is a prepetition receiver entitled to a claim in a subsequent bankruptcy and, if so, under what conditions?

A: The guiding analytical principle is that the fees and expenses of a state court receiver are compensable on an administrative priority basis whenever that receiver has been displaced by a superseding bankruptcy case. Under 11 U.S.C. § 543(c)(2), when a custodian is superseded by the commencement of a bankruptcy case under chapters 9 or 11, the court is directed to provide for the payment of reasonable compensation for services rendered and expenses incurred by the custodian. Section 503(b)(4) of the Bankruptcy Code further extends this treatment to the fees and expenses of the custodian's attorneys, and section 507(a)(2) affords such administrative expenses priority in distribution.

However, the viability of a prepetition receiver's claim is not automatic. The prepetition receiver must ordinarily demonstrate to the court that her services affirmatively benefitted the bankruptcy estate. *See*, *e.g.*, *In re Bodenheimer, Jones, Szwak, & Winchell L.L.P.*, 592 F.3d. 664, 672 (5th Cir. 2009) (establishing that a claimant under the Bankruptcy Code must demonstrate a benefit to the bankruptcy estate); *In re TYS, Inc.*, 425 B.R. 26, 38 (Bankr. D. Mass. 2010) (denying compensation to state court custodian on the grounds that custodian conferred no benefit upon the bankruptcy estate); *In re Brooke Corp.*, 485 B.R. 650, 660 (Bankr. D. Kan. 2013) ("Courts generally require a benefit to the estate when finding that expenses of a superseded custodian are entitled to administrative expense status").

Indeed, even where a prepetition receiver merely seeks to vindicate a prepetition order approving her fees and expenses, under Section 543, while a court "may recognize a presumption in favor of the reasonableness of [a state court] allowance, [it] must ultimately exercise its independent judgment whenever determining compensation payable out of an estate being administered" subject to the Bankruptcy Code. *See*, *e.g.*, *In re Gomes*, 19 B.R. 9, 11 (Bankr. D. RI 1982). In order for a court to exercise such "independent judgment", a prepetition receiver demonstrate that the earlier order "was based upon a[] judicial inquiry into the quality and/or extent of the services performed." *Id.*

[**JDC PERSONAL ANECDOTE RE REJECTION OF PRE-RECEIVERSHIP CUSTODIAL CLAIM**]

Accordingly, it is critical for a prepetition receiver to maintain diligent records regarding the nature and substance of her services – and their benefit to a subsequent estate – keeping records of how much those services cost is, alone, not enough. A claim supported by detailed records and an affirmative showing of a benefit to a subsequent bankruptcy estate is likely to face less scrutiny (or opposition) than one supported merely be a schedule of fees owed.

Q: What about the converse? If a bankruptcy precedes a receivership, can the debtor professionals expect an administrative priority claim?

A: Not necessarily. In the context of a bankruptcy case, such professionals are employed under 11 U.S.C. § 327 and compensated pursuant to 11 U.S.C. § 330. Their fees and expenses, once approved by the court, are treated as priority administrative expenses of the bankruptcy estate under 11 U.S.C. § 503(b)(2). However, that priority does not translate automatically into a federal receivership. The Bankruptcy Code provides administrative priority for the fees and expenses of attorneys retained by a custodian who has been displaced by the commencement of a bankruptcy case; however, "custodian" is defined narrowly and does not encompass debtors or debtors-in-possession. *See* 11 U.S.C. § 101(11) (defining "custodian" without including debtors-in-possession); *see also SEC v. Byers*, 592 F. Supp. 2d 532, 539 (S.D.N.Y. 2008) ("a debtor-in-possession is not a 'custodian' within the meaning of the Bankruptcy Code"). As such, while a pre-petition/pre-receivership custodian may assert an administrative priority claim, a debtor's professionals are likely not accorded the same priority. In the receivership context, there is no statutory or analogous authority that would grant their unpaid fees administrative priority status.

Q: Under what circumstances may a California receiver file a bankruptcy case?

A: It depends. As a preliminary matter, a receiver must be appointed over the entity she proposes to place into bankruptcy. Even then, California state court receivers do not possess inherent authority to file bankruptcy petitions on behalf of entities in receivership.

California courts have consistently held that receivers possess no powers beyond those conferred by statute, court order, or subsequent judicial directives; receivers possess only those powers specifically granted by statute, court order, or subsequent judicial authorization.. In *Morand v. Superior Court*, the court emphasized that "the functions and powers of a receiver are controlled by statute, by the order appointing him, and by orders subsequently made by the court. He has no powers beyond those so conferred" 38 Cal.App.3d 347 (1974*); see also City of Sierra Madre v. SunTrust Mortgage*, 32 Cal.App.5th 648, 656 (2019) ("[A] receiver is an officer of the court and is subject to the court's continuing control, and only has those powers granted to it by statute or an order of the court"). Federal law recognizes that authority to act on behalf of an entity is determined by state law. In *Sino Clean Energy Inc. v. Seiden*, the Nevada District Court held that while federal law prevents states from denying entities access to bankruptcy courts, state law, "state law – not federal law – governs whether a person is authorized to file a bankruptcy petition on behalf of a corporation" in receivership. 565 B.R. 677, 680-81 (D. Nev. 2017)

Notably, California receivers are granted explicit authority to file bankruptcy petitions through specific statutory provisions or express court authorization. Several California statutes explicitly provide receivers with bankruptcy filing authority subject to court approval. See, e.g., Cal.. Fin. Code § 90013 (" A receiver, monitor … or other designated fiduciary or officer of the court appointed by the superior court pursuant to this section may, with the approval of the court, exercise any or all of the powers of the defendant's officers, directors, partners, trustees, or persons who exercise similar powers and perform similar duties, including the filing of a petition for bankruptcy"); Health and Safety Code § 1392 (same).

What makes a great order?

- Defendant/debtor perspective

Receiver v BK- pros/cons

Receiver in a BK case

- How do you excuse turnover?
- Why would you do it?
- Benefits of BK
    - Super priority
    - Priming lien
    - What are the terms for financing in BK?
    - Auto stay
    - Rejection of leases
    - Free and clear sales
    - Can a receiver file a BK?
    - Should you include authority in your order?
    - Remedies available in BK that aren't in civil

Receiver Concerns

- Protection for Receiver fees/costs in BK/Protection for Receiver from creditors pre receivership/professionals
- What to do when you are in possession of assets and BK is open and no order allowing payment but necessary payments must be made (insurance, roof leak etc).
- Can you take a retainer?
- What happens to proceeds of loan in receiver's hands?

565 B.R. 677
United States District Court, D. Nevada.

SINO CLEAN ENERGY INC., acting BY AND THROUGH BAOWEN REN, Peng Zhou, Wenjie Zhang, Zhixin Jing, and Paul Chui; and Huiqin Chen, Li Han, Guangjon Huang, Xiaodong Jiang, Xueling Jing, Yufeng Li, Haicho Li, Lanying Li, Liang Wang, Zhen Wu, Ting Xte, Heshun Yang, Chunyun Zhang, Tiekuan Zhang, Appellants
v.
Robert W. SEIDEN, Esq., in his capacity as Receiver over Sino Clean Energy Inc., Appellee

2:15–cv–01781–JAD
|
Bankruptcy No. BK–S–15–14261–BTB
|
Signed 01/23/2017

Synopsis
Background: More than one year after state court appointed a receiver to take over company's affairs and seven months after receiver removed company's directors from their board positions for mismanaging the company, former directors filed Chapter 11 petition on behalf of company. Receiver moved to dismiss, arguing that former directors lacked authority to file petition. The Bankruptcy Court granted the motion, and former directors appealed.

Holdings: The District Court, Jennifer A. Dorsey, J., held that:

[1] under Nevada law, company's former directors did not have authority to file for bankruptcy on its behalf, and

[2] federal bankruptcy law does not preempt a state-court-appointed receiver from preventing a corporation's directors from filing for bankruptcy by replacing them with new directors.

Affirmed.

Procedural Posture(s): On Appeal; Motion to Dismiss.

West Headnotes (12)

[1] **Bankruptcy**🔑Conclusions of law; de novo review
Bankruptcy🔑Discretion
Bankruptcy🔑Clear error
District court reviews a bankruptcy court's decision to dismiss a case for abuse of discretion and applies a two-part test, considering de novo whether the court applied the correct legal standard and reviewing the bankruptcy court's findings of fact for clear error.

[2] **Bankruptcy**🔑Clear error
Bankruptcy court's fact finding is only "clearly erroneous" if it was without adequate evidentiary support or was induced by an erroneous view of the law.

[3] **Bankruptcy**🔑Scope of review in general
In reviewing a bankruptcy court's decision to dismiss a case, the district court may not simply substitute its view for that of the bankruptcy court.

[4] **Bankruptcy**🔑Scope of review in general
District court may affirm the bankruptcy court's decision to dismiss a case on any basis supported by the record.

[5] **Bankruptcy**🔑Representatives of corporations
State law, not federal law, governs whether a person is authorized to file a bankruptcy petition on behalf of a corporation.

2 Cases that cite this headnote

[6] **Bankruptcy**🔑Representatives of corporations
Bankruptcy courts have no jurisdiction to determine that those who in fact do not have the authority to speak for a corporation as a matter of local law are entitled to be given such authority

and therefore should be empowered to file a bankruptcy petition on behalf of the corporation.

2 Cases that cite this headnote

[7] **Bankruptcy**🔑Representatives of corporations

Under Nevada law, company's former directors, who had been removed from their board positions by state-court appointed receiver for mismanaging the company, did not have authority to file a Chapter 11 petition on company's behalf; Nevada law vested the authority to make important decisions, including whether to file for bankruptcy, in a corporation's current board of directors, it was undisputed that company's new board, that is, the board in power at the time of the bankruptcy filing, opposed the filing, and there was no showing that the receiver was biased or significantly delayed in appointing a new board so as to interfere with company's ability to get into bankruptcy court in a timely matter.

2 Cases that cite this headnote

[8] **Bankruptcy**🔑Representatives of corporations

Federal bankruptcy law does not preempt a state-court-appointed receiver from preventing a corporation's directors from filing for bankruptcy by replacing them with new directors.

2 Cases that cite this headnote

[9] **Bankruptcy**🔑Corporations

States cannot outright bar corporations from filing for bankruptcy.

[10] **Corporations and Business Organizations**🔑Representing creditors and shareholders
Receivers🔑Representation by receiver of court and of parties

Under Nevada law, a corporation's receiver must make decisions in the shareholders' best interest, just as the board of directors does. Nev. Rev. St. § 78.635.

[11] **Bankruptcy**🔑Corporations

Although states are empowered to determine who is best suited to make business decisions for a corporation, states cannot significantly interfere with a corporation's access to the bankruptcy system.

1 Case that cites this headnote

[12] **Bankruptcy**🔑Right of review and persons entitled; parties; waiver or estoppel

State-court-appointed receiver for company, who had moved to dismiss Chapter 11 petition filed on company's behalf by its former directors, had standing to appear in former directors' appeal of bankruptcy court's dismissal order.

Attorneys and Law Firms

***678** Matthew C. Zirzow, Larson & Zirzow, Las Vegas, NV, for Appellants.

Douglas E. Spelfogel, Katherine R. Catanese, Foley & Lardner LLP, New York, NY, Ryan Jefferson Works, McDonald Carano Wilson LLP, Las Vegas, NV, for Appellee.

Order Affirming Bankruptcy Court Decision

Jennifer A. Dorsey, United States District Judge

Appellants are former directors of Sino Clean Energy Inc. They filed for bankruptcy on behalf of Sino, the bankruptcy court dismissed their petition, and they now appeal. In dismissing, the bankruptcy ***679** court reasoned that only a corporation's current board of directors can file for bankruptcy—and here, at the time the appellants filed, a state-appointed receiver had already removed them from their director positions for mismanaging the company. Because Sino's new board of directors had not authorized the filing, the bankruptcy court dismissed its petition. On appeal, the appellants contend that federal law preempts any state law (including a state receiver) that restricts a company's directors from filing for bankruptcy—and that Sino's former directors therefore retained the ability to file despite their ousting by the receiver.

The appellants' argument blurs the line between two related—but distinct—rules: the rule preventing states from barring *corporations* from filing for bankruptcy, and the

longstanding rule empowering states to bar *certain individuals* from making that decision for a corporation. I decline their invitation to extend the rule that states cannot bar corporations from the bankruptcy courts to also mean that states cannot prevent certain individual directors from being the ones who decide whether the corporation may file—a question that has always been left to the states. The bankruptcy system is just as available to Sino now as it was before the receiver was appointed; only the identity of the person making that decision for Sino has changed. I thus affirm the bankruptcy court's dismissal.[1]

Background

A. Sino was forced into receivership, and the receiver replaced the appellants with new board members.

Sino is a holding company for various entities in China that produce coal-water slurry—an alternative fuel that it claims burns cleaner than traditional coal. Starting in 2011, Sino became embroiled in sundry U.S. litigations (including at least a defamation case and a class action).[2] Sino's shareholders eventually asked a Nevada court to appoint a receiver to take over Sino's affairs, fearing that the appellants would mismanage the company into insolvency.[3]

Although they were served with the shareholder's complaint, the appellants never responded to the state action. The state court entered an order (1) appointing a receiver and (2) finding that the appellants were liable for grossly mismanaging Sino.[4] The state court's order empowered the receiver to pick a new board of directors for Sino and to take control of Sino's property.[5]

The receiver attempted to work with the appellants, but to no avail. In 2014, the receiver replaced the appellants in their board positions with a new board of directors.[6] It does not appear that the appellants have cooperated with Sino's new board or the receiver since.[7]

***680** Then in the summer of 2015—more than a year after the receiver took over (and seven months after the new board was in place at Sino)—appellants filed a bankruptcy petition on behalf of Sino.[8] Sino's then-current board passed a resolution directing that the bankruptcy petition be withdrawn.[9]

B. The bankruptcy court dismissed this case because appellants were no longer Sino's directors, and thus they lacked authority to file for bankruptcy on behalf of the company.

Shortly after the bankruptcy case started the receiver moved to dismiss, arguing that the appellants had no authority to file for bankruptcy on behalf of Sino because they were no longer its directors. After a lengthy oral argument, the bankruptcy judge provided a thorough decision from the bench, granting the receiver's motion to dismiss.[10]

The bankruptcy court held that Sino's board of directors had in fact been replaced before the appellants filed their bankruptcy petition.[11] The court concluded that the case must be dismissed because only a corporation's current directors can act on its behalf, and the appellants (as former directors) therefore had no authority act for Sino. The court relied heavily on the Ninth Circuit case of *Oil & Gas Co. v. Duryee*, 9 F.3d 771 (9th Cir. 1993). The ousted board appeals.

Discussion

A. Standard of Review

[1] [2] [3] [4] I review a bankruptcy court's decision to dismiss for abuse of discretion and apply a two-part test.[12] I consider de novo whether the court applied the correct legal standard.[13] But I review the bankruptcy court's findings of fact for clear error.[14] A fact finding is only clearly erroneous "if it was without adequate evidentiary support or was induced by an erroneous view of the law."[15] I "may not simply substitute [my] view" for that of the bankruptcy court.[16] Finally, I may affirm on any basis supported by the record.[17]

B. The bankruptcy court properly dismissed this case because the appellants had no authority to file for bankruptcy on behalf of Sino.

[5] [6] This case turns on a single issue: Do the appellants have authority to file for bankruptcy on Sino's behalf? An important starting principle is that state law—not federal law—governs whether a person is authorized to file a bankruptcy petition on behalf of a corporation.[18] This fact reflects a preference for allowing states to make ***681** judgments about who should, and who should not, make the

important decision of whether a corporation should for bankruptcy. Indeed, the Supreme Court has been clear on this point: "If the District Court finds that those who purport to act on behalf of the corporation have not been granted authority by local law to institute the proceedings, it has no alternative but to dismiss the petition."[19] Bankruptcy courts have no jurisdiction to "determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation."[20]

[7] Appellants do not meaningfully dispute that Nevada law precludes them from filing for bankruptcy on behalf of Sino.[21] After all, Nevada law vests the authority to make important decisions (including whether to file for bankruptcy) in a corporation's *current* board of directors. And at the time the appellants filed their bankruptcy petition in this case, the state-appointed receiver had ousted them from their board positions and installed a new board for Sino. Nor do the appellants dispute that Sino's new board (in power at the time of the bankruptcy filing) opposed the filing. This would thus seem an easy case: Sino's new board was the only one under Nevada law who could decide whether to file bankruptcy; Sino's old board (the appellants) were powerless to file their petition and it was properly dismissed.

[8] But appellants contend that federal bankruptcy law preempts a state-appointed receiver from preventing a corporation's directors from filing for bankruptcy by replacing them with new directors. The appellants primarily rely on a single bankruptcy case from the District of Arizona, *In re Corporate and Leisure*.[22] And indeed, in a lengthy decision, the Arizona bankruptcy court held that federal law preempts a "receivership order that attempts to preclude any of the original constituents of the organizational entity from filing a petition on its behalf"—including by, as was the case here, replacing the corporation's board with a new one.[23] But *Corporate and Leisure* is an outlier, and I find its reasoning unpersuasive.

[9] [10] In reaching its holding, the *Corporate and Leisure* court largely relied on cases holding that state receivers cannot outright bar a corporation itself from filing for bankruptcy, which is not helpful here given that Sino's new board can still file for bankruptcy should it choose to do so.[24] Appellants' other cited cases address the ***682** same rule.[25] At bottom, both the court in *Corporate and Leisure* and the appellants appear to be blurring the line between the rule preventing states from barring corporations from bankruptcy court, and the longstanding rule *empowering states* to determine who gets to file for bankruptcy in the first place.[26] Appellants provide no rationale for treating a state-appointed receiver any differently from other state laws defining who can file for bankruptcy on behalf of a corporation.

The only relevant Ninth Circuit precedent suggests that states are free to allow receivers to decide which members of a company's management can file for bankruptcy. In *Oil & Gas v. Duryee*, Judge Kozinski explained that once a state gives control of a corporation over to a third-party trustee (in that case a rehabilitator)—that is the "only person ... who could go to court on behalf" of the corporation.[27] In *Duryee*, that meant that a corporation president's attempt to file for bankruptcy was "null and void."[28]

A recent bankruptcy case from the Central District of California is even more on ***683** point.[29] In *In re Licores*, the court held that a company's former partners could no longer file for bankruptcy once a state-appointed receiver had ousted them from their management positions.[30] The court explained that there is a difference between a state preventing *certain directors or partners* from filing for bankruptcy, which the state can do—and a state preventing a *corporation itself* from filing for bankruptcy, which the state cannot do.[31] The court rejected the argument that a state court "cannot divest the [directors of the company] from commencing a bankruptcy proceeding because it runs contrary to Congress's intent to enact uniform laws of bankruptcy."[32] It explained that "the Receivership Order ... [did] not divest the Debtor [of] its power to seek bankruptcy protection; rather, the order identifies who has the power to file the bankruptcy petition on behalf of Debtor."[33]

[11] [12] Ultimately, the weight of authority suggests two relevant principles: (1) states are empowered to determine who is best suited to make business decisions for a corporation; but (2) states cannot significantly interfere with a corporation's access to the bankruptcy system. The bankruptcy court's determination here that the appellants had no authority to file for bankruptcy aligns with both of these principles. A Nevada court determined that the appellants were committing misfeasance and could no longer be trusted to make decisions for Sino. So the state-appointed receiver picked a new board to make the corporation's decisions. There is no sensical reason to conclude that the appellants cannot be trusted to make any important business decision

for Sino—but at the same time, federal law requires that they must be trusted to make the critical decision about whether to file for bankruptcy.[34] There is no evidence that either the receiver or the new board cannot file for bankruptcy on behalf of Sino, so there is no bar between Sino and the bankruptcy-court system that might trigger federal preemption.[35] I thus affirm the bankruptcy court's dismissal.[36]

***684 Conclusion**

Accordingly, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the bankruptcy court's decision is **AFFIRMED**. The Clerk of Court is directed to close this case.

All Citations

565 B.R. 677, Bankr. L. Rep. P 83,065

Footnotes

1 I find this motion suitable for disposition without oral argument. Nev. L.R. 78–1.

2 ECF No. 11 at 138–39.

3 *Id.*

4 *Id.* at 164–68.

5 *Id.*

6 *Id.* at 140. Technically, the receiver replaced the board with a single director, Gregg Graison. The record supports the conclusion that Graison was properly installed as Sino's president, vice president, secretary, treasurer, and sole director. *Id*; *see also id.* at 256 (Graison's resolution as "sole member of the company" memorializing Graison's appointment as sole director); *id.* at 258 (listing of officers showing Graison as sole director of Sino as of December 2014).

7 For example, there is evidence the appellants failed to respond to the receiver's requests for information. *Id.* at 141. Later, at least one of the appellants communicated with the receiver, but it appears that he failed to follow up. *Id.* In fact, the receiver has filed a motion in the state-court action to hold this director in personal contempt. *Id.*

8 *Id.* at 145.

9 *Id.* at 256.

10 ECF No. 15 at 201.

11 *Id.*

12 *Leavitt v. Soto*, 171 F.3d 1219, 1223 (9th Cir. 1999).

13 *Id.*

14 *Id.*

15 *Wall St. Plaza, LLC v. JSJF Corp.*, 344 B.R. 94, 99 (9th Cir. BAP 2006).

16 *Barrera v. W. United Ins. Co.*, 567 Fed.Appx. 491, 493 (9th Cir. 2014) (*citing* *U.S. v. Hinkson*, 585 F.3d 1247, 1262 (9th Cir. 2009).

17 *Heilman v. Heilman*, 430 B.R. 213, 216 (9th Cir. BAP 2010).

18 *Price v. Gurney*, 324 U.S. 100, 107, 65 S.Ct. 513, 89 L.Ed. 776 (1945).

19 *Id.* at 106, 65 S.Ct. 513; *see also* *Tenneco West, Inc. v. Marathon Oil Co.*, 756 F.2d 769, 771 (9th Cir. 1985); *In re Licores*, No. SA 13-10578-MW, 2013 WL 6834609, at *5 (C.D. Cal. Dec. 20, 2013).

20 *Price*, 324 U.S. at 107, 65 S.Ct. 513.

21 Appellants do not argue in their opening brief that the bankruptcy court's finding that Sino's board had been replaced was clearly erroneous.

22 *In re Corp. & Leisure Event Prods., Inc.*, 351 B.R. 724 (Bankr. D. Ariz. 2006).

23 *Id.*

24 The court cited to a handful of cases that hold that states cannot prevent "an entity" from filing for bankruptcy relief; it cited no decisions holding that state law, or a state–appointed receiver, cannot determine which individual directors can file. *See* *id.* at 731. For example, the court cites to *In re Klein's Outlet, Inc.*, 50 F.Supp. 557, 559 (S.D.N.Y. 1942), which held that the mere fact that a receiver was appointed did not prevent the directors from filing for bankruptcy. *See also* *Cash Currency Exchange, Inc. v. Shine*,

762 F.2d 542, 552 (7th Cir. 1985) (holding that a receiver's appointment "is irrelevant to the determination whether a *particular entity* may file for bankruptcy relief" (emphasis added)); *Larson v. Kreisers, Inc.*, 112 B.R. 996, 998 & 1000 (Bankr. D.S.D. 1990) ("The court ... has not unearthed any statutory or decisional law to support the contention that a state court receivership generally bars bankruptcy filing."); *In re S & S Liquor Mart, Inc.*, 52 B.R. 226, 227 (Bankr. D.R.I. 1985) ("[I]t is fundamental that a state court receivership proceeding may not operate to deny a corporate debtor access to the federal bankruptcy courts.").

25 I agree that states cannot outright bar corporations from filing for bankruptcy. Not only do legion cases say so, but I have little doubt that Congress's sweeping bankruptcy laws would preempt state-law remedies that keep a corporation from the federal bankruptcy system.

26 Nor do I find the Arizona bankruptcy court's reasoning otherwise helpful. The court stated that whether the receiver has the power to file for bankruptcy did not change the analysis, because Congress intended bankruptcy relief to be for the benefit of not just the creditors (who initiate the receivership) but others, such as the shareholders. *In re Corp. & Leisure Event Prods., Inc.*, 351 B.R. at 732. This implies that a receiver may not adequately represent the interests of a corporation's shareholders and therefore cannot be trusted to decide whether to file for bankruptcy on behalf of a corporation. But here, it is the new board that would decide whether to file, not the receiver. And in any event, under Nevada law, a receiver must make decisions in the shareholders' best interest, just as the board of directors does—so there does not appear to be a problem of adverse incentives. *See* Nev. Rev. Stat. § 78.635 (stating that receivers represent shareholders, and that the receiver can settle with a creditor only if "deem[ed] just and beneficial to the corporation"). The state-court order in this case also required the receiver to "maximize value for all shareholders." ECF No. 11 at 164. Perhaps this case would be different if appellants could show that a receiver was biased or significantly delayed in appointing a new board, thus interfering with the corporations' ability to get into bankruptcy court in a timely matter. But that is not the case. The receiver appointed a new board almost a year before the appellants filed this rogue bankruptcy petition.
The court in *Corporate and Leisure* also reasoned that Congress must have intended to let bankruptcy courts settle disputes between receivers and directors because it gave bankruptcy courts equitable power over property held by state receivers. *See* 11 U.S.C. § 543(b)(2); *Dill v. Dime Sav. Bank*, 163 B.R. 221, 225 (E.D.N.Y. 1994). But the fact that bankruptcy courts have equitable power to turn property over to a receiver says nothing about a bankruptcy court's power to decide who can file for bankruptcy.

27 *Oil & Gas Co. v. Duryee*, 9 F.3d 771, 773 (9th Cir. 1993).

28 *Id. Duryee* is arguably dicta on this point because the underlying debtor could not file for bankruptcy in the first place. That said, I find the decision's language helpful in predicting how the Ninth Circuit would rule on this issue.

29 *In re Licores*, No. SA 13-10578-MW, 2013 WL 6834609, at *5 (C.D. Cal. Dec. 20, 2013).

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.* The only cases I have found that hold that a receiver cannot interfere with a *former* board's ability to file for bankruptcy are premised on the idea that receivers cannot file for bankruptcy (so that by barring the directors, the receiver is practically barring the company altogether). *See, e.g., In re Prudence Co.*, 79 F.2d 77, 80 (2d Cir. 1935). Those cases are unhelpful because, here, a new board was installed (and thus whether the receiver could file does not matter). They are also unhelpful because it appears that the modern trend is to allow receivers to file for bankruptcy. *See, e.g., JY Creative Holdings Inc. v. McHale*, No. 14-2899, 2015 WL 541692 (M.D. Fla. Feb. 10, 2015).

34 Filing for bankruptcy brings obvious benefits and challenges for a corporation, and the decision to file is thus not a trivial one.

35 Nothing in the receivership order suggests that the receiver or new board cannot file for bankruptcy. Nor have appellants argued that they cannot. Appellants also argue that the bankruptcy filing was ratified later by the appellants themselves. But the same problem remains that the appellants are no longer Sino's board of directors.

36 Appellants also argue that the appellee's brief should be struck because he does not have authority, as a receiver, to appear. I need not look to the receiver's briefing to see that appellants' arguments fail and that the bankruptcy court was right to dismiss this case. Regardless, receivers have standing in an appeal. *In re Licores*, 2013 WL 6834609, at *3 (C.D. Cal. Dec. 20, 2013) ("[A]nyone who has a legally protected interest that could be affected by a bankruptcy proceeding is entitled to assert that interest with respect

to any issue to which it pertains.”).

End of Document