

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re

LAPPIN ELECTRIC CO.

Debtor.

Case No. 97-26130

Chapter 7

MEMORANDUM DECISION

The chapter 7 trustee objected to claim number 87, filed by GS2, as an unsecured priority claim in the amount of \$110,000. The parties have agreed that the relevant facts are not in dispute and submitted briefs on their respective positions. This court has jurisdiction under 28 U.S.C. § 1334, and this is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

An involuntary petition was filed against the debtor on June 20, 1997. Prior to the petition, the debtor and an affiliate, Lappin Lighting, Inc., had negotiated and entered into an agreement to sell their assets as a going-concern to Consolidated Electrical Distributors, Inc. (CED). The sale had been scheduled to close on June 23, 1997. However, as a result of the involuntary petition filed against the debtor, the purchaser refused to close the sale.

Pursuant to an emergency motion brought by the debtor, this court suspended the proceedings on June 23, 1997, to allow the debtor to convey substantially all of its assets to CED. The court did not approve or disapprove the sale to CED, but rather found that it was in the best interests of the debtor and creditors to suspend further proceedings of the case, pursuant to 11 U.S.C. § 305, to permit the parties an opportunity to close the sale. No provision was made

for anyone who brokered the sale. After the transactions conveying the assets of the debtor to CED closed, the order for relief was entered on June 25, 1997.

Prior to the filing of the involuntary petition, the claimant, GS2, had entered into a retainer agreement with the debtor for the purpose of conducting discussions and negotiations leading to the consummation of a sale of the stock or assets of the Lappin entities. The services the claimant intended to render included:

the preparation, in consultation with [R. Todd Lappin], of a list of possible purchasers, the compilation of information about the Company, the preparation of a memorandum approved by [R. Todd Lappin] for use with possible purchasers. As to any prospective purchaser, [the claimant would] advise [R. Todd Lappin] on the financial aspects of the proposed transaction, its structure, and will assist in negotiating the sale.

(GS2 retention letter, February 9, 1996.)

The debtor agreed to pay the claimant a cash retainer fee of \$15,000, payable in five monthly installments. Three installments were paid before the involuntary petition was filed, and the trustee did not dispute the claim for the unpaid amount as a general, unsecured debt. The debtor further agreed to the following terms in the event a transaction was consummated:

(i) during the term of this agreement, or (ii) not later than eighteen months after the expiration of this agreement with a party (or any affiliate thereof) identified during the term of this agreement, you agree to pay, or cause to be paid, to GS2 a transaction fee (if GS2 [or any affiliate thereof] was in contact with the prospective purchaser prior to the expiration of this agreement, a purchaser shall be deemed to have been identified by GS2 if GS2 submitted its name to the Company in writing within five (5) days after the expiration of this agreement). The transaction fee is \$125,000, less the amount of any retainer fee previously paid to GS2

(GS2 retention letter, February 9, 1996.) Claim number 87 was filed in the amount of \$110,000, taking into consideration the paid retainer plus the claim for the unpaid amount. The agreement also provided for an incentive amount in the event the aggregate consideration was received in

excess of certain set thresholds, which did not occur. The transaction fee was payable to the claimant in cash at the closing of the transaction, but closing appears to have taken place without its being paid.

After the involuntary petition was filed against the debtor, the claimant's brief states that the claimant was asked by the debtor's management to assist with respect to a sale of the assets of the debtor in accordance with the terms and conditions of the retainer agreement. Apparently, this is undisputed. The claimant subsequently performed services pursuant to the retainer agreement during the "gap" period, a portion of which was during the suspension period, resulting in the sale of assets.

ARGUMENTS

The claimant asserts its claim is entitled to priority under 11 U.S.C. § 507(a)(2) because it performed services to the debtor during the "gap period." GS2 contends that the services rendered during the gap period were rendered in the ordinary course of the debtor's business or financial affairs as they then existed. According to the claimant, the ordinary nature of the financial affairs can be best discerned by the fact that the retainer agreement had been entered into prior to the filing of the involuntary petition. The attempt by the trustee to reap the benefits of the services performed by GS2 without providing any compensation to the claimant on account of the services that were rendered is inequitable, in the view of the claimant.

The trustee argues that the claimant is not entitled to a priority claim under § 507(b)(2) because the claim did not arise out of the ordinary course of the debtor's business or financial affairs. The liquidation of the debtor's business was not in the ordinary course of the debtor's

business or financial affairs. The trustee asserts that the facts of this case are comparable to the situation in *In re Monarch Capital Corp.*, 163 B.R. 899 (Bankr. D. Mass. 1994), wherein the bankruptcy court concluded that the sale of the debtor's subsidiary was out of the ordinary course.

DISCUSSION

Under the Bankruptcy Code, “gap” creditors are those creditors in involuntary cases who do business with, or extend credit to, debtors after the filing of the involuntary petition and prior to entry of an order for relief. 11 U.S.C. § 507(a)(2). Section 502(f) states that

In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

11 U.S.C. 502(f). GS2's claim clearly arose after the involuntary petition was filed and before the order for relief. No one has argued that the suspension is of any significance, and transactions that took place during the suspension period in this case meet the definition of gap claims. While the contract was entered into prepetition, the event that gave rise to the right to payment occurred during the gap period, thus making the claimant a gap creditor.

Nonetheless, the effect of § 502(f) is to give a debtor's unsecured gap creditor second priority claim status only if the claim arose “in the ordinary course of the debtor's business or financial affairs.” The Code does not define the “ordinary course of business or financial affairs,” and courts are left to examine many factors to determine whether a debt is incurred in the ordinary course of business.

The meaning of what constitutes the ordinary course of a debtor's business is most often discussed under preference analyses, *e.g.*, *In re Milwaukee Cheese Wisconsin, Inc.*, 112 F.3d 845, 847 (7th Cir. 1997). "Ordinary course of business" is a term also used in § 363(c)(1), which allows a debtor-in-possession to enter into transactions in the ordinary course of business without court approval, and in § 363(b)(1), which requires court approval for the sale, use, or lease of property of the estate by the debtor-in-possession or trustee outside the ordinary course of business. Section 364(a) uses the term in allowing the trustee to obtain credit as an administrative expense "in the ordinary course of business." As the bankruptcy court in *In re Hanson Indus.*, 90 B.R. 405, 414-15 (Bankr. D. Minn. 1988), pointed out, the term "ordinary course of business" has thus developed both a vertical and a horizontal dimension.

Where the term "ordinary course of business" is used, the horizontal, or industry-wide, test involves a comparison of the debtor's business to other like businesses. Under this test, the court must compare the debtor's business to other like businesses and decide whether a type of transaction is in the course of that debtor's business or in the course of some other business. *Id.* at 414 (citing *In re Waterfront Cos.*, 56 B.R. 31, 35 (Bankr. D. Minn. 1985)).

The vertical, or creditors' expectation (meaning creditors doing business with the debtor, other than the claimant), test looks to whether the transaction is one that subjects a hypothetical creditor to an economic risk not anticipated by that hypothetical creditor when extending credit to the debtor. *Id.* at 414 (citing *In re Johns-Manville Corp.*, 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986)). In other words, is the claim so unusual that an ordinary trade creditor would not expect the debtor to be engaging in such a transaction? The vertical test may also be framed as whether the transaction was within the day to day business of the debtor without some kind of separate

authorization. *Id.* (citing *In re Waterfront Cos.*, 56 B.R. 31, 35 (Bankr. D. Minn. 1985)). The test focuses on a comparison between the debtor's pre- and postpetition activities to discern whether there were significant alterations in its activity. *Id.*

Under either test:

an examination of the transaction vis-a-vis the debtor's business or vis-a-vis the industry, the size, nature or both, of the transaction may be dispositive on the issue of ordinariness. What may be ordinary for a large, multinational corporation engaged in a number of businesses is distinctly different from what is ordinary in a smaller corporation with lesser capital, fewer employees and fewer business transactions.

Hanson, 90 B.R. at 414.

Although the analysis of the term in the context of a preferences or sale is useful, the term is actually narrower in the context of a gap claim. Section 502(f) gives gap creditors second priority if the debt was incurred "in the ordinary course of the *debtor's* business or financial affairs," (emphasis added), which does not seem to require a horizontal review of industry practices.

In this case, unfortunately for the claimant, GS2 cannot prevail regardless of the test applied. Lappin was engaged in the wholesale distribution of electrical supplies, with its principal place of business in Milwaukee, Wisconsin. Lappin operated nine branches in Wisconsin and Illinois and, at the time of the petition, employed more than 100 people. Regardless of when the contract with the broker was entered into, the debtor was not in the business of selling substantially all of its assets.

The case of *In re Monarch Capital Corp.*, 163 B.R. 899, 905 (Bankr. D. Mass. 1994), is on point and instructive. The bankruptcy court disallowed the business broker's gap claim because, among other things, the claim arose in connection with a transaction which was not in

the ordinary course of the debtor's business – the sale of a subsidiary. The brokerage firm had been retained by the debtor, a holding company with subsidiaries engaged in insurance and other financial services, to pursue the sale of the debtor's subsidiary. The broker subsequently sought entitlement to a priority gap claim for services it rendered between the date of the involuntary filing and the order for relief. Although the debtor had sold subsidiaries in the past, the court determined that the out-of-the-ordinary nature of the transaction did not change, despite the relatively small value of the sold subsidiary compared to the value of the debtor's total holdings. *Id.*

This result may seem unfair when compared to the specific authority found in § 303(f), which allows an involuntary debtor to operate its business while its ultimate status is adjudicated. Under § 303(f), the debtor may also acquire or dispose of property, without any ordinary course limitation, as if the involuntary petition had not been filed. *See* 11 U.S.C. § 303(f). Nevertheless, the “ordinary course” limitation for priority payment of gap creditors is found in § 502(f), and by reference in § 507(a)(2), even though it is not in § 303(f). So, while the sale was permissible (and benefitted the estate, as the claimant asserts), the unpaid obligation to GS2 arising from that transaction is only entitled to a priority if the obligation was incurred in the ordinary course of the debtor's business. Particular fact situations can sometimes give rise to inequities, but bankruptcy statutes and policy require that claims asserting priority be strictly construed. *Hanson*, 90 B.R. at 409. Since the sale of the debtor's assets was not in its ordinary course of its business, the claimant is not entitled to priority under § 502(f). The trustee's objection to the priority status of GS2's claim number 87 is therefore sustained.

There was no discussion of where the claim fits in the distribution scheme of 11 U.S.C. § 726, and that matter is not addressed by this decision.

This decision constitutes the court's findings of fact and conclusions of law under Fed. R. Bankr. P. 7052. The trustee will submit an order consistent with this decision.

Dated at Milwaukee, Wisconsin, April 29, 2002.

BY THE COURT

Honorable Margaret Dee McGarity
United States Bankruptcy Judge