UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re:

AMERICAN TOY & FURNITURE COMPANY, INC., Debtor.

Case No. 92-27686

Chapter 7

MEMORANDUM DECISION

I. INTRODUCTION

This matter came before the court upon a motion by Norwest Bank Minnesota, N.A., for allowance and payment of a superpriority administrative expense claim under 11 U.S.C. §§ 507(b), 507(a)(1) and 503(b). The chapter 7 trustee opposed the motion and argued that Norwest is not entitled to superpriority status because its claim does not arise under § 503(b). This court has jurisdiction under 28 U.S.C. § 1334(b), and this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B).

II. FACTS

American Toy & Furniture Company, Inc., manufactured highly decorated children's furniture and games, which were sold through catalogues, such as Sears, and by retail customers. Most of the images used in decoration were copyrighted and applied to the products by license agreement. The debtor's major mode of doing business was to take orders from customers through manufacturers' representatives early in the year, manufacture ordered items during the

spring and summer, and ship around October so the goods would be available for Christmas sales. These Christmas sales constituted most of the debtor's seasonal business.

In September 1989, the debtor had entered into a loan agreement with Norwest for revolver and term notes, of which over $5 million was due on the date the debtor filed for bankruptcy protection. American Toy's indebtedness to Norwest was secured by a valid and properly perfected, first-priority security interest in all of its assets.

On December 11, 1992, American Toy filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. On that same date, the debtor also filed a motion to use cash collateral and to provide adequate protection. Norwest, as the holder of the secured claim, filed a motion to terminate the automatic stay on December 28, 1992. Pending conclusion of a final hearing on these motions, the parties entered into a stipulation and the court signed an order on January 12, 1993, effective as of December 11, 1992, authorizing interim use of cash collateral and requiring the debtor in possession to provide adequate protection.

At the hearing on the motions, both the debtor and Norwest projected a profitable year. The bank's expert testified that the debtor would have equity in the property at year-end if it remained in business (Transcript of 1/26/93 hearing, p. 4). Based on the evidence presented, the court determined that the orderly liquidation value of the collateral would be between approximately $8 million and $12 million at various points in the year. *See* Court Minutes of the Hearing on January 26, 1993. The court denied Norwest's motion and entered an order providing for use of cash collateral and adequate protection. Debtor's actual cash on hand as of January 31, 1993, was $3,392,039, with total current assets of $6,767,863.

American Toy continued operations for over a year, during which time it obtained § 364 borrowing and otherwise continued to use the collateral securing Norwest's claim. The debtor paid Norwest adequate protection payments totaling $1,183,000. Ultimately, the debtor's sales were for much less than anticipated, and the debtor was unable to propose and obtain approval of a plan of reorganization. The court granted Norwest's motion for relief from the automatic stay as of April 1, 1994. The debtor's cash on hand at that time was $121,422, and total current assets equaled $2,741,041.

Following liquidation of available collateral, Norwest realized the net sum of $3,325,404, leaving it with a shortfall of $2,174,596 on its secured claim of $5.5 million.[1] The parties stipulated that this shortfall is the amount of Norwest's deficiency claim. While the real estate and equipment realized less than the original estimate, the primary cause of the shortfall was the consumption of cash and current assets during the year of operation as a debtor in possession, without a corresponding benefit in the amount of sales. Obviously, adequate protection proved to be anything but. Norwest contends it is entitled to a superpriority administrative expense claim under 11 U.S.C. §§ 507(b), 507(a)(1) and 503(b) for its loss resulting from the debtor's use of its cash collateral.

III. ARGUMENTS

Both Norwest and the trustee agree that Norwest's deficiency claim of $2,174,596 does not prime other chapter 7 administrative expenses. 11 U.S.C. § 726(b). Norwest claims that it is

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[1]On March 30, 1994, the court approved a compromise between the parties which allowed Norwest's claim in the amount of $5.5. million.

entitled to superpriority status under 11 U.S.C. § 507(b), which grants such status to a secured creditor when there is a failure of adequate protection provided by the trustee, or in this case the debtor in possession, under §§ 362, 363 or 364. *In re Becker*, 51 B.R. 975, 978 (Bankr. D. Minn. 1985). Section 507(b) provides:

> If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

11 U.S.C. § 507(b).

According to Norwest, it must demonstrate the following elements to obtain superpriority status under § 507(b): (1) Norwest was a holder of a claim secured by a lien on property of the debtor; (2) Norwest was granted adequate protection under §§ 362, 363 or 364; and (3) notwithstanding such protection, Norwest has a claim allowable under § 507(a)(1), and by reference under § 503(b), because the adequate protection required by imposition of the stay under § 362, the use, sale or lease of property under § 363, or the granting of a lien under § 364(d) was later found to be inadequate. *See In re James B. Downing & Co.*, 94 B.R. 515, 520 (Bankr. N.D. Ill. 1988). Norwest asserts that it can satisfy these requirements.

The chapter 7 trustee opposes Norwest's motion and contends that its claim is not entitled to superpriority status pursuant to § 507(b) because it does not arise under § 503(b); that is, Norwest's claim is not a chapter 11 administrative expense. *See In re Ralar Distributors, Inc.*, 166 B.R. 3, 8 (Bankr. D. Mass. 1994), *aff'd*, 182 B.R. 81 (D. Mass. 1995), *aff'd*, 69 F.3d 1200

(1st Cir. 1995). To qualify for priority under § 507(a)(1), a necessary step before qualifying for superpriority under § 507(b), the claim must be an administrative expense claim under § 503(b). Section 503(b) provides that administrative claims 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).

The trustee points out that the Seventh Circuit has held "a claim will be afforded priority under § 503 if the debt both (1) 'arise[s] from a transaction with the debtor-in-possession' and (2) is 'beneficial to the debtor-in-possession in the operation of the business.'" *Matter of Jartran, Inc.*, 732 F.2d 584, 587 (7th Cir. 1984) (quoting *In re Mammoth Mart, Inc.*, 536 F.2d 950, 954 (1st Cir. 1976)). According to the trustee, Norwest's claim does not satisfy the first criterion.

IV. DISCUSSION

A. 11 U.S.C. § 507

Section 507 of the Bankruptcy Code directs the allocation of a debtor's assets by establishing a hierarchy of payments to creditors. Creditors with a higher priority must be paid in full before creditors with a lower priority receive anything. *Cf. SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 611, 85 S.Ct. 513, 523 (1965). Secured creditors are entitled to the benefit of their security. 11 U.S.C. §§ 362(d)(2), 363(e), 506. Administrative claimants are paid first with unsecured funds. 11 U.S.C. § 507(a)(1). In this case, the reference to administrative claims is for chapter 11 expenses, as it is undisputed that chapter 7 expenses will be paid in full before Norwest's claim. There will be sufficient funds to do so with funds derived primarily from the recovery of avoidable transfers. Norwest wishes to maximize its claim to funds available for

chapter 11 administrative claimants by moving ahead of other chapter 11 administrative claimants. There probably will not be sufficient funds for all creditors of this priority.

Administrative claimants are those entities having claims under 11 U.S.C. § 503(b). For our purposes, administrative claims 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). An administrative claimant with superpriority under § 507(b) must be paid in full before any other administrative claimant of the same level of priority receives payment.

The controversy associated with granting a superpriority to an inadequately protected secured creditor arises from the language of § 507(b), itself. In fact, § 507(b) has been called a "prism in the fog," *In re Callister*, 15 B.R. 521, 526 (Bankr. D. Utah 1981); and the endeavor to determine whether an inadequately protected secured creditor should be granted a superpriority has been described as "a complex maze of ambiguous statutory provisions and opaque, inconsistent case law." *Baybank-Middlesex v. Ralar Distributors, Inc.*, 69 F.3d 1200, 1202 (1st Cir. 1995), *aff'g In re Ralar Distributors, Inc.*, 166 B.R. 3, 4 (Bankr. D. Mass. 1994) ("Resolution of the controversy involves application of the obscure language of section 507(b) to the elusive concept of adequate protection.").

To further the confusion, § 361(3) of the Code prohibits granting adequate protection to a secured creditor in the form of an administrative expense:

> When adequate protection is required . . . of an interest of an entity in property, such adequate protection may be provided by —
> (1) requiring the trustee to make a cash payment . . .;
> (2) providing to such entity an additional or replacement lien . . .; or
> (3) granting such other relief, *other than entitling such entity to compensation*

> *allowable under section 503(b)(1) of this title as an administrative expense*, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

11 U.S.C. § 361 (emphasis added). Consequently, a court cannot grant administrative status to a secured creditor prospectively as adequate protection; it may only do so retroactively after adequate protection proves to have been inadequate. In other words, to achieve superpriority, the secured creditor must not only have been inadequately protected, its claim must qualify for administrative priority, even though it could not have received administrative priority as adequate protection.

The legislative history of the statute is similarly murky. The House version of the Bankruptcy Reform Act initially provided in § 361(3) that adequate protection could be provided by granting an administrative expense to the creditor. H.R. 8200, 95th Cong., 1st Sess., § 361(3) (1977). However, the Senate Bill did not contained a similar provision. S. 2266, 95th Cong., 2nd Sess. (1978). Neither bill contained the present § 507(b). Sections 507(b) and 361(3) first appeared in their present form in the compromise that became the Bankruptcy Code:

> Section 507(b) of the House amendment is new and is derived from the compromise contained in the House amendment with respect to adequate protection under section 361. Subsection (b) provides that to the extent adequate protection of the interest of a holder of a claim proves to be inadequate, then the creditor's claim is given priority over every other allowable claim entitled to distribution under section 507(a).

124 Cong. Rec. 32,398 (1978). This statement by Congressman Don Edwards, which would indicate congressional intent, conflicts with the actual language § 507(b). *See In re Five Star Partners, L.P.*, 193 B.R. 603, 610 n. 2 (Bankr. N.D. Ga. 1996) ("It should be noted that the prohibition in section 361(3) against use of an administrative expense claim as a form of adequate protection applies only in the first instance. Section 361(3) does not bar a court from

granting an administrative expense claim after a failure of adequate protection already provided by the trustee."); *Ralar Distributors, Inc.*, 166 B.R. at 6, 8. Although legislative history would suggest that Congress wanted to protect prepetition lenders who have no administrative expense claim in the first instance, the statute requires that the claim be allowable under § 507(a)(1), which applies to postpetition expenses. The fundamental basis for statutory interpretation is the language of the statute itself. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 557-58, 110 S.Ct. 2126, 2130 (1990). Thus, the court must go back to the language of § 507 for guidance.

There are numerous cases holding that a secured creditor is entitled to a superpriority simply because the adequate protection provided to the creditor proved to be inadequate. *E.g., Grundy Nat'l Bank v. Rife*, 876 F.2d 361, 363-64 (4th Cir. 1989); *In re James B. Downing & Co.*, 94 B.R. 515, 520 (Bankr. N.D. Ill. 1988); *In re Callister*, 15 B.R. 521, 528 (Bankr. D. Utah 1981). However, § 507(b) provides that inadequate protection is not enough by itself. The claimant must have an allowable administrative expense claim pursuant to § 503(b).

B. 11 U.S.C. § 503(b)

Courts have differed in their analysis and conclusions as to whether compensation of a secured creditor is a valid administrative expense. Section 503(b)(1)(A), which for our purposes is the only applicable subsection of § 503(b), provides that administrative claims 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." The trustee contends that the court should follow the criteria used to assess administrative claims established by the

First and Seventh Circuits.

The First Circuit in *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir. 1976) (ruling under the Bankruptcy Act), articulated guidelines used to determine whether an expense is given administrative priority. First, the debt must arise from a transaction with the debtor in possession. Second, the transaction must be beneficial to the debtor in possession in the operation of its business. *Id*. at 954; *see also In re United Trucking Service, Inc.*, 851 F.2d 159, 161-62 (6th Cir. 1988).

The trustee does not dispute the second requirement, and this court agrees. The debtor's use of assets and cash benefitted the estate — the debtor stayed in business for a year. Norwest's claim is primarily for consumption of liquid assets, and less so for depreciation in value or mistake in valuation of a particular secured asset. *Cf. Matter of Plunkett*, 191 B.R. 768, 780 (Bankr. E.D. Wis. 1995), *aff'd*, 82 F.3d 738 (7th Cir. 1996) (holding that creditor's expense of not foreclosing on income producing property was not "actual and necessary" cost of preserving the estate because no benefit accrued to the estate). The *Plunkett* court noted that to be an "actual and necessary" cost of preserving the estate, an expenditure must benefit the estate as a whole. *Id*. (citing *Jartran*, 886 F.2d at 871). Thus, "there must be some net benefit to the estate or a preservation of the status quo after the costs to the creditor and the benefits to the estate are taken into account." *Id*. The creditor's cost provided no net benefit to the *Plunkett* estate, nor did it have any effect on the status quo. The loss related solely to one asset, not to the entire estate. Thus, *Plunkett* is distinguishable because here the collateral was used by an operating entity that comprised the entire estate at the time. Real estate is a passive investment, but the debtor was engaged in active production. American Toy took raw materials and added value by

manufacturing those goods into a product, which it sold to produce accounts receivable. The debtor used Norwest's collateral for the benefit of the entire estate, even though the benefit was not enough to save the debtor.

Other courts have been more expansive than *Plunkett* in what is deemed to have benefitted the estate. The court in *In re Five Star Partners, L.P.*, 193 B.R. 603, 613 (Bankr. N.D. Ga. 1996), applied a two part test similar to *Jartran* to determine whether a claim qualified as an administrative expense. The court noted:

> "The priority of an administrative expense is the highest. 11 U.S.C. § 507(a)(1). The allowance of such a priority is to be carefully considered, only after notice and hearing. 11 U.S.C. § 503. That which is actually utilized by a trustee in the operation of a debtor's business is a necessary cost and expense of preserving the estate and should be accorded the priority of an administrative expense. That which is thought to have some potential benefit, in that it makes a business more likely saleable, may be a benefit but is too speculative to be allowed as an 'actual, necessary cost and expense of preserving the estate.'"

Id. (quoting *In re Subscription Television of Greater Atlanta*, 789 F.2d 1530, 1532 (11th Cir. 1986)). The secured assets were actually utilized in the operation of American Toy's business. The use of the collateral by the debtor was not to make the business more saleable, it was to buy raw materials and to pay labor for the manufacture of those materials.

The deficiency asserted by Norwest must also arise from a *transaction* with American Toy. Courts have also interpreted this requirement differently. The court in *Matter of Jartran, Inc.*, 732 F.2d 584 (7th Cir. 1984), explained the rationale for its interpretation of § 503:

> The policies underlying the provisions of § 503 . . . are not hard to discern. If a reorganization is to succeed, creditors asked to extend credit after the petition is filed must be given priority so they will be moved to furnish the necessary credit to enable the bankrupt to function. Thus, "[w]hen third parties are *induced* to supply goods or services to the debtor-in-possession . . . the purposes of [§ 503] plainly require that their claims be afforded priority." Without a provision like § 503, efforts to reorganize would be

> hampered by the necessity of advance payment for all goods and services supplied to the estate since presumably no creditor would willingly assume the status of a non-priority creditor to a debtor undergoing reorganization.

Id. at 586 (citations omitted; quoting *Mammoth Mart*, 536 F.2d at 954). Both *Mammoth Mart* and *Jartran* held that *voluntary* inducement is required for an expense to be adjudicated an administrative claim. *See also In re Ralar Distributors, Inc.*, 166 B.R. 3 (Bank. D. Mass. 1994), *aff'd*, 182 B.R. 81 (D. Mass. 1995), *aff'd sub nom. Baybank-Middlesex v. Ralar Distributors, Inc.*, 69 F.3d 1200 (1st Cir. 1995). Here, Norwest's participation in the debtor's attempted reorganization was anything but voluntary.

The court in *Ralar Distributors, Inc.*, 166 B.R. 3, denied a secured creditor a superpriority claim because it was unable to show that the debtor's use or sale of collateral caused a decline in value of the collateral. Such a decline clearly occurred in this case. The *Ralar* court also concluded that superpriority claims are only allowed for those creditors who *agree* to extend postpetition credit to the bankruptcy estate as a loan or by furnishing goods or services. *Id*. at 8. It must be noted, however, that the statute does not require a *voluntary* transaction.

The Eleventh Circuit held that "[t]he negotiation for continued possession of the [collateral] in return for adequate protection is a post-petition transaction providing new value to the bankruptcy estate." *In re Carpet Center Leasing Co.*, 991 F.2d 682, 687 (11th Cir. 1993) (creditor held security interest in debtor's fleet of tractors). The *Carpet Center* court distinguished *Jartran*:

> In [*Jartran*], the debtor enjoyed the benefits of advertising services that were performed on the basis of pre-petition contracts. The advertising service provider claimed entitlement to administrative priority for the cost of providing the ads, but the Seventh Circuit Court of Appeals held that the debtor engaged in no post-petition transaction which induced the provision of the ads because the commitment to provide the ads was

> formed before the debtor filed its bankruptcy petition. In this case, by contrast, Debtor induced the post-petition provision of goods to the estate by negotiating for retention of the trucks, otherwise subject to repossession, in return for adequate protection payments. Rather than simply enjoying the benefits of a pre-petition commitment, Debtor actively bargained for the use of the tractors after filing its bankruptcy petition.

Id. (citation omitted).

This court agrees with the analysis set forth by *Carpet Center* and believes that this case is likewise distinguishable from *Jartran*. American Toy enjoyed the use of Norwest's collateral throughout its postpetition operation, and this use constitutes a postpetition transaction. There was an early agreement between the debtor and Norwest for interim use of cash collateral for a short time pending the outcome of a final hearing on Norwest's motion for relief from the automatic stay, and the debtor consented to pay adequate protection. This was clearly a postpetition *voluntary* transaction between the debtor and secured creditor. When the court denied Norwest's motion to lift the stay, it was induced to provide cash collateral to the debtor, albeit involuntarily. The involuntary nature of the process does not negate the fact that Norwest and the debtor engaged in a postpetition transaction, unlike *Jartran*, providing new value to the estate. It would be strange indeed if Norwest were entitled to superpriority only if it *agreed* to the use of cash collateral (which it did briefly), but it would be denied superpriority under the same economic circumstances if it litigated its rights and was *forced* by court order to put its interests at risk. Section 707(b) has no such requirement. Norwest is entitled to an administrative expense priority.

One court held that a similar interpretation of § 507(b) "conflicts with the policy of encouraging suppliers to extend post-petition credit by giving their claims first priority," and consequently, "suppliers may be discouraged from providing goods and services on credit to the

debtor." *Five Star Partners*, 193 B.R. at 612. This court disagrees. The debtor is using the creditor's cash collateral as it is using the goods supplied by the trade creditor. The act of consuming cash and accounts receivable results in taking the secured creditor's money and using it to pay trade creditors. Thus, trade creditors have the advantage of consumption of the collateral as it is used to provide goods and services for the debtor, the classic example of an administrative expense.

V. CONCLUSION

Based upon this analysis, the motion of Norwest Bank Minnesota, N.A., for payment of a superpriority administrative expense claim pursuant to 11 U.S.C. §§ 507(b), 507(a)(1) and 503(b) is granted.

Dated at Milwaukee, Wisconsin, February 24, 1997.

BY THE COURT

___/s/___________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge