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In This Issue

JUST GOT PAID: CUSTODIANSHIPS, PAYMENT AND BANKRUPTCY

HON. JOHN T. GREGG
UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF MICHIGAN

Custodianships and bankruptcy often present conjoined yet competing interests, including whether the custodian or the debtor is vested with the authority to commence a bankruptcy, and whether the custodian should remain in such capacity notwithstanding the bankruptcy filing. A trilogy of recent decisions brings to the forefront yet another conflicting overlap between bankruptcy and custodianships – compensation and other payment issues after a debtor subject to a custodianship thereafter becomes the subject of a bankruptcy case. *See In re Stainless Sales Corp*., 579 B.R. 836 (Bankr. N.D. Ill. 2017) ("*Stainless Sales I*"); *In re Montemurro*, 581 B.R. 565 (Bankr. N.D. Ill. 2018); *In re Stainless Sales Corp*., ___ B.R. ___, 2018 WL 1604628 (Bankr. N.D. Ill. Mar. 30, 2018) ("*Stainless Sales II*").[1] While challenging to digest, all three decisions thoughtfully probe and articulate the legal standards for payment under sections 503 and 543 when custodianships cross over to bankruptcy.[2]

A. Creditor to Whom Custodian Obligated Prepetition Was Entitled to Administrative Expense

In *Stainless Sales I*, the court considered whether the claim of a creditor to whom the custodian (but not the debtor) was obligated could be satisfied after the debtor filed for bankruptcy. Prepetition, the debtor made an assignment for the benefit of creditors under Illinois law. The assignee thereafter scheduled an auction of the debtor's assets. Prior to the auction, one of the debtor's creditors requested that the assignee return a forklift that the creditor had leased to the debtor. Before the assignee could return the forklift, however, the auction occurred and the forklift was sold to a third party for approximately $15,000.

One day after the auction and before the assignee could distribute the proceeds, certain creditors of the debtor filed an involuntary bankruptcy petition against the debtor. After the court entered an order for relief, the creditor filed an application for an administrative expense for the value of the forklift. The chapter 7 trustee objected to the application because there was allegedly no benefit to the debtor's estate.

The court began its analysis by rejecting the creditor's argument that *Reading Co. v. Brown*, 391 U.S. 471 (1968) provides a basis to award an administrative expense to a creditor for the acts of a custodian. In *Reading*, a decision under the Bankruptcy Act, the United States Supreme Court considered whether to grant the equivalent of an administrative expense to a party who suffered

[1] A "custodian" includes an assignee for the benefit of creditors, a state or federal court-appointed receiver, and similar agents under applicable law. 11 U.S.C. § 101(11); *see also* 11 U.S.C. § 543.

[2] Neither the author nor the Bankruptcy Court for the Western District of Michigan express any opinion regarding the decisions discussed in this article. The article is by no means comprehensive. Practitioners are encouraged to review the actual decisions in order to thoroughly understand the issues and holdings.

damages due to a fire that occurred after the commencement of the bankruptcy case but while a receiver remained in possession of the debtor's property. The Supreme Court awarded the administrative expense because "costs that form 'an integral and essential element of the continuation of business' are necessary expenses even though priority is not necessary to the continuation of the business."

The *Stainless Sales I* court found that *Reading* did not provide a basis to award an administrative expense under the circumstances before it. According to the court, *Reading* was distinguishable in at least two respects. First, the court noted that *Reading* was rendered prior to the enactment of the Bankruptcy Code, which specifically addresses the overlap between custodians and receivers in sections 503 and 543. Second, the court observed that *Reading* appears to be limited to post-petition conduct, as other courts have held.

The court was also unpersuaded by the creditor's argument that section 503(b)(3)(E) supports its request. Section 503(b)(3)(E) provides that the court shall allow an administrative expense for "the actual, necessary expenses . . . incurred by a custodian superseded under section 543" of the Bankruptcy Code. According to the creditor, because a custodian is entitled to an administrative expense under section 503(b)(3)(E), a party to whom a custodian is obligated should be afforded the same relief. The court found such an interpretation attenuated, deeming such a reading to be inconsistent with the overall priority scheme of the Bankruptcy Code. In concluding that the creditor was not entitled to an administrative expense under section 503(b)(3)(E), the court explained that the better reading is to limit relief under section 503(b)(3)(E) to the party expressly named therein – the custodian.

The court did not end its analysis with section 503(b)(3)(E), however. During the hearing on the application, the court questioned whether section 543 might provide some recourse for the creditor. Section 543(c)(1) states that the court "shall protect all entities to which a custodian has become obligated with respect to such property or proceeds, product, offspring, rents, or profits of such property." Applying this standard, the court noted that there is little doubt that the assignee was liable to the creditor for conversion of the forklift, thereby satisfying an essential element under section 543(c)(1). The court also concluded that there was no issue as to whether the proceeds from the sale of the forklift became property of the bankruptcy estate.

The court identified the more difficult issue as being the nature of protection contemplated by section 543(c)(1). The court noted that the term "protection" is undefined in the Bankruptcy Code, and the statute itself provides little context to aid in the interpretation. The court also observed that while other courts have equated "protection" with "payment," such an approach is a "convenient shorthand" without analysis. *See In re 400 Madison Avenue Ltd. P'ship*, 213 B.R. 888 (Bankr. S.D.N.Y. 1997); *In re Wayne Engineering Corp.*, 2007 WL 704521 (Bankr. N.D. Iowa Mar. 5, 2007); *see also* COLLIER ON BANKRUPTCY, 543.04 (16th ed. 2017) (generally relying on *400 Madison Avenue* and *Wayne Engineering*).

Feeling compelled to address whether and to what extent protection should be equated with payment, the court commented that requiring payment under section 543(c)(1) would create a superpriority status that is not required or authorized under the Bankruptcy Code. Moreover, if the court were to require payment under section 543(c)(1), it would be inconsistent with section

543(c)(2), a subsection which does in fact require *payment* as opposed to *protection*. The court recognized that Congress knew how to direct payment as it expressly did under section 543(c)(2). Congress did not do so under section 543(c)(1).

The court also considered whether a creditor to whom a custodian is obligated might be relegated to the status of a general unsecured creditor. However, the court concluded that such a claim might be worthless and thus provide no "protection" whatsoever. Finally, the court rejected the argument that a claim under section 543(c)(1) could be elevated to a super-priority. Section 507, which provides a list of priority claims, is exhaustive and does not include any claims or protection under section 543.

With all of that said, the court returned to section 503(b). Citing to *Mediofactoring v. McDermott (In re Connolly N. Am., LLC)*, 802 F.3d 810 (6th Cir. 2015) and other decisions, the court emphasized that the list of administrative expenses under section 503(b) is non-exhaustive. The court thus stated:

> Here, there is a compelling justification to afford these parties administrative expense reimbursement. Section 543 requires the court to protect innocent parties, such as [the creditor], to whom a custodian has become obligated. They may not assert section 503(b)(3)(E) expenses directly, and the custodian who is obligated to them may not do so at all. Allowing the court to fashion a remedy appears to be precisely what Congress intended, and the use of the term protection itself – a term otherwise without specific meaning in bankruptcy parlance, appears intended to allow the court the maximum amount of flexibility in so doing.

In sum, the court held that "protection" under section 543(c)(1) can take the form of an administrative expense under section 503(b) to be paid by the debtor's estate. The court reasoned that although expansion of the list of express administrative expenses under section 503(b) should be undertaken sparingly, the facts and circumstances in *Stainless Sales I* justified such relief.

B. Two Avenues for Compensation of Custodian for Prepetition Services

In the second decision, *Montemurro*, the court waded into a statutory morass when it considered how a custodian might be awarded compensation or otherwise paid for prepetition services. Prior to the debtors' bankruptcy filing, the Illinois state court appointed a receiver to demolish a building on a parcel of property individually owned by the debtors. After the building had been razed, the debtors filed for relief under chapter 11. The receiver did not continue to function in such capacity post-petition. Nonetheless, the receiver filed an application for an administrative expense under section 543(c)(2) for the prepetition services he rendered. The debtors objected.

The court began by explaining the different standards created for compensation under sections 543 and 503(b)(3)(E). Under section 543(c)(2), a custodian is entitled to "reasonable compensation for services rendered and costs and expenses." However, under section 503(b)(3)(E), a custodian is eligible to receive an administrative expense, but only for actual and

necessary compensation and related expenses.[3] Accordingly, the court noted, it is less than clear which section of the Bankruptcy Code is controlling. Or, might they both be applicable?

Undertaking a careful analysis, the court distinguished section 543(c)(2) from section 503(b)(3) by noting that section 503(b)(3)(E) expressly applies to only those custodians who are superseded under section 543. Therefore, a superseded custodian (*i.e.*, one who is functioning in such capacity as of the petition date but does not continue in such role post-petition) is eligible to have his or her claim paid as an administrative expense if the services and related expenses are actual and necessary. A custodian who continues in such capacity post-petition, however, is not eligible to have its claim paid as an administrative expense under section 503(b)(3)(E). The court further observed that section 543(c)(2) also provides for compensation to custodians. The compensation need not be actual and necessary. Instead, section 543(c)(2) only requires that it be "reasonable."

The court next addressed who is eligible for relief under section 543(c)(2). In order to avoid redundancy with section 503(b)(3)(E), the court noted that "such custodian" in section 543(c)(2) relates to those custodians with knowledge of the case under section 543(a), regardless of whether the custodian has been superseded. The court concluded that section 543(c)(2) allows a court to provide for "reasonable compensation" to a custodian, regardless of whether the custodian has been superseded.

Keeping in mind that section 503(b)(3)(E) provides an administrative expense only for superseded custodians, the court grappled with the means by which to compensate custodians who are not superseded. The court turned to section 543(c)(2), noting that its express language states that the court shall "provide for the payment" of compensation to a custodian. According to the court, the passive wording of "provide for the payment" allows the court to permit a custodian to seek payment through non-bankruptcy means, such as by obtaining payment from a non-debtor party who is obligated under the receivership order or non-bankruptcy law. Although a custodian cannot seek compensation under section 543(c)(2) against the debtor or property of the estate, the court hypothesized that a custodian might nonetheless have recourse against a non-debtor or even a debtor's property that does not constitute property of the estate.

Distilling the aforementioned thicket of statutory interpretation, the court somewhat apologetically summarized the legal standards as follows:

> If and to the extent the compensation requested of the custodian is to be paid from estate property, the heightened standard of actual and necessary as set forth in section 503(b)(3)(E) should be applied. To the extent compensation is from another source, the reasonableness standard in section 543(c)(2) should apply. If a

[3] At one point, *Montemurro* seems to state that the "actual and necessary" modifiers apply only to expenses, and not compensation, of the custodian under section 503(b)(3)(E). *In re Montemurro*, 581 B.R. at 573. However, later in the opinion, the court explained that any compensation awarded to a custodian under section 503(b)(3)(E) is subject to the "actual and necessary" requirement. *Id*. at 575-76. Any inconsistency in *Montemurro* appears to have been implicitly addressed in *Stainless Sales II*, when the court reaffirmed that any administrative expense under section 503(b)(3) must be actual and necessary. *See In re Stainless Sales Corp*., 2018 WL 1604628, at *6 (Bankr. N.D. Ill. Mar. 30, 2018) (citing *In re Montemurro*, 581 B.R. at 575-76).

> custodian is excused from compliance under section 543(d), however, only the section 543(c)(2) reasonableness standard would apply.
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> * * *
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> While the court will adopt the reading set forth herein despite the odd result, it is not without reservations and the overall impression that the entire scheme as set forth in the Bankruptcy Code is in desperate need of revision.

With the general statutory analysis complete, the court returned to the specific facts at issue in *Montemurro*. After finding that the receiver had turned over the property to the debtors post-petition in compliance with his obligations under section 543(b), the court deemed the receiver to have been superseded. As such, the court held that a superseded custodian can be compensated under either section 503(b)(3)(E) or section 543(c)(2). The court declined to render a decision on the application before it, however, because the standard to be applied to the proofs was less than clear at the outset.[4]

C. Professionals of Custodians Have Three Statutory Means to Seek Compensation

In the most recent decision in the trilogy, *Stainless Sales II*, the same court was again confronted with payment issues relating to a custodianship. This time, the fees and expenses of the custodian's legal counsel for pre- and post-petition services were at issue.

In *Stainless Sales II*, legal counsel for an assignee for the benefit of creditors was retained by the assignee prepetition and given a retainer in the amount of $155,000. After certain creditors filed an involuntary petition for relief against the debtor under chapter 11, the assignee filed a motion to continue in such capacity post-petition under section 543, which the court granted. The court ultimately entered an order for relief, but converted the case to chapter 7.

Approximately eight months after the bankruptcy petition was filed, legal counsel for the assignee filed its first fee application in which it sought an administrative expense for services it provided to the assignee pre- and post-petition. The chapter 7 trustee objected.

Drawing from *Stainless Sales I* and *Montemurro*, the *Stainless Sales II* court concluded that the professionals of a custodian potentially have three means by which to seek compensation for the pre- and post-petition services they provide to a custodian. First, section 543(c)(1) states that the court shall protect all persons to whom a custodian has become obligated. According to the court, legal counsel for the assignee was certainly a party to whom the assignee had become obligated. Unlike section 503(b)(4), the court reasoned, section 543 does not contain a separate provision for payment of a custodian's professionals. As such, Congress intended to ensure that professionals have the ability to be paid as a protection mechanism under section 543(c)(1). And,

[4] The court narrowed the issue further for the final hearing by noting that there was no source of funds with which to pay the receiver under section 543(c)(2). Because the only source of payment was from property of the estate, the court identified the sole remaining issue as whether the receiver was entitled to an administrative expense under section 503(b).

in order to provide protection under section 543(c)(1), it might be appropriate to award the custodian's professionals an administrative expense under section 503(b), as the court did in *Stainless Sales I*.

Second, the court observed that section 543(c)(2) could also be implicated. That section requires the court to "provide for the payment of reasonable compensation for *services* rendered and *costs* and *expenses* incurred by" a custodian. Section 543(c)(2) is different than section 503(b)(3)(E), the latter of which only covers compensation and expenses, but not costs. By including "costs" under section 543(c)(2), Congress intended to capture professional services of a custodian.

Third, the court noted that section 503(b)(4) expressly addresses the fees and expenses of an attorney or accountant of an entity whose expense is allowable under certain subsections of section 503(b)(3). Because a custodian's fees and expenses are allowable under section 503(b)(3)(E), the fees and expenses of legal counsel to the assignee could be eligible for an administrative expense under section 503(b)(4).[5]

Next, the court addressed the means by which to compensate the custodian's legal counsel for three distinct periods: (i) prepetition, (ii) post-petition in chapter 11, and (iii) post-petition in chapter 7. With respect to the prepetition period and citing to *Stainless Sales I*, the court explained that although legal counsel could potentially be eligible for an administrative expense, an expansion of section 503(b) beyond the subsections expressly enumerated therein should be employed with restraint. Section 543(c)(1) and section 543(c)(2) could also provide a basis for compensation paid to a custodian's legal counsel or accountant for prepetition services.[6]

With respect to post-petition compensation in chapter 11 and chapter 7, the court deemed the standard to be the same. *See* 11 U.S.C. § 503(b); *see also* 11 U.S.C. § 726(b). Because neither the trustee nor legal counsel identified any source of payment other than property of the estate that might afford relief under section 543 for post-petition services, the court proceeded under section 503(b)(4).

The court first rejected the trustee's contention that legal counsel for the custodian was not eligible for compensation because it had not been retained. The court explained that section 327 does not apply to custodians:

> Because [legal counsel] was not employed under section 327, the general compensation provisions under section 330 did not, by their express terms, apply to it. *See* 11 U.S.C. § 330(a)(1); *cf.* 11 U.S.C. § 330(a)(4)(B) (providing an alternative standard for compensating counsel in chapter 13 matters, where professionals are not retained and thus not subject to section 330(a)(1)). Here, professionals

[5] The court further explained that allowance of the fees and expenses of a custodian is not a prerequisite to allowance under section 503(b)(3)(E) because "allowable" and "allowed" are different concepts.

[6] Because the parties failed to sufficiently address these prepetition compensation issues in their briefing and the court ultimately afforded relief under section 503(b)(4), the court elected not to address prepetition compensation under sections 543(c)(1), 543(c)(2) and 503(b).

providing services to custodians have an alternative standard for compensation codified in section 503(b) and 543. They need not look elsewhere.

The court next explained that notwithstanding the trustee's argument to the contrary, section 503(b)(4) applies to both pre- and post-petition professionals of a custodian. In a fairly summary fashion, the court turned to the express language of section 503(b)(4), which makes no mention of the prepetition or post-petition nature of such services. *Compare* 11 U.S.C. § 503(b)(1)(A)(i) ("after the commencement of the case") *with* 11 U.S.C. § 503(b)(9) ("before the date of commencement of a case"). Legal counsel for the assignee was thus entitled to an administrative expense under section 503(b)(4) for its pre- and post-petition services.[7]

The decisions in *Stainless Sales I, Montemurro*, and *Stainless Sales II* address important issues concerning the relationship between custodianships and bankruptcy. As noted in *Montemurro* and *Stainless Sales II*, the statutory framework is less than ideal. Nonetheless, when carefully reviewed, all three decisions provide thoughtful guidance and analysis for use in future cases.

[7] The *Stainless Sales II* court undertook a thorough analysis of the fees and expenses, which need not be discussed as part of this article. Of particular note, however, is the court's conclusion that unusual circumstances existed which justified counsel's request for fees and expenses related to the preparation and litigation of the fee application. The court deviated from its general rule that fees related to preparation of a fee application should not exceed 3-5% of the total compensation requested. The court also concluded that *Baker Botts L.L.P. v. ASARCO LLC*, ___ U.S. ___, 135 S.Ct. 2158, 2164 (2015) was inapplicable because legal counsel's fees and expenses were sought under section 503, not section 330.

PROOF OF CLAIM ON STALE DEBT DOES NOT VIOLATE FAIR DEBT COLLECTION PRACTICES ACT

ELISABETH VON EITZEN
EMILY RUCKER
WARNER NORCROSS & JUDD

In *Midland Funding, LCC v. Johnson*, issued May 15, 2017, the Court held that a creditor does not violate the Fair Debt Collection Practices Act (FDCPA) when it files a proof of claim in a Chapter 13 case after the applicable statute of limitations period for that debt has passed. The decision establishes that filing the time-barred proof of claim does not qualify as a false, deceptive, misleading, unconscionable or unfair practice under the FDCPA.

The Court's Reasoning

Initially, the Court noted that the law of many states provides that a creditor has a right to payment of a debt even after the expiration of the limitations period. While the expiration of the limitations period renders a claim unenforceable, a proof of claim on a stale debt is not false, deceptive or misleading because the bankruptcy code does not limit "claims" to "enforceable claims." Moreover, the Court noted that generally, a debtor must assert the statute of limitations in a lawsuit or the defense is waived.

The Court distinguished a Chapter 13 bankruptcy proceeding from a collection lawsuit, noting that in a lawsuit, a debtor may unknowingly pay a stale debt to his or her disadvantage. However, in a bankruptcy proceeding, the debtor initiates the proceeding and has the benefit of established procedures and is guided by a knowledgeable bankruptcy trustee. These protections reduce risk to the debtor and decrease the likelihood that the debtor will unknowingly pay a stale debt.

The Court also suggested that a debtor may actually benefit when a creditor asserts a stale claim in bankruptcy, since the debt will be discharged and erased from the debtor's later credit reports.

Finally, the Court emphasized that to find a violation of the FDCPA under these circumstances would upset the "delicate balance" that the Court attempts to maintain between the bankruptcy code and the FDCPA, particularly in terms of the obligations placed upon creditors and debtors in bankruptcy.

Impact and Implications for Creditors and Debtors

The Supreme Court's decision may provide peace of mind to certain businesses, particularly those that buy older debt from others. Debtors and trustees must remain vigilant in evaluating proofs of claim to ensure that no claims are barred by the statute of limitations.

The Court's decision is limited to Chapter 13 bankruptcies and does not affect other collection activities aimed at stale debts. Several lower courts have held that seeking to enforce stale debts outside of bankruptcy is an unfair practice under the FDCPA.

PROPERTY OF THE ESTATE IN CHAPTER 7: IT'S COMPLICATED

PREVIEW OF BREAKOUT SESSION N
SATURDAY, JULY 28
30TH ANNUAL BANKRUPTCY SECTION SEMINAR
FEDERAL BAR ASSOCIATION – WESTERN DISTRICT OF MICHIGAN

In order to close the estate, a chapter 7 trustee must expeditiously perform certain specific tasks, including the collection and liquidation of property of the estate, the investigation of the financial affair of the debtor, the examination of all proofs of claims filed by creditors, and furnish such information concerning the estate and the estate's administration as might be requested by a party in interest. The duty to expeditiously close the estate will often conflict with other duties, but this conflict is explicitly recognized in the text of the bankruptcy code, 11 U.S.C. § 704(a)(1), which requires the bankruptcy trustee to balance the need for expeditious conduct against the best interest of the parties.

It is well recognized that the trustee's duties under section 704 are not equal. The duty to close the estate as quickly and as expeditiously as is compatible with the best interests of the parties in interest has been called the trustee's "main duty." The other duties set forth in the provisions of section 704 are merely directive as to what the trustee shall do in accomplishing the main objective and purpose of the appointment.

As section 704 indicates, the chapter 7 trustee's fiduciary duty extends to both the creditors and the debtor in order to maximize the value of the estate. This raises particularly complicated issues given the confluence of fewer bankruptcy filings with the appreciation of home values, particularly in the Western District of Michigan:

- Debtor's counsel should beware of using their client's personal opinion as to home value, the price at which the neighbor's home sold, and Zillow, might not be enough to determine the actual value of the real property.

- Are Trustee's driving chapter 7 debtors into chapter 13 cases, and thus reducing even further the ability to collect assets in the chapter 7 world? Is Debtor's counsel taking on too much risk in filing chapter 7?

- When can, or should, a motion to abandon be filed? Trustees need time to complete their due diligence on all assets.

- What risks should you be reviewing with your client?

- Is it the end of the world if a client negotiates to pay what appears to be a non-exempt asset over a reasonable amount of time?

Join the Hon. James D. Gregg, Trustee Jeff Moyer, Matt Boyd, and Todd Almassian to discuss these complicated issues that face debtor's counsel and Trustees and how they relate to 11 U.S.C. § 704(a)(1).

LIMITED LIABILITY COMPANIES & FIDUCIARY DUTIES: FOR BETTER OR FOR WORSE, IN SICKNESS & IN HEALTH

PREVIEW OF BREAKOUT SESSION C
FRIDAY, JULY 27
30TH ANNUAL BANKRUPTCY SECTION SEMINAR

The cross section of bankruptcy law and the law governing limited liability companies poses a unique set of issues for bankruptcy practitioners. This can be true whether the company is a potential debtor in pursuit of an order for relief in a chapter 7 or chapter 11 case, or rather when the membership interest in the company (or a portion thereof) is held in the name of an individual debtor who files a chapter case:

- What types of issues might an attorney, accountant, appraiser, auctioneer, or other professional face when the professional represents both the limited liability company and a member of the company, and how do these issues manifest themselves in the context of retention under section 327?

- Debtor's counsel should also be aware of keeping separate the debts of an individual debtor in a consumer bankruptcy case and those of the debtor's limited liability company.

- What constitutes property of the estate when a limited liability company files a chapter case? When the member files?

- To what extent can the trustee utilize the economic and noneconomic rights of a member?

- What types of issues might arise under section 365 of the Code when applied to operating agreements of limited liability companies?

- To what extent might members of a limited liability company block a vote or consent in favor of the filing of a bankruptcy petition on behalf of a limited liability company?

Join the Hon. Jeffrey R. Hughes, John T. Piggins, Dean E. Rietberg, and Anthony J. Kochis to discuss these and other issues pertaining to limited liability companies and bankruptcy.