In the United States Bankruptcy Court
for the
Southern District of Georgia
Savannah Division

In the matter of:	)	
	)	Chapter 7 Case
TOPGALLANT GROUP, INC.	)	
	)	Number 89-41997
Debtor	)	

ORDER ON APPLICATION FOR ALLOWANCE OF ATTORNEY'S FEES AND EXPENSES ADVANCED

The Trustee in the above-captioned case filed an application seeking to compensate the law firm of Brennan, Harris and Rominger for certain fees incurred and expenses advanced in representation of the Trustee.

A hearing was scheduled for July 21, 1992, to consider said application and was continued to July 27, 1992, for further consideration. At the hearing, no objection was raised by the United States Trustee or any other party in interest to the amount or the allowability of the fees that were sought. However, an objection was asserted by counsel for Fleet Factors, doing business as Ambassador Factors, to payment of any fee which might be allowed from any source other than unrestricted unencumbered funds now or hereafter held by the Trustee. In support of its objection, Ambassador asserts that it is a secured creditor with a valid perfected security interest in accounts receivable, proceeds and other enumerated collateral of Topgallant Group, Inc., which although having no remaining direct liability to Ambassador remains contingently liable pursuant to a guaranty it executed of the indebtedness of Topgallant Lines, Inc., a related corporation also a Chapter 7 debtor in this Court. Ambassador argues that the collateral securing the obligation of Topgallant Lines to Ambassador is insufficient to liquidate the Ambassador claim in full resulting in the likelihood that

Topgallant Group, Inc., and the assets it pledged will be subject to the Ambassador claim and security interest.

The Trustee alleges that because Topgallant Group has no direct obligation to Ambassador, the funds on hand should be treated as unencumbered, that the security interest granted Ambassador Factors is not broad enough to encompass the fund out of which the Trustee seeks to pay the fees in question; and that the security interest held by Ambassador Factors was given at a time and under circumstances which make the guarantee a voidable preference pursuant to 11 U.S.C. Section 547. Those issues will be addressed by separate order. This Order deals with a separate theory under which fees incurred by the Trustee may be paid out of assets which are subject to the valid perfected security interest in favor of Ambassador or any other secured creditor.

For purposes of this Order I have assumed that the funds currently held by the Trustee out of which the Trustee proposes to pay his counsel are subject to a valid perfected security interest. The issue of the source out of which the Trustee is permitted to compensate counsel has presented recurring difficulties throughout the pendency of this case and this ruling will in all likelihood control the outcome not only of this particular fee application but others which may follow.

Procedural Posture of the Case

I will attempt to summarize the current state of prior rulings of this Court as it bears on the issue before me. On February 4, 1991, I entered an Order granting partial summary judgment in Adversary Proceeding #90-4072 in which I ruled that the valid maritime lien claims held by numerous claimants were entitled to priority over the UCC based security interest of Ambassador Factors. Thereafter, on February 5, 1992, I granted summary judgment ruling that Ambassador's interest as a perfected UCC security interest holder had priority over the claims of a number of alleged holders of maritime lien claims because those holders had taken letters of credit, letters of undertaking, or bonds for security for the indebtedness they were owed as a result of which they released or waived their rights to arrest the Debtor's vessels *in rem*. Both of

those Orders are presently on appeal to the United States District Court for this District.

The Trustee has filed or assumed the responsibility for the prosecution of a number of adversary proceedings. *See* James L. Drake, Jr., Trustee v. Ambassador Factors, Division, Fleet Factors Corp., Adversary Proceeding #91-4043; James L. Drake, Jr., Trustee v. Ambassador Factors, Division, Fleet Factors Corp., Adversary Proceeding #91-4044; James L. Drake, Jr., Trustee v. Frank K. Peeples, Southeastern Maritime Co., Inc., Peeples Industries, Inc., et al., Adversary Proceeding No. 91-4141; James L. Drake, Jr., Trustee v. Frank K. Peeples, Southeastern Maritime Co., Inc., Peeples Industries, Inc., et al., Adversary Proceeding No. 91-4142. The Trustee further has advised the Court and the parties that based on his investigation of transactions in which the Debtor engaged in the ninety days immediately preceding its filing that approximately 10 million dollars in payments were made which the Trustee must investigate further to determine whether they are avoidable as preferences under 11 U.S.C. Section 547.

In Adversary Proceeding No. 91-4141, the Trustee contends in Count V of his complaint that Ambassador received approximately $1.8 million in "excess payments" from the Debtor during the 90 days before filing bankruptcy. The Trustee argues that Ambassador was undersecured during this period and that the $1.8 million in payments to Ambassador should be avoidable as a preference under 11 U.S.C. Section 547. Also, the Trustee alleges in Court VI of his complaint that insiders of the Debtor, Frank K. Peeples, Semco, and the "Semco Guarantors," guaranteed certain debts to Ambassador; thus, the Trustee claims that approximately $20 million in payments made to Ambassador between March 31, 1989, and December 13, 1989, the date Debtor filed bankruptcy, should be avoidable as a preference which benefitted insiders.

There are at present no funds in the hands of the Trustee which all parties can or will agree are unencumbered assets out of which general administrative expenses may be paid, and the Trustee is therefore severely limited in pursuing causes of action and/or further investigation of Debtor's pre and post-petition transfers as required by 11 U.S.C. Section 704. The question is therefore presented whether there is any source of funds from which the Trustee and his counsel may properly be compensated for the performance

of obligations imposed by the Code. 11 U.S.C. Section 506(c) provides one avenue. That section provides in relevant part:

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

11 U.S.C. §506(c). Section 506(c) usually applies where debtor incurs expenses to protect or benefit a secured creditor's collateral. *See generally*, In re Glasply Marine Industries, Inc., 971 F.2d 391, 393 (9th Cir. 1992). In re James E. O'Connell Co., Inc., 893 F.2d 1072 (9th Cir. 1990); In re Sonoma V, 24 B.R. 600 (9th Cir. B.A.P. 1982). *See also* Matter of Trim-X, Inc., 695 F.2d 296, 301 (7th Cir. 1982) (Benefit, consent, and cause, should be considered under Section 506(c)); In re New England Carpet Co., 744 F.2d 16 (2nd Cir. 1984).

It has been contended in a brief filed by Ambassador Factors that 506(c) is not intended to compensate a trustee for pursuing claims or actions it may have against the creditor (Ambassador) from whose collateral (the accounts receivable) the fees would be paid. Ambassador cites numerous authorities for the proposition that for an allowance of compensation to the Trustee under 506(c) there must be some direct, identifiable benefit to the secured party out of whose collateral the expenses are deducted. Assuming without deciding that that is the appropriate standard for a Section 506(c) fee award, Ambassador's argument begs the question whether Section 506(c) is the only avenue under which the Trustee may be compensated out of secured property. To answer that question, the Court is confronted with an interpretation of the scope of 11 U.S.C. Section 552(b) which provides in relevant part:

> Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the

> commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Stated succinctly, Section 552(b) provides that a pre-petition security agreement which grants to the lender a security interest in proceeds of its collateral which is enforceable under applicable non-bankruptcy law, is enforceable against proceeds of the collateral received by the estate post-petition "except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."

This exception "gives the court flexibility in limiting the effect of pre-petition proceeds clauses." Collier on Bankruptcy, ¶552.02 at 552-7. Clearly, the trustee may recover from proceeds reasonable necessary costs of preserving or disposing of the collateral under Section 506(c) if the creditor is benefitted. However, Section 552(b) is broader than simply a restatement of Section 506(c).

> Section 552(b), unlike Section 506(c), is not pegged to 'reasonable necessary costs and expenses of preserving, or disposing of,' property, which costs or expenses 'benefit' the holder of the secured claim. Moreover, Section 552(b) does not require, by its terms, that the estate invest any monies in connection with the subject proceeds or that if monies are spent or action is taken, that it enhance the value of the collateral, or that it be 'at the expense of' the estate or 'to the prejudice of' the estate. A court applying Section 552(b) may give more or less weight to some or all of these factors, but in the final analysis, a decision must be made according to the 'equities of the case.' These equities, in addition to those noted above, may include any improvement or decline in value of the proceeds and whether this improvement or decline is caused by any party or is the result of impersonal forces such as the vagaries of nature or fluctuations in the market, cooperation or obstruction by the secured party, and efficiencies or inefficiencies of the estate.

Id. at 552-9 and 10. *See also* In re Trans-Texas Petroleum Corp., 33 B.R. 67 (Bankr. N.D.Texas, 1983) (Court should consider hardship to the parties in deciding whether or not a security interest should be modified or limited under Section 552(b)).

In United Virginia Bank v. Slab Fork Coal Co., 784 F.2d 1188 (4th Cir. 1986), the Fourth Circuit reversed and remanded rulings of the bankruptcy and district judges, finding that the courts had misapplied Section 552(b) by concluding that certain proceeds of collateral were unencumbered because they constituted after acquired property. In remanding the case, however, the Fourth Circuit pointed out that Section 552 "gives the bankruptcy court considerable latitude in applying pre-petition security interests to post-petition proceeds." Id. at 1191. It specifically held that "a bankruptcy court may choose not to apply a pre-petition security interest to post-petition proceeds 'based on the equities of the case'." Further, the Court stated "[i]t appears clear from the legislative history related to §552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code. The latitude afforded to the bankruptcy court seems to this Court to indicate that such a balancing of interests was intended in the framing of §552." Id.

Most courts which have considered Section 552(b) considered fact situations in which the language was used to prevent a windfall to a secured creditor, for example, when unencumbered funds of the estate were utilized to enhance the value of collateral subject to a security interest. However, the language of Section 552(b) reaches beyond those limited facts which the court could have addressed as a Section 506(c) determination. *See* In re Cross Baking Co., Inc., 818 F.2d 1027, 1033 (1st Cir. 1987), quoting with authority language from Collier holding that "[i]f a creditor's collateral is processed and sold or proceeds are otherwise collected, either the creditor or the trustee, debtor, or debtor-in-possession may request a noticed hearing to have the court determine whether the creditor's interest in proceeds should be limited based on the equities of the case." *See also* In re Village Properties, Ltd., 723 F.2d 441, 444 (5th Cir. 1984) (Although Congress has the power to restructure state created security interests post-petition, it chose not to exercise it with respect to post-petition proceeds across the board but "Section 552(b) does permit a bankruptcy judge to deviate from state law 'based on the equities of the case'."); J. Catton Farms, Inc., v. First National Bank of Chicago, 779 F.2d 1242, 1246 (7th Cir. 1985) (Proceeds, "even if acquired after the date of bankruptcy, are part of a lender's security unless the court decides that it would be inequitable to enforce a security interest in them.")

The bankruptcy court in In re Airport Inn Associates, Ltd., 132 B. R. 951 (Bankr. D. Colo. 1990), concluded that what "constitutes the equities of a particular case is left to the discretion of the bankruptcy judge," citing J. Catton Farms, supra at 1247. "In determining whether the exception applies courts look at the amount of time and funds expended on the collateral, the position of the secured party, and the rehabilitative nature of the bankruptcy . . . However, courts are more likely to apply the exception when the secured party is oversecured." Id. at 959 (other citations omitted). Again, this court treated the purpose of the equity exception as being limited to the prevention of a windfall to a secured lender whose collateral had appreciated in value. *See* In re Delbridge, 61 B.R. 484, 490 (Bankr. E.D.Mich. 1986) (In determining whether a pre-petition lender could claim that milk proceeds of a dairy operation constitute products of a cow rather than a debtor/farmer who provides labor, it is unfair to let the creditor with a pre-petition lien on milk take the entire cash proceeds produced largely as a result of debtor/farmer's post-petition time, labor, and input; Section 552(b) gives "the court leeway to fashion an appropriate equitable remedy."

In Wilke Truck Service, Inc., v. Wiegmann, 95 B.R. 90 (Bankr. S.D.Ill. 1989), the court concluded that the "'equity exception' of section 552(b) allows the court to override otherwise valid security interests in proceeds." 95 B.R. at 93. However, the court cited only the general instances where the trustee uses unencumbered assets to increase the value of the collateral. In In re Willowood East Apartments of Indianapolis II, Ltd., 114 B.R. 138 (Bankr. S.D.Ohio 1990), the court denied debtor's effort to use post-petition rents for payment of legal expenses and filing and prosecuting its Chapter 11 as such were "not ordinary operating expenses" within the language of the mortgage and assignment of rents, and because the lender was undersecured which meant that any invasion or encroachment on the net rents would result in a decrease in the lender's interest in property. Most importantly, debtor had not offered to protect that encroachment by cash payments from another source, an additional or replacement lien or other indubitable equivalent under section 363 and 361. Nevertheless, the court recognized that section 552(b) as enacted is broader than the version commented upon in the legislative history which comments appear to limit Section 552 to instances where the value of the collateral has been enhanced by use of unencumbered assets. The court indicated that it might in the future utilize Section 552(b) to pay attorney's fees for the debtor's defense of actions brought by creditors

which were ill-founded or frivolous. Id. at 143-145.

According to legislative history, Section 552(b) as passed was a compromise between the narrower version of the House Bill and a broader Senate amendment. As enacted the section is broader than the language on which the House Report is based.

> Section 552(b) represents a compromise between the House bill and the Senate amendment . . . The provision allows the court to consider the equities in each case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party. Although this section grants a secured party a security interest in proceeds, product, offspring, rents, or profits, the section is explicitly subject to other sections of Title 11. For example, the trustee or debtor in possession may use, sell, or lease proceeds, product, offspring, rents, or profits under Section 363.

124 Cong. Rec. H11097-98 (daily ed. Sept. 28, 1978); S 17414 (daily ed. Oct. 6, 1978); remarks of Rep. Edwards and Sen DeConcini (emphasis provided).

Although the House may have initially intended to limit Section 552(b), the version as enacted grants the court the discretion to limit any post-petition security interest in proceeds where the equities of the case demand such a result. If Section 552(b) were limited to the case where there was a direct benefit to the creditor's collateral, it would be superfluous in light of the provisions of Section 506(c). It appears that the final version of Section 552(b) was intended to give the bankruptcy court broader equitable power, which is lacking in Section 506(c). The situation where the value of the collateral increases due to debtor's expenditures and efforts is just one example where the court may apply the "equity exception" and is not the only situation where Section 552(b) may be applied. *See* Willowood, 114 B.R. at 143, ("The legislative history to that section indicates that 'equities of the case' includes the situation where application of a pre-petition security interest to post-petition rents would be unfair to unsecured creditors because expenditures would be required of the estate to preserve the secured creditor's collateral or improve its position.") (Emphasis

provided). Clearly a bankruptcy court has discretion "to find an appropriate balance between the rights of secured parties and the rehabilitative purposes of the Code." United Virginia Bank, supra at 1191. In In re Colonial Realty Investment Co., 516 F.2d 154 (1st Cir. 1975) the court addressed the concern of using income from secured properties to finance expenses of administration. According to the court, there must be "a preliminary inquiry at the earliest possible time into the probability of benefit and detriment to secured creditors from proposed proceedings and an explicit preliminary finding of probable benefit or, at least, no probable injury." 516 F.2d at 160. Although Colonial Realty was decided before enactment of the Bankruptcy Code, the count did fashion a pragmatic approach taking the creditor's possible hardship into consideration. The rule in Colonial Realty appears to be a predecessor of the "equities" exception in Section 552(b).

Here, in the absence of funds to finance litigation the rehabilitative purposes of the Code cannot be achieved by the Trustee. To do so he must be able to pursue voidable preferences and fraudulent transfer claims such as those alleged in the pending adversaries. If the actions are successful, fees will ultimately be paid out of the recovery. If not, a source for repayment of such fees as are allowed in the future must be found. Since the Trustee at present holds no funds which have been determined to be unencumbered, the only source for payment of the fees in issue is the proceeds of secured collateral. Section 552(b) in its broad grant of discretion authorizes a bankruptcy court to limit the post-petition attachment of a security interest in the proceeds of a pre-petition asset. I conclude that considering the equities of the case, it is appropriate to authorize the Trustee to pay these fees out of encumbered funds. Section 552(b) also limits the security interest in the event Section 363 governing the Trustee's use of cash collateral governs. Section 363(a) provides:

> (a) In this section, 'cash collateral' means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

11 U.S.C. §363(a). Generally a trustee may not use cash collateral unless each creditor with an interest in the collateral consents or the court with notice and a hearing authorizes the use of the collateral. Section 363(c)(2); In re Cross Baking Co., Inc., 818 F.2d 1027, 1031 (1st Cir. 1987). Additionally, the court at any time on request of a party in interest may condition such use upon the debtor's providing adequate protection of the creditor's interest. Section 363(e). *See* In re George Ruggiere Chrysler - Plymouth, 727 F.2d 1017 (11th Cir. 1984) ("[T]he guiding inquiry is whether its security interests are 'adequately protected' absent the additional protection that the cash collateral would provide . . . In determining whether a creditor's secured interests are so protected, there must be an individual determination of the value of that interest and whether a proposed use of cash collateral threatens that value"); Midlantic National Bank v. Sourlis, 141 B.R. 826, 835-36 (D.N.J. 1992).

According to the Eleventh Circuit in Ruggiere Chrysler-Plymouth, supra, the value of the secured creditor's interest "for purposes of determining 'adequate protection' is limited to the lesser of the amount of the secured claim or the amount of the collateral." 727 F.2d at 1020.

Adequate protection does not require that a creditor's claim be treated as fully secured; instead, "the test is whether the debtor has provided a method of ultimately giving creditors the value of their cash collateral." Matter of Johnson, 47 B.R. 204, 209 (Bankr. W.D. Wisc. 1985) (quoting Miller, Adequate Protection in Respect of the Use, Sale or Lease of Property, 1 Bankr. Dev. J. 47, 80 (1984)). The court should consider the purpose of section 363(e) which is to provide the secured creditor "in value essentially what he bargained for." Johnson, 47 B.R. at 208. *See also* In re Lawrence, 41 B.R. 36, 38 (Bankr. D.Minn. 1984) (Creditor "is entitled to make a claim for an administrative expense pursuant to Section 507(b) to the extent the 'adequate protection' proves to be subsequently inadequate").

Section 361 provides three non-exclusive examples of adequate protection, which include:

> . . . providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in

the value of such entity's interest in such property;

11 U.S.C. §351(2). *See generally* Matter of James Wilson Associates, 965 F.2d 160, 171 (7th Cir. 1992). I conclude under Section 552(b) to permit the Trustee to fulfill his statutory duties to administer the estate, including the prosecution of various adversary proceedings, that Ambassador's or other creditors' liens in and to proceeds of their pre-petition accounts receivable shall be limited to permit payment of allowed administrative expenses. As adequate protection, said creditors are granted a replacement lien, to the extent that the priority of their security interests are hereafter determined, in and to the net recoveries obtained by the Trustee in preference litigation or any other unencumbered assets which may be recovered by the estate. Said replacement lien shall arise only to the extent that such expenses are not repaid out of the recoveries from litigation in which the expenses are incurred. However, to the extent that such replacement lien is insufficient to allow secured creditors to recover in full, I find that the equities of this case are such that the security interest in proceeds of pre-petition accounts receivable be limited to the extent necessary to provide "reasonable compensation" as contemplated in 11 U.S.C. Section 330 to the attorneys pursuing such litigation. The Trustee IS ORDERED to aggressively prosecute such additional preference claims he may have. The Court will monitor the status of such litigation from time-to-time as necessary. *See* Alchar Hardware Co. v. Wiener (In re Alchar Hardware), 730 F.2d 1386 (11th Cir. 1984) (Finding of adequate protection not final order that may be appealed because it may be reconsidered from time to time by the bankruptcy court under Section 363(e)).

The Trustee is FURTHER ORDERED to insure that the accrual of all uncompensated professional services be clearly documented as between the many files in litigation so that compensation authorized to be paid from encumbered funds can readily be reimbursed from recoveries in particular cases when unencumbered assets are collected. The Trustee is directed to confer with opposing counsel and submit a proposed procedure for accounting for the accrual of expenses and the various funds out of which said expenses may be paid in accordance with the terms of this order. The Trustee's application is approved and he is authorized to make payment as authorized in this order.

Lamar W. Davis, Jr.
United States Bankruptcy Judge

Dated at Savannah, Georgia

This ___ day of December, 1992.