N O T E S O N

DEBTOR/CREDITOR

R E L A T I O N S

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Bank Avoids Collateral Preservation Cost

Under the Bankruptcy Code, a debtor in possession or trustee may charge the cost of preserving collateral to the secured creditor, provided the secured creditor benefits from that preservation. Where the debtor in possession arranged for the services necessary to preserve collateral, but did not pay the vendor, courts have been divided as to whether the vendor itself may directly seek payment from the secured creditor. The United States Supreme Court recently determined that bankruptcy law does not give the vendor an independent right to seek payment from the secured creditor.

The difficulty for a vendor is illustrated by the facts of the case. The Chapter 11 debtor's insurance carrier provided insurance for the debtor's restaurant and service station business. However, the debtor did not pay all of the monthly premiums. All of the debtor's assets were pledged as collateral for a loan. After the Chapter 11 failed and a Chapter 7 trustee was appointed, the insurance carrier unsuccessfully sought payment directly from the secured lender whose collateral benefited from the insurance. The trustee, with the clear statutory right to pursue the lender for payment, had no interest in doing so, as any recovery would go to pay the insurer.

Vendors who are providing goods or services to a Chapter 11 debtor should determine whether the debtor's assets are subject to a security interest. If so, the vendor can take steps initially to ensure that the secured creditor will be liable to the vendor for the benefit provided by the vendor's goods or services. These protections may take the form of permission from the Bankruptcy Court for the vendor to collect from the secured creditor or a super priority secured status for the vendor. Of course, there is always COD.

Hartford Underwriters Insurance Co. v. Union Planters Bank, 2000 U.S. LEXIS 3624 (Sup. Ct. May 30, 2000).

Trust Fund Taxes Paid First

As corporations slide into bankruptcy, "trust fund" taxes, such as employee withholding, often go unpaid. The Internal Revenue Code makes the responsible officers of the corporation personally liable for these unpaid trust fund taxes. Therefore, a debtor's management prefers that the bankruptcy estate first pay the trust fund taxes to extinguish the personal liability of officers.

If a corporate debtor is liquidated by a Chapter 7 trustee, taxing authorities are able to allocate any payments to the non-trust fund taxes first. However, a Louisiana bankruptcy court has ruled that if the corporation liquidates pursuant to a Chapter 11 plan, the plan may require the IRS to allocate tax payments first to the satisfaction of the trust fund taxes. The bankruptcy court concluded that this departure from normal procedures was appropriate in order to encourage the continued participation of the debtor's management in achieving maximum recovery for creditors in the liquidation of the assets.

In re Poydras Manor, Inc., 242 B.R. 603 (Bankr. E.D. La. 2000).

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