RECENT DEVELOPMENTS IN SECTION 507 — PRIORITIES

Michael T. Driscoll[*]

I. INTRODUCTION

The Bankruptcy Code aims to secure equal distribution among creditors except where Congress has authorized a preferential treatment to certain classes of creditors holding unsecured claims.[1] Section 507 of the Bankruptcy Code sets forth the order in which these claims are entitled to priority of payment over all other unsecured claims when the estate cannot pay all such claims in full.[2] "Statutory priorities are

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[*]Michael T. Driscoll is an associate with Sheppard Mullin Richter & Hampton, LLP. The views expressed in this article do not necessarily represent the views of Sheppard Mullin Richter & Hampton, LLP or its clients.

[1]See *Howard Delivery Service, Inc. v. Zurich American Ins. Co.*, 547 U.S. 651, 655, 126 S. Ct. 2105, 165 L. Ed. 2d 110, 46 Bankr. Ct. Dec. (CRR) 177, 55 Collier Bankr. Cas. 2d (MB) 775, 37 Employee Benefits Cas. (BNA) 2743, Bankr. L. Rep. (CCH) P 80624 (2006) ("[T]he Bankruptcy Code aims, in the main, to secure equal distribution among creditors . . . We take into account, as well, the complementary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress."). Section 507 applies to Chapter 7, 11, 12, and 13. *In re Sanders*, 341 B.R. 47, 50, 55 Collier Bankr. Cas. 2d (MB) 1891, Bankr. L. Rep. (CCH) P 80523 (Bankr. N.D. Ala. 2006), order aff'd, 347 B.R. 776 (N.D. Ala. 2006). Section 507(a)(2) is the only subsection of the statute that is applicable in Chapter 9 cases. See 11 U.S.C.A. § 901(a) (listing Bankruptcy Code sections applicable to Chapter 9).

[2]See 11 U.S.C.A. § 507; *U.S. v. Frontone*, 383 F.3d 656, 662, 52 Collier Bankr. Cas. 2d (MB) 1683, 94 A.F.T.R.2d 2004-5853 (7th Cir. 2004) ("Section 507 is about the order in which claims are paid when, as is usually the case, the bankrupt's liabilities exceed his assets."); *U.S. v. Victor*, 121 F.3d 1383, 1389, 38 Collier Bankr. Cas. 2d (MB) 669, Bankr. L. Rep. (CCH) P 77450, 97-2 U.S. Tax Cas. (CCH) P 50539, 80 A.F.T.R.2d 97-5513 (10th Cir. 1997) ("The creation of § 507 evidences Congress's acknowledgment that particular types of unsecured claims deserve special status to ensure repayment before depletion of the bankruptcy estate."); *New Neighborhoods, Inc. v. West Virginia Workers' Compensation Fund*, 886 F.2d 714, 718, 19 Bankr. Ct. Dec. (CRR) 1470, Bankr. L. Rep. (CCH)

to be narrowly construed because the presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among his creditors."[3] A claimant seeking priority status under section 507 has the burden of proving entitlement to such priority.[4]

Section 507 is divided in four subsections. Section 507(a) sets forth ten categories in order of priority that claims should be paid:[5]

(1) claims for domestic support obligations;

(2) administrative expenses under section 503(b) of the Bankruptcy Code, unsecured claims of any Federal reserve bank for loans pursuant to section 13(3) of the Federal Reserve Act, and any fees and charges assessed against the estate pursuant to chapter 123 of title 28;

P 73157 (4th Cir. 1989) ("Statutory priorities, as set forth in the Bankruptcy Code, are intended 'to assure payment, if possible, to certain classes of claims by requiring that they be paid before others are satisfied.' ") (internal citation omitted).

[3] *In re Amarex*, 853 F.2d 1526, 1530, 18 Bankr. Ct. Dec. (CRR) 222, Bankr. L. Rep. (CCH) P 72413 (10th Cir. 1988) (internal quotation omitted); see also *In re Birmingham-Nashville Exp., Inc.*, 224 F.3d 511, 515, 36 Bankr. Ct. Dec. (CRR) 139, 44 Collier Bankr. Cas. 2d (MB) 935, Bankr. L. Rep. (CCH) P 78237, 2000 FED App. 0259P (6th Cir. 2000) ("[P]riorities are to be interpreted narrowly."); *In re Southern Star Foods, Inc.*, 210 B.R. 838, 842, 38 Collier Bankr. Cas. 2d (MB) 820 (B.A.P. 10th Cir. 1997), aff'd, 144 F.3d 712, 32 Bankr. Ct. Dec. (CRR) 783, 40 Collier Bankr. Cas. 2d (MB) 93, 22 Employee Benefits Cas. (BNA) 1363, Bankr. L. Rep. (CCH) P 77693 (10th Cir. 1998) ("[P]riorities should be given a narrow, strict construction.").

[4] *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 866, 26 Bankr. Ct. Dec. (CRR) 19, Bankr. L. Rep. (CCH) P 76096 (4th Cir. 1994); *In re Insilco Technologies, Inc.*, 309 B.R. 111, 114, 42 Bankr. Ct. Dec. (CRR) 258 (Bankr. D. Del. 2004); *In re DeMert & Dougherty, Inc.*, 227 B.R. 508, 512, 33 Bankr. Ct. Dec. (CRR) 829 (Bankr. N.D. Ill. 1998).

[5] 11 U.S.C.A. § 507(a). Congress has periodically changed the priority of claims pursuant to section 507(a). For example, when Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), it established a first priority for domestic support obligations and added a tenth priority for claims resulting in "death or personal injury resulting from the unlawful operation of the motor vehicle or vessel while intoxicated." See Pub. L. No. 109-8, 119 Stat. 23 (2005).

(3) claims under section 502(f) of the Bankruptcy Code (claims arising during an involuntary case);[6]

(4) claims for wages, salaries, or commissions earned by an individual and sales commissions earned by an individual or corporation;

(5) claims for contributions to an employee benefit plan;

(6) claims by grain producers and United States fishermen;

(7) claims by individuals for deposits arising from the purchase, lease, or rental of property, or the purchase of services for personal, family, or household use;

(8) claims by governmental units for prepetition taxes and custom duties;

(9) claims based upon a commitment to a federal depository institutions regulatory agency; and

(10) claims for death or personal injury resulting from the unlawful operation of a motor vehicle or vessel while intoxicated.

Section 507(b) allows a "superpriority" administrative expense to a secured creditor when adequate protection payments prove insufficient to compensate for the diminution of the value of its collateral.[7] Section 507(c) accords priority status to an erroneous tax refund or credit of a governmental unit pursuant to section 507(a)(8).[8] Section 507(d) bars a subrogee of claims under section 507(a)(1), (4) – (9) from as-

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[6]Section 502(f) allows claims in an involuntary case that arise after the commencement of the case but before the earlier of the appointment of a trustee and the order of relief. 11 U.S.C.A. § 502(f). These types of claims are often referred to as "gap claims." See, e.g., *In re Baab Steel, Inc.*, 495 B.R. 530, 534, 58 Bankr. Ct. Dec. (CRR) 98, 70 Collier Bankr. Cas. 2d (MB) 478 (Bankr. D. Colo. 2013); *In re Valley View Shopping Center, L.P.*, 260 B.R. 10, 23 n.8 (Bankr. D. Kan. 2001); *In re Advanced Electronics, Inc.*, 107 B.R. 503, 505 (Bankr. M.D. Pa. 1989).

[7]*In re Scopac*, 624 F.3d 274, 282, 53 Bankr. Ct. Dec. (CRR) 221, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010).

[8]11 U.S.C.A. § 507(c); *In re Old Carco LLC*, 452 B.R. 100, 114, 55 Bankr. Ct. Dec. (CRR) 72 (Bankr. S.D. N.Y. 2011).

serting a priority position; however, this subsection does not bar assignees from asserting priority treatment.[9]

The dollar figures cited in section 507(a)(4) (employee wage, salary, or commission claims), (a)(5) (employee benefit plan claims), (a)(6) (grain producer and fisherman claims), and (a)(7) (individual deposit claims) are adjusted at 3-year intervals based on the Consumer Price Index as determined by the United States Department of Labor.[10] The adjustments become effective on April 1 of the adjustment year.[11] The dollar figure adjustments apply to cases filed after the adjustment date.[12] On April 1, 2016, the dollar figures were adjusted to: (i) $12,850 under section 507(a)(4); (ii) $12,850 under section 507(a)(5)(B)(i); (iii) $6,325 under section 507(a)(6)(B); and (iv) $2,850 under section 507(a)(7).[13] The next dollar figure adjustment will occur for cases filed after April 1, 2019.

The purpose of this chapter is to provide an update on the subsections of section 507 that have received recent treatment by courts. Section 507(a)(2), (a)(6), (a)(7), (a)(9), (a)(10), (c), and (d) are omitted from this chapter because courts have not recently addressed these subsections.

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[9]11 U.S.C.A. § 507(d); *In re Premier Operations*, 294 B.R. 213, 220, 50 Collier Bankr. Cas. 2d (MB) 1068 (S.D. N.Y. 2003) ("Section 507(d) bars a subrogee of a § 507(a)(6) claim from stepping into a priority position, but permits an assignee to assert such a claim in certain circumstances."). "The key distinction between a subrogee and an assignee is that a subrogee acquires the claim because the subrogee . . . had a legal or contractual duty to the original claim holder to pay the obligation. An assignee, in contrast, is under no obligation of any sort to acquire the claim from the original claim holder and acquires the claim through a voluntary transaction." Premier Operations, 294 B.R. at 221 (internal quotation omitted).

[10]11 U.S.C.A. § 104(a).

[11]11 U.S.C.A. § 104(a).

[12]11 U.S.C.A. § 104(a).

[13]80 Fed. Reg. 8748 (Feb. 22, 2016).

II. SECTION 507(a)(1) — CLAIMS FOR DOMESTIC SUPPORT OBLIGATIONS

Section 507(a)(1) sets forth a first priority for unsecured claims arising from "domestic support obligations."[14] With the enactment of BAPCPA, domestic support obligations moved from a seventh priority to a first priority.[15] The term "domestic support obligation" is defined by section 101(14A).[16] "The label applied to the obligation by the court or the parties is not necessarily controlling for Bankruptcy Code purposes."[17] Instead, courts examine the intended purpose the obligation was designed to serve.[18] Certain courts have adopted multi-factor tests to determine intent of the obligation while others have applied a totality of circumstances examination.[19] Domestic support obligations are nondischargeable pursuant to section 523(a)(5).[20]

Section 507(a)(1) includes three subsections that govern the treatment of these claims. Section 507(a)(1)(A) provides a first priority to debts in the nature of alimony, maintenance, or support, including interest, owed to a spouse, former spouse, child of the debtor, such child's parent, legal guardian, or responsible relative arising by an agreement,

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[14]11 U.S.C.A. § 507(a)(1).

[15]Pub. L. No. 109-8, 119 Stat 23 (2005).

[16]See 11 U.S.C.A. § 101(14A).

[17]*In re Smith*, 586 F.3d 69, 73–74, 62 Collier Bankr. Cas. 2d (MB) 1288, Bankr. L. Rep. (CCH) P 81620 (1st Cir. 2009).

[18]Smith, 586 F.3d at 74; *In re Brody*, 3 F.3d 35, 38 (2d Cir. 1993).

[19]See, e.g., Smith, 586 F.3d at 74 (adopting a totality of circumstances approach and stating that "[t]his Court has not adopted a specific multi-factor test used to discern intent when determining whether an obligation is in the nature of support."); *In re Sternberg*, 85 F.3d 1400, 1405, Bankr. L. Rep. (CCH) P 76999 (9th Cir. 1996) (applying a four-factor test); *In re Gianakas*, 917 F.2d 759, 762, 20 Bankr. Ct. Dec. (CRR) 1861, 23 Collier Bankr. Cas. 2d (MB) 1510, Bankr. L. Rep. (CCH) P 73666 (3d Cir. 1990) (adopting a three-factor test); *In re Calhoun*, 715 F.2d 1103, 1107, 10 Bankr. Ct. Dec. (CRR) 1402, 9 Collier Bankr. Cas. 2d (MB) 290, Bankr. L. Rep. (CCH) P 69349 (6th Cir. 1983) (adopting a four-factor test); *In re Phegley*, 443 B.R. 154, 158, 64 Collier Bankr. Cas. 2d (MB) 1672 (B.A.P. 8th Cir. 2011) (adopting a six-factor test); *In re Horner*, 222 B.R. 918, 922 (S.D. Ga. 1998) (applying a nine-factor test); *In re Daulton*, 139 B.R. 708, 710 (Bankr. C.D. Ill. 1992) (applying a twenty-factor test).

[20]11 U.S.C.A. § 523(a)(5).

divorce decree, or court order.[21] Section 507(a)(1)(B) grants a second priority to those claims that have been assigned to a "governmental unit."[22] Section 507(a)(1)(C) establishes a priority over the above subsections when a trustee incurs administrative expenses administering assets to pay the domestic support obligations.[23]

Trentadue v. Gay

In *Trentadue v. Gay*, the district court for the Eastern District of Wisconsin considered whether the bankruptcy court erred when it allowed the section 507(a)(1) priority claim of an attorney that represented the debtor's former spouse in a child custody matter.[24] Prior to the bankruptcy filing, a Wisconsin state court entered an order requiring Christopher Trentadue (the "Debtor") to pay his former spouse's attorney $25,000 due to the Debtor's litigation tactics during a child custody battle with his former spouse.[25] The Debtor never paid the attorney fees and, instead, filed a Chapter 13 bankruptcy petition.[26] The spouse's former attorney filed a proof of claim for $25,000 under section 507(a)(1).[27] The Debtor objected to the claim on the ground that it was not a domestic support obligation as required by section 507(a)(1), but rather, was a punishment imposed on him by the Wisconsin state court.[28] The bankruptcy court allowed the claim under the rationale that it was "in the nature of support."[29] The Debtor appealed to the district court.[30]

On appeal, the district court observed that because courts typically determine as a question of fact whether debts constitute domestic support obligations, the Debtor had the

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[21]11 U.S.C.A. § 507(a)(1)(A).

[22]11 U.S.C.A. § 507(a)(1)(B).

[23]11 U.S.C.A. § 507(a)(1)(C).

[24]*Trentadue v. Gay*, 538 B.R. 770, 771 (E.D. Wis. 2015).

[25]Trentadue, 538 B.R. at 771.

[26]Trentadue, 538 B.R. at 771.

[27]Trentadue, 538 B.R. at 771.

[28]Trentadue, 538 B.R. at 771–72.

[29]Trentadue, 538 B.R. at 772.

[30]Trentadue, 538 B.R. at 771.

burden of demonstrating clear error by the bankruptcy court.[31] After a review of the record below, the district court concluded that the bankruptcy court properly considered, among other issues, whether the attorney fee award was a punishment and whether the fee award related to the care, custody, and welfare of minors.[32] The district court observed that the fee award appeared not to punish the Debtor, but rather to compensate the Debtor's former spouse for the litigation tactics employed by the Debtor during the custody trial.[33] Further, the district court noted that the bankruptcy court's ruling was consistent with other courts across the United States.[34] Accordingly, the district court determined that the bankruptcy court did not clearly err when it allowed the priority claim under section 507(a)(1).

On September 28, 2015, the Debtor filed an appeal of the district court's decision to the Seventh Circuit.[35] As of the writing of this chapter, the Debtor's appeal is pending.

III. SECTION 507(a)(3) — CLAIMS ARISING UNDER SECTION 502(f)

Section 507(a)(3) provides a third priority for unsecured claims arising under section 502(f).[36] In turn, section 502(f) provides that in an involuntary case a creditor may be entitled to a claim that arose in the ordinary course of 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 of relief.[37] Claims under section 502(f) are typically referred to as "gap claims."[38]

In re Howrey LLP

In *In re Howrey LLP*, the bankruptcy court for the Northern District of California in a case of first impression

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[31]Trentadue, 538 B.R. at 772–73.

[32]Trentadue, 538 B.R. at 774.

[33]Trentadue, 538 B.R. at 774–75.

[34]Trentadue, 538 B.R. at 775.

[35]Trentadue, Case No. 15-3142, Doc. No. 15 (E.D. Wis. 2015).

[36]11 U.S.C.A. § 507(a)(3).

[37]11 U.S.C.A. § 502(f).

[38]See, e.g., Baab Steel, Inc., 495 B.R. at 534; Valley View Shopping Ctr., 260 B.R. at 23 n.8; Advanced Elec., Inc., 107 B.R. at 505.

considered whether landlord claims for unpaid rent accruing between the filing of an involuntary petition and the entry of the order of relief were entitled to priority status pursuant to section 507(a)(3).[39] This case commenced when petitioning creditors filed an involuntary petition under Chapter 7 against a dissolved law firm (the "Debtor") that was in the process of winding down its business.[40] After initially fighting the involuntary petition, the Debtor voluntarily converted to Chapter 11 and the bankruptcy court entered an order of relief.[41]

Five landlords (collectively, the "Landlords") filed claims against the Debtor arising out of the post-conversion rejection of the Landlords' leases or subleases.[42] The Landlords' claims included priority claims under section 507(a)(3) for the rent accrued during the period from the date of the involuntary petition to the date of the conversion from Chapter 7 to Chapter 11 (the "Gap Claims").[43] The official committee of unsecured creditors (the "Committee") filed objections to the Landlords' assertion of the Gap Claims.[44]

In adjudicating the objections to the Gap Claims, the bankruptcy court first considered when the Gap Claims arose.[45] The Committee asserted that the Gap Claims arose when the Debtor entered into the leases and thus section 502(f) was not applicable because it applies only to claims arising in the ordinary course of the Debtor's business or financial affairs after the commencement of the case.[46] The bankruptcy court first rejected this argument by noting that the Committee's position was without any convincing support and such a result would unfairly exclude landlords from the right

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[39]*In re Howrey LLP*, 534 B.R. 373, 61 Bankr. Ct. Dec. (CRR) 111 (Bankr. N.D. Cal. 2015).

[40]Howrey, 534 B.R. 373.

[41]Howrey, 534 B.R. 373.

[42]Howrey, 534 B.R. at 373–74.

[43]Howrey, 534 B.R. at 374.

[44]Howrey, 534 B.R. at 374. The Committee objected to all five of the Gap Claims, however, the Chapter 11 trustee appointed in the case joined the Committee's objection to three of the Gap Claims. Howrey, 534 B.R. at 374.

[45]Howrey, 534 B.R. at 375.

[46]Howrey, 534 B.R. at 375.

to gap claims like other creditors while still being subject to the automatic stay.[47] The bankruptcy court also noted that although the issue whether such claims for section 502(f) priority had not been directly addressed by courts, and ruled that the Gap Claims arose postpetition when the monthly rent became due.[48] The Committee also argued that the Landlords had lease rejection damages under section 502(g)(1) and thus were not entitled to priority status; however, the bankruptcy court rejected this argument because the leases were not rejected during the gap period.[49]

Next, the bankruptcy court considered whether the Gap Claims arose in the ordinary course of business.[50] As the Debtor was in the process of winding down the law firm, the Committee argued, it was no longer operating in the ordinary course of business as required for claims under section 502(f).[51] The bankruptcy court rejected this argument by noting that the leases were entered into in the ordinary course of business and that the Gap Claims arose due to the continued occupancy by the Debtor, which constituted the status quo with respect to the Landlords.[52] The result would be different, the bankruptcy court noted, had the Debtor abandoned the leases during the gap period and allowed the Landlords to lift the stay to terminate the leases. Such a circumstance would be a departure from the normal landlord-tenant relationship and would not constitute an ordinary course transaction giving rise to a debt entitled to priority under section 502(f). Accordingly, for these reasons, the bankruptcy court overruled the Debtors objections and allowed the Landlords' Gap Claims under section 507(a)(3).

IV. SECTION 507(a)(4) — CLAIMS FOR WAGES, SALARIES, AND COMMISSIONS AND SECTION 507(a)(5) — CLAIMS FOR CONTRIBUTIONS TO AN EMPLOYEE BENEFIT PLAN

Section 507(a)(4) and (5) govern the priority treatment of

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[47]Howrey, 534 B.R. at 375.

[48]Howrey, 534 B.R. at 376.

[49]Howrey, 534 B.R. at 377.

[50]Howrey, 534 B.R. at 378.

[51]Howrey, 534 B.R. at 378.

[52]Howrey, 534 B.R. at 378.

employee compensation.[53] Although claims for wages, salaries, and commissions are granted a higher priority than claims for employee benefit plans, the two priorities are unique because they share a common cap.[54] Observing the relationship between the two subsections, the United States Supreme Court stated, "[t]he current Code's juxtaposition of the wages and employee benefit plan priorities manifests Congress' comprehension that fringe benefits generally complement, or 'substitute' for, hourly pay."[55]

Section 507(a)(4) grants a fourth priority to unsecured wages, salaries, and commissions that were earned within 180 days before the filing of a petition or the cessation of the debtor's business, whichever event occurs first.[56] An individual creditor's wage claim under section 507(a)(4) may include vacation, severance, and sick leave.[57] An independent contractor, whether an individual or corporation, with one employee selling goods or services may assert a priority claim for a sales commission only if the independent contractor earned seventy-five percent of his or her salary from the debtor during the preceding 12 months.[58] Priority claims under this subsection may not exceed the statutory cap, which is currently set at $12,850.[59]

The purpose of the section 507(a)(4) priority is to alleviate the financial hardship of a worker who loses some or all of his or her salary as a result of an employer's bankruptcy.[60] Although there is no explicit statutory authority under section 507(a)(4), it is customary for a debtor in possession in Chapter 11 cases to request bankruptcy court approval to

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[53]11 U.S.C.A. § 507(a)(4) and (5). See also William L. Norton, Jr. & William L. Norton III, 5 Norton Bankr. L & Practice. 3d § 49:46 (2015 ed.) ("This statutory treatment reflects the reality that wages and fringe benefits are treated as complementary in labor agreements.").

[54]See Howard Delivery Serv., 547 U.S. at 659–60 ("No other subsections of § 507 are joined together by a common cap in this way").

[55]Howard Delivery Serv., 547 U.S. at 659.

[56]11 U.S.C.A. § 507(a)(4).

[57]11 U.S.C.A. § 507(a)(4)(A).

[58]11 U.S.C.A. § 507(a)(4)(B).

[59]11 U.S.C.A. § 507(a)(4)(B).

[60]*In re Bender Shipbuilding and Repair Co., Inc.*, 2013 WL 3546296, *3 Bankr. S.D. Ala. 2013) (internal citation omitted).

pay the prepetition priority wage claims at the beginning of the case under a "first day order."[61] Courts have authorized the payment of these wage obligations under the rationale that a Chapter 11 reorganization is dependent on employee performance, which, in turn, is dependent on the timely and uninterrupted payment of ordinary wages.[62]

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[61]See, e.g., James H.M. Sprayregen et. al., First Things First — A Primer on How to Obtain Appropriate "First Day" Relief in Chapter 11 Cases, 11 J. Bankr. L. & Practice 275, 292–293 (2002) ("To ensure a debtor's business is able to make a smooth transition into bankruptcy, it is crucial that the debtor retain as many employees as necessary. This is facilitated by the motion seeking authority to pay prepetition wages and employee benefits . . ."); William L. Norton, Jr. & William L. Norton III, 5 Norton Bankr. L & Practice. 3d § 95:7 (2014 ed.) ("[T]here is little doubt that certain payments such as employee salaries and benefits which are inherently necessary for the continued operations of the debtor and the possibility of a successful reorganization should be routinely authorized in orders prepared with the filing of the bankruptcy petition, i.e., first-day orders . . ."); *In re Tusa-Expo Holdings, Inc.*, 50 Bankr. Ct. Dec. (CRR) 228, 2008 WL 4857954, *4 (Bankr. N.D. Tex. 2008) (authorizing the payment of prepetition wage claims shortly after the filing of the bankruptcy petition); *In re The Colad Group, Inc.*, 324 B.R. 208, 214, 44 Bankr. Ct. Dec. (CRR) 194, 54 Collier Bankr. Cas. 2d (MB) 350 (Bankr. W.D. N.Y. 2005) (granting debtor authority to pay employee prepetition wages and benefits); *In re CEI Roofing, Inc.*, 315 B.R. 50, 61 (Bankr. N.D. Tex. 2004), opinion issued, (July 7, 2004) (holding that sections 105 and 507(a)(3) and (4) authorize the payment of priority wage claims prior to the confirmation of the case "[t]o the extent that the existing holders of claims of higher priority than the wage claims consent or do not timely object"); *In re Equalnet Communications Corp.*, 258 B.R. 368, 371, 37 Bankr. Ct. Dec. (CRR) 101 (Bankr. S.D. Tex. 2000) (authorizing the payment of prepetition independent contractor wages pursuant to an emergency motion). See also H.R. REP. 95-595 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6314 ("[I]f it is clear that there are adequate assets in the estate to pay all priority creditors through the fourth or fifth priority, it would be appropriate to pay wage claims as soon as practicable, even before all administrative expenses were determined, because most often the employees that worked for the failing enterprise will need the money they receive in payment of their claims to live on.").

[62]See Tusa-Expo Holdings, 2008 WL 4857954, at *4 ("A central purpose of chapter 11 is to realize on a debtor's going concern value. That going concern value is dependent in part on the debtor's work force . . . The continuity and performance of a debtor's work force is, in turn, typically dependent on timely payment of wages and benefits."); Equalnet, 258 B.R. at 370 ("The need to pay these [wage] claims in an ordinary course of business time frame is simple common sense. Employees are more likely to stay in place and to refrain from actions which could be detrimental to

Similarly, section 507(a)(5) provides a fifth priority to claims for contributions to an employee benefit plan arising for services rendered within 180 days before the filing of a petition or the cessation of the debtor's business, whichever event occurs first.[63] Claims under this subsection are limited by: (i) the number of employees covered by each such plan multiplied by $12,850; less (ii) the aggregate amount paid to such employees under paragraph (4) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan."[64]

The term "employee benefit plan" is not defined by the Bankruptcy Code.[65] The United States Supreme Court has defined it to mean "fringe benefits," which typically include payments under pension plans and group health, life, and disability insurance policies[66] Claims for premiums owed to workers' contribution plans fall outside of the scope of section 507(a)(5) because workers' compensation plans are designed to shield the employer from tort liability.[67] Congress created this priority with the enactment of the Bankruptcy Code in 1978 in response to two United States Supreme Court cases that held that payments under employee benefit plans were not entitled to wage priority under the Bankruptcy Act of 1898.[68]

Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)

In *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, the Third Circuit considered whether the bankruptcy court for the District of Delaware erred when it approved a settle-

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the case and/or the estate if their pay and benefits remain intact and uninterrupted.").

[63]11 U.S.C.A. § 507(a)(5)(A).

[64]11 U.S.C.A. § 507(a)(5)(B).

[65]See 11 U.S.C.A. § 101.

[66]Howard Delivery Serv., 547 U.S. at 654.

[67]Howard Delivery Serv., 547 U.S. at 663 n.6.

[68]Howard Delivery Serv., 547 U.S. at 658 (citing *U.S. v. Embassy Restaurant, Inc.*, 359 U.S. 29, 79 S. Ct. 554, 3 L. Ed. 2d 601, 59-1 U.S. Tax Cas. (CCH) P 9297, 3 A.F.T.R.2d 881 (1959) and *Joint Industry Bd. of Elec. Industry v. U.S.*, 391 U.S. 224, 88 S. Ct. 1491, 20 L. Ed. 2d 546, 68 L.R.R.M. (BNA) 2193, 57 Lab. Cas. (CCH) P 12679 (1968)).

ment order in a Chapter 11 bankruptcy that allowed distributions to general unsecured creditors prior to the satisfaction of the priority claims of former employees under section 507(a)(4).[69] In 2008, Jevic Holding Corp. and its affiliates (the "Debtors") filed for Chapter 11 protection in the bankruptcy court for District of Delaware.[70] At the time of the filing, the Debtors owed approximately $53 million in secured debts and approximately $20 million in tax and general unsecured debts.[71]

During the bankruptcy case, certain of the Debtors' former truck driver employees (the "Drivers") filed a class action suit alleging violations of state and federal Worker Adjustment and Retraining Notification ("WARN") statutes by the Debtors and Sun Capital Partners ("Sun"), the private equity firm that acquired the Debtors prepetition through a leveraged buyout.[72] The bankruptcy court ultimately granted summary judgment in favor of Sun, but granted summary judgment against the Debtors under a state WARN statute.[73] The damages portion of the suit was not determined; however, the Drivers estimated their claim at $12.4 million, which included a $8.3 million priority claim under section 507(a)(4).[74]

Also during the bankruptcy case, the official committee of unsecured creditors (the "Committee") filed an adversary proceeding on behalf the estates against CIT Group ("CIT"), the Debtors' secured lender, and Sun.[75] The Committee alleged that the leveraged buyout of the Debtors by Sun, with financing provided by CIT, allegedly hastened the Debtors' bankruptcy by adding debts that the Debtors were unable to

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[69] *In re Jevic Holding Corp.*, 787 F.3d 173, 175, 61 Bankr. Ct. Dec. (CRR) 21, Bankr. L. Rep. (CCH) P 82826, 165 Lab. Cas. (CCH) P 10774 (3d Cir. 2015), cert. granted, 2016 WL 3496769 (U.S. 2016), Petition for Certioari was pending as of the writing of this article.

[70] Jevic, 787 F.3d at 176.

[71] Jevic, 787 F.3d at 176.

[72] Jevic, 787 F.3d at 176.

[73] Jevic, 787 F.3d at 177, n.2.

[74] Jevic, 787 F.3d at 77.

[75] Jevic, 787 F.3d at 176.

service.[76] After the bankruptcy court denied CIT's motion to dismiss and dismissed the Committee's attempts to equitably subordinate CIT's secured claims under section 544, the parties reached a settlement agreement whereby CIT would pay administrative expenses of $2 million and Sun would assign a $1.7 million lien to the Debtors so that priority tax and general unsecured creditors could receive a distribution.[77] In addition, the settlement agreement contemplated a structured dismissal of the bankruptcy cases, dismissal of the litigation, and releases to the above parties.[78] The Drivers were excluded from distributions under the settlement agreement.[79]

The Drivers and the United States Trustee objected to the settlement agreement on the grounds that the distributions under the settlement agreement violated the priority scheme of section 507.[80] In addition, the United States Trustee objected to the structured dismissal of the cases on the ground that structured dismissals were not permitted under the Bankruptcy Code.[81] The bankruptcy court approved the settlement agreement and both the Drivers and the United States Trustee appealed to the district court.[82] The district court affirmed the bankruptcy court and the Drivers appealed to the Third Circuit.[83] The United States Trustee filed an *amicus curiae* brief in support of the Drivers.[84]

On appeal, the Third Circuit, in a 2-1 decision, affirmed the bankruptcy court's approval of the settlement agreement.[85] Judge Thomas M. Hardiman, writing the majority opinion, acknowledged that the Bankruptcy Code does not expressly authorize structured dismissals, but noted that section 349 permits courts to alter the effect of a dis-

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[76] Jevic, 787 F.3d at 176.

[77] Jevic, 787 F.3d at 176.

[78] Jevic, 787 F.3d at 177.

[79] Jevic, 787 F.3d at 177.

[80] Jevic, 787 F.3d at 178.

[81] *Jevic*, 578 F.3d at 178.

[82] Jevic, 787 F.3d at 179.

[83] Jevic, 787 F.3d at 179.

[84] Jevic, 787 F.3d at 179.

[85] Jevic, 787 F.3d at 185–86.

missal "for cause."[86] The majority concluded that absent a showing that a structured dismissal has been designed to evade procedural protections and safeguards of a plan process or conversion to Chapter 7, a bankruptcy court has the discretion to approve a structured dismissal.[87]

Next, the majority considered whether a settlement agreement in a Chapter 11 case could make distributions to creditors allegedly inconsistent with the priority scheme of section 507.[88] The majority reviewed the decisions of two other circuit courts in similar circumstances. In *In Matter of AWECO, Inc.*,[89] the Fifth Circuit rejected a settlement agreement that would have made a distribution to unsecured creditors despite outstanding secured claims on the ground that such distribution would violate the "fair and equitable" requirement under Chapter 11.[90] The majority, however, preferred the result in the Second Circuit's decision *In re Iridium Operating LLC*.[91] In *Iridium*, the Second Circuit agreed with a bankruptcy court's approval of the unsecured creditors' committee's settlement agreement that made distributions to lower-priority creditors without satisfying the claims of a higher priority creditor on the ground that other factors weighed in favor of approving the settlement agreement.[92]

Adopting the more flexible approach under *Iridium*, the majority in *Jevic* stated that a bankruptcy court may approve a settlement agreement that deviates from the priority scheme of section 507 "only rarely," and then only if the court finds that there are specific and credible grounds to justify such a deviation.[93] Applying this standard to the *Jevic* case, the majority held that the bankruptcy court had suf-

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[86]Jevic, 787 F.3d at 181.

[87]Jevic, 578 F.3d at 182.

[88]Jevic, 578 F.3d at 182.

[89]*Matter of AWECO, Inc.*, 725 F.2d 293, 11 Bankr. Ct. Dec. (CRR) 953, Bankr. L. Rep. (CCH) P 69722 (5th Cir. 1984).

[90]Jevic, 578 F.3d at 182.

[91]*In re Iridium Operating LLC*, 478 F.3d 452, 47 Bankr. Ct. Dec. (CRR) 243, Bankr. L. Rep. (CCH) P 80874 (2d Cir. 2007).

[92]Jevic, 578 F.3d at 183.

[93]Jevic, 578 F.3d at 184–86.

ficient reason to approve the settlement agreement; however, Judge Hardiman acknowledged that the majority's determination was a "close call" that was the "least bad alternative" under the circumstances:

> [T]he Bankruptcy Court had to choose between approving a settlement that deviated from the priority scheme of § 507 or rejecting it so a lawsuit could proceed to deplete the estate. Although we are troubled by the fact that the exclusion of the Drivers certainly lends an element of unfairness to the first option, the second option would have served the interests of neither the creditors nor the estate. The Bankruptcy Court, in Solomonic fashion, reluctantly approved the only course that resulted in some

payment to creditors other than CIT and Sun.[94]

Accordingly, the majority affirmed the bankruptcy court's approval of the settlement agreement.[95]

Judge Anthony J. Scirica wrote a dissenting opinion. Judge Scirica conceded that a settlement agreement that deviates from the priority scheme may be necessary to the extent that it maximizes the value of the estate.[96] But here, Judge Scirica wrote, there has been no demonstration that the settlement agreement maximizes value to the estates[97] Rather, the settlement agreement appeared to benefit the unsecured creditors who were not entitled to a distribution prior to satisfaction of the Driver's priority claims, so that the "settlement then appears to constitute an impermissible end-run around the carefully designed routes by which a debtor may emerge from Chapter 11 proceedings."[98] According to Judge Scirica, a better result would have been to allow payments to the Drivers as administrative creditors, but to have the bankruptcy court determine the amounts owed to the Drivers and to redistribute amounts paid to unsecured creditors to the Drivers.[99]

Following the Third Circuit decision, the Drivers filed a motion for rehearing en banc; however, this request was

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[94]Jevic, 578 F.3d at 184–85.

[95]Jevic, 578 F.3d at 186.

[96]Jevic, 578 F.3d at 187.

[97]Jevic, 578 F.3d at 187.

[98]Jevic, 587 F.3d at 188.

[99]Jevic, 587 F.3d at 188.

denied on August 18, 2015. On November 17, 2015, the Drivers filed a writ of certiorari with the Supreme Court.[100] As of the writing of this chapter, the Court has not made a determination whether to grant certiorari.

In re Tropicana Entertainment, LLC

In *In re Tropicana Entertainment, LLC*, the bankruptcy court for the District of Delaware considered whether a creditor was entitled to priority status under section 507(a)(5) for contributions to an employee benefit plan made within the 180 day period preceding the bankruptcy filing.[101] The debtors in these jointly administered Chapter 11 cases (the "Debtors") were affiliated entities that operated hotels and casinos across the United States.[102] Prior to the bankruptcy filings, Columbia Sussex Corporation ("Columbia"), pursuant to various service agreements, provided accounting and management services to certain of the Debtors including the establishment and administration of health insurance programs and a qualified 401(k) retirement savings plan for certain employees of the Debtors.[103]

Following the confirmation of the Chapter 11 cases, Columbia filed a motion for the allowance of priority claims under section 507(a)(5) and postpetition administrative claims under section 503(b) arising out of plan premiums payments allegedly made on behalf of certain of the Debtors' employees.[104] Later, Columbia filed a motion for summary judgment seeking $3,703,130.55 in prepetition priority claims and $1,161,250.91 in postpetition claims.[105] The Debt-

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[100] *Casimir Czyzewski, et al. v. Jevic Holding Corp., et al.*, No. 15-646, 2015 WL 7252903 (Nov. 17, 2015).

[101] *In re Tropicana Entertainment, LLC*, 61 Bankr. Ct. Dec. (CRR) 190, 2015 WL 6112064, *1 (Bankr. D. Del. 2015). The bankruptcy court also considered the administrative claim request of another creditor under section 503(b); however, that discussion is omitted from this summary.

[102] Tropicana, 2015 WL 6112064, at *1.

[103] Tropicana, 2015 WL 6112064, at *4.

[104] Tropicana, 2015 WL 6112064, at *1.

[105] Tropicana, 2015 WL 6112064, at *2.

ors filed an objection to Columbia's motion for summary judgment.[106]

The Debtors sought to disallow the priority claims on the ground that section 507(a)(5) applies only to fringe benefit claims paid to employees.[107] The Debtors argued that the term "services rendered" under section 507(a)(5) restricts the application of priority status to employees and does not apply to third parties.[108]

The bankruptcy court disagreed with this position, relying on the United States Supreme Court's 2006 decision in *Howard Delivery Service, Inc. v. Zurich American Insurance Company*, which suggested that an insurance provider may be entitled to a priority claim under section 507(a)(5).[109] Further, the bankruptcy court rejected the Debtors' policy argument that allowing an insurance provider to receive a priority claim would result in the sharing of distributions to employees because an employee's wage priority under section 507(a)(4) is higher than an insurance provider's priority under section 507(a)(5).[110] Accordingly, the bankruptcy court allowed the priority claims under section 507(a)(5); however, it required that Columbia further demonstrate that its claims did not exceed the limitation under section 507(a)(5).[111] In addition, the bankruptcy court denied Columbia's request for an allowance under section 503(b)(3)(D) and (b)(1)(A) until Columbia demonstrated "an actual, demonstrable benefit to the estate," which could not be determined until the adjudication of an adversary proceeding against Columbia by the litigation trustee.[112]

V. SECTION 507(a)(8) — CLAIMS BY GOVERNMENTAL UNITS FOR CERTAIN PREPETITION TAXES AND CUSTOM DUTIES

Section 507(a)(8) grants an eighth priority to governmental

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[106]Tropicana, 2015 WL 6112064, at *2.

[107]Tropicana, 2015 WL 6112064, at *8.

[108]Tropicana, 2015 WL 6112064, at *8.

[109]Tropicana, 2015 WL 6112064, at *9.

[110]Tropicana, 2015 WL 6112064, at *10.

[111]Tropicana, 2015 WL 6112064, at *10.

[112]Tropicana, 2015 WL 6112064, at *10.

units for seven categories of prepetition tax and custom duty obligations.[113] These categories are: (A) taxes measured by income or gross receipts; (B) property taxes; (C) trust fund taxes;[114] (D) employment taxes; (E) excise taxes; (F) custom duties; and (G) tax or custom penalties arising from an actual pecuniary loss.[115] Congress first recognized a priority for prepetition taxes when it enacted the Bankruptcy Act of 1898.[116] Governmental units are afforded this priority because, among other reasons, they are involuntary creditors that do not choose to extend credit to a debtor and do not have the opportunity to obtain security prior to the tax or custom duty becoming due.[117]

The above tax categories are subject to time limitations that are triggered by certain events that occur prior to the bankruptcy. For example, income or gross receipts taxes, employment taxes, and excise taxes are limited in their priority status to the three-year period preceding the filing of the

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[113]11 U.S.C.A. § 507(a)(8); see also 11 U.S.C.A. § 101(27) (defining "governmental unit").

[114]Section 507(a)(8)(C) specifically uses the phrase, "a tax required to be collected or withheld for which the debtor is liable in whatever capacity." 11 U.S.C.A. § 507(a)(8)(C). Courts, however, use the term "trust fund taxes." See, e.g., *In re Monahan*, 497 B.R. 642, 644, 70 Collier Bankr. Cas. 2d (MB) 415, 112 A.F.T.R.2d 2013-6158 (B.A.P. 1st Cir. 2013); *In re Hansen*, 470 B.R. 535, 542, 56 Bankr. Ct. Dec. (CRR) 93, 67 Collier Bankr. Cas. 2d (MB) 1543, Bankr. L. Rep. (CCH) P 82253, Unempl. Ins. Rep. (CCH) P 22390 (B.A.P. 9th Cir. 2012); *In re Mosbrucker*, 227 B.R. 434, 435, 33 Bankr. Ct. Dec. (CRR) 738, Bankr. L. Rep. (CCH) P 77867, 99-1 U.S. Tax Cas. (CCH) P 50124, 83 A.F.T.R.2d 99-341 (B.A.P. 8th Cir. 1998), aff'd, 198 F.3d 250, 99-2 U.S. Tax Cas. (CCH) P 50883, 84 A.F.T.R.2d 99-6457 (8th Cir. 1999).

[115]11 U.S.C.A. § 507(a)(8).

[116]*U.S. v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 220, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 29 Bankr. Ct. Dec. (CRR) 271, 35 Collier Bankr. Cas. 2d (MB) 463, 20 Employee Benefits Cas. (BNA) 1289, Bankr. L. Rep. (CCH) P 76971, 96-1 U.S. Tax Cas. (CCH) P 50322, 77 A.F.T.R.2d 96-2562 (1996).

[117]H.R. REP. 95-595, at 190 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6150. See also *In re Oliver*, 511 B.R. 556, 559 (Bankr. W.D. Wis. 2014) (stating that governmental unit was an involuntary creditor); *In re Montgomery*, 446 B.R. 475, 479, Bankr. L. Rep. (CCH) P 81947, 2011-1 U.S. Tax Cas. (CCH) P 50222, 107 A.F.T.R.2d 2011-808 (Bankr. D. Kan. 2011), aff'd, 475 B.R. 742, Bankr. L. Rep. (CCH) P 82307, 2012-2 U.S. Tax Cas. (CCH) P 50431, 110 A.F.T.R.2d 2012-5008 (D. Kan. 2012) (same).

petition.[118] Property tax priorities are limited to the one-year period preceding the petition date.[119] Tax or custom penalties arising from an actual pecuniary loss are limited to the time frame of the underlying tax category.[120] Trust fund taxes have no time limitation.[121] The time limitations were designed to balance the competing interests of parties in bankruptcy cases:

> A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.[122]

The terms "tax" and "custom duties" are not defined by the Bankruptcy Code.[123] In determining whether an obligation is a "tax" for purposes of section 507(a)(8), courts must "look beyond the label placed on the exaction" and employ a "functional analysis."[124] In *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, the United States Supreme Court employed the functional analysis approach to determine whether a particular exaction pursuant to 26 U.S.C.A. § 4971 was an excise tax afforded priority status under section 507(a).[125] The Court determined that, for Bankruptcy Code purposes, a "tax is an enforced contribution to provide for the support of government; a penalty . . . is an exaction

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[118]11 U.S.C.A. § 507(a)(8)(A), (D), and (E).

[119]11 U.S.C.A. § 507(a)(8)(B).

[120]11 U.S.C.A. § 507(a)(8)(G).

[121]11 U.S.C.A. § 507(a)(8)(C).

[122]*In re Waugh*, 109 F.3d 489, 492, 37 Collier Bankr. Cas. 2d (MB) 1421, Bankr. L. Rep. (CCH) P 77331, 97-1 U.S. Tax Cas. (CCH) P 50304, 79 A.F.T.R.2d 97-1604 (8th Cir. 1997) (quoting S. REP. 95-989, at 14 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5800).

[123]See 11 U.S.C.A. § 101.

[124]CF & I Fabricators, 518 U.S. at 220–23.

[125]CF & I Fabricators, 518 U.S. at 216. The Supreme Court decided the case when the tax claims were afforded a seventh priority. CF & I Fabricators, 518 U.S. at 216.

imposed by statute as punishment for an unlawful act."[126] A tax or custom duty that is given priority under section 507(a)(8) is also excepted from discharge under section 523(a)(1)(A).[127]

In re Carpenter (Carpenter v. Montana Department of Labor and Industry Unemployment Insurance Contributions Bureau)

In *In re Carpenter (Carpenter v. Montana Department of Labor and Industry Unemployment Insurance Contributions Bureau)*, the Bankruptcy Appellate Panel (the "BAP") for the Ninth Circuit considered whether the bankruptcy court for the District of Montana erred when it held that the Montana Department of Labor and Industry Unemployment Insurance Contributions Bureau ("Montana") was entitled to a priority claim under section 507(a)(8)(E) for unpaid corporate taxes.[128] Daniel and Mary Carpenter (the "Debtors") were officers and shareholders of Big Sky Fire Protection, Inc. ("Big Sky").[129] Big Sky failed to pay unemployment tax contributions for a twenty month period to Montana.[130]

Following the Debtors' Chapter 11 filing, Montana filed a proof of claim for $78,757.55 under section 507(a)(8) for Big Sky's unpaid tax obligations arising out of Montana's responsible person statute, which imposes personal tax liability on officers for unpaid corporate taxes.[131] The Debtors objected to the proof of claim on the ground that the Debtors could not be vicariously liable for Big Sky's tax obligations under existing case law because unemployment insurance obligations are not trust fund taxes entitled to priority status

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[126]CF & I Fabricators, 518 U.S. at 224 (quoting *U.S. v. La Franca*, 282 U.S. 568, 572, 51 S. Ct. 278, 75 L. Ed. 551, 2 U.S. Tax Cas. (CCH) P 679, 9 A.F.T.R. (P-H) P 985 (1931)).

[127]11 U.S.C.A. § 523(a)(1)(A); *U.S. v. Jackson*, 241 B.R. 473, 475, Bankr. L. Rep. (CCH) P 77998, 84 A.F.T.R.2d 99-6056 (Bankr. M.D. Ala. 1999).

[128]*In re Carpenter*, 540 B.R. 691, 694, 61 Bankr. Ct. Dec. (CRR) 230, Unempl. Ins. Rep. (CCH) P 22427 (B.A.P. 9th Cir. 2015).

[129]Carpenter, 540 B.R. at 693.

[130]Carpenter, 540 B.R. at 693.

[131]Carpenter, 540 B.R. at 693.

under section 507(a)(8)(C).[132] In response to the Debtors' objection, Montana clarified that it sought priority status for the Big Sky obligations as an excise tax under section 507(a)(8)(E).[133] Following an evidentiary hearing, the bankruptcy court overruled the Debtors' objection and allowed Montana's priority claim.[134]

On appeal to the BAP, the Debtors noted that the inclusion of the phrase "for which the debtor is liable in whatever capacity" under the trust fund priority of section 507(a)(8)(C) exposes persons other than the primary tax obligor to tax liability.[135] The Debtors argued that the absence of this phrase under the other subsections of section 507(a)(8) was significant because it suggested that Congress did intend to expose others to the tax obligations of a priority tax debtor with the exception of trust fund obligations under section 507(a)(8)(C).[136]

To adjudicate the issues, the BAP first reviewed the history of the phrase and its subsequent judicial interpretation.[137] The BAP noted that the phrase originated under the enactment of the Bankruptcy Code in 1978 in response to the United States Supreme Court decision in *United States v. Sotelo*.[138] In *Sotelo*,[139] the responsible officers of a bankrupt corporation were assessed a "penalty" by the Internal Revenue Service that was equal to the tax owed by the corporation.[140] The responsible officers argued that they should not be liable for the corporation's tax debts and that the characterization of the tax debt as a "penalty" made the

[132]Carpenter, 540 B.R. 693–94.

[133]Carpenter, 540 B.R. at 694.

[134]Carpenter, 540 B.R. at 694. In addition, the bankruptcy court allowed Montana's claim of a $125 penalty as a general unsecured claim. Carpenter, 540 B.R. at 694.

[135]Carpenter, 540 B.R. at 695.

[136]Carpenter, 540 B.R. at 695.

[137]Carpenter, 540 B.R. at 696.

[138]Carpenter, 540 B.R. at 696–97.

[139]436 U.S. 268 (1978).

[140]Carpenter, 540 B.R. at 696–97.

debt dischargeable.[141] The Supreme Court held, five months prior to the enactment of the Bankruptcy Code, that the debt was a tax despite its designation as a penalty, and thus, not dischargeable.[142] The BAP found the *Soleteo* decision significant because the Supreme Court broadly applied priority status to tax debts owed by a responsible officer despite the lack of responsible officer liability under the former Bankruptcy Act.[143]

The BAP observed that, according to the legislative history of section 507(a)(8), Congress explicitly codified the *Soleto* decision when enacting the tax priority provisions of the Bankruptcy Code.[144] The BAP noted that neither the *Soleto* decision nor the legislative history of section 507(a)(8) appeared to limit responsible officer liability solely to trust fund tax debts.[145] In reliance on the *Soleto* decision, the BAP held that the Montana statute imposing responsible officer liability on the Debtors was a tax and that such debt received the same priority as the underlying tax, which was an excise tax under section 507(a)(8)(E).[146] The BAP also relied on the *Soleto* policy argument that the allowance of priority status for debts owed by responsible officers served as an incentive for corporations to satisfy their tax debts.[147] Accordingly, the BAP affirmed the bankruptcy court's decision allowing Montana's priority claim.[148]

VI. SECTION 507(b) — SUPERPRIORITY ADMINISTRATIVE EXPENSES

Section 507(b) allows a "superpriority" administrative expense where adequate protection payments prove insufficient to compensate a secured creditor for the diminution of

[141]Carpenter, 540 B.R. at 697.

[142]Carpenter, 540 B.R. at 697.

[143]Carpenter, 540 B.R. at 697–98.

[144]Carpenter, 540 B.R. at 697.

[145]Carpenter, 540 B.R. at 697.

[146]Carpenter, 540 B.R. at 700.

[147]Carpenter, 540 B.R. at 700.

[148]Carpenter, 540 B.R. at 700.

the value of its collateral.[149] "It is an attempt to codify a statutory fail-safe system in recognition of the ultimate reality that protection previously determined [to be] the 'indubitable equivalent' . . . may later prove inadequate."[150] Section 507(b) is designed "to fund claims arising from the inadequacy of adequate protection to fully compensate a secured creditor for erosion in the value of its property interest during the course of a bankruptcy case."[151]

A creditor asserting a superiority administrative claim must demonstrate that: 1) adequate protection had been previously provided to the debtor and this protection was inadequate; 2) the creditor has an allowable administrative expense claim; and 3) the claim arises from either the automatic stay under section 362, the use, sale, or lease of collateral under section 363, or the granting of a lien under section 364(d).[152]

In re Construction Supervision Services, Inc.

In *In re Construction Supervision Services, Inc.*, the bankruptcy court for the Eastern District of North Carolina considered whether a secured creditor was entitled to a superpriority administrative expense under section 507(b).[153] Branch Banking and Trust Company ("BB & T") held a security interest on the accounts receivable, real property, and certain personal property of Construction Supervision Ser-

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[149]*In re Scopac*, 624 F.3d 274, 282, 53 Bankr. Ct. Dec. (CRR) 221, 64 Collier Bankr. Cas. 2d (MB) 726, Bankr. L. Rep. (CCH) P 81866 (5th Cir. 2010); see also *In re Pacific Lumber Co.*, 584 F.3d 229, 239 n.11, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009); *In re Midway Airlines, Inc.*, 383 F.3d 663, 669 n.2, 43 Bankr. Ct. Dec. (CRR) 158, Bankr. L. Rep. (CCH) P 80161 (7th Cir. 2004); *LNC Investments, Inc. v. National Westminster Bank, N.J.*, 308 F.3d 169, 172, 40 Bankr. Ct. Dec. (CRR) 85 (2d Cir. 2002).

[150]Scopac, 624 F.3d at 282 (quoting *In re Carpet Center Leasing Co., Inc.*, 4 F.3d 940, 941 (11th Cir. 1993)).

[151]*In re Air Beds, Inc.*, 92 B.R. 419, 424, 19 Collier Bankr. Cas. 2d (MB) 1380 (B.A.P. 9th Cir. 1988).

[152]*Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 865, 26 Bankr. Ct. Dec. (CRR) 19, Bankr. L. Rep. (CCH) P 76096 (4th Cir. 1994).

[153]*In re Construction Supervision Services, Inc.*, 2015 WL 4873062, *3 (Bankr. E.D. N.C. 2015), aff'd, 2016 WL 2764328 (E.D. N.C. 2016).

vices, Inc. (the "Debtor").[154] Shortly after the Chapter 11 case was filed, the bankruptcy court entered an order granting the Debtor the authority to use BB & T's cash collateral.[155] The order provided that BB & T would be entitled to adequate protection payments and, to the extent that there was a failure to make such payments, that BB & T would receive a superpriority administrative claim pursuant to section 507(b).[156]

Approximately two months into the reorganization, the bankruptcy court entered an order allowing material suppliers to serve notice of their liens on the Debtor's property, which included BB & T's collateral.[157] Under North Carolina law, the filing of the notices by the material suppliers established priority of their liens over the liens of BB & T.[158] The case was later converted to Chapter 7 and a Chapter 7 trustee (the "Trustee") was appointed.[159] The Trustee liquidated the Debtor's assets and ultimately paid BB & T in excess of $1.2 million in principal, prepetition interest, and postpetition interest.[160] Thereafter, BB & T sought allowance of an administrative claim arising from postpetition interest and attorney fees and expenses under section 506(c) and a superpriority administrative expense claims arising from the diminution of the collateral under section 507(b).[161] On the issue of the section 506(c) claim, the bankruptcy court, applying Fourth Circuit law, determined that BB & T was oversecured in its collateral, but only to the amount of $34,868.24.[162]

In its analysis of the claim under section 507(b), the bank-

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[154]Construction Supervision, 2015 WL 4873062, at *1.

[155]Construction Supervision, 2015 WL 4873062, at *1.

[156]Construction Supervision, 2015 WL 4873062, at *1.

[157]Construction Supervision, 2015 WL 4873062, at *2. The Debtor appealed the bankruptcy court's order allowing the filing of the notices; however, both the district court and the United States Court of Appeals for the Fourth Circuit affirmed the bankruptcy court's order. Construction Supervision, 2015 WL 4873062, at *2.

[158]Construction Supervision, 2015 WL 4873062, at *2.

[159]Construction Supervision, 2015 WL 4873062, at *2.

[160]Construction Supervision, 2015 WL 4873062, at *3.

[161]Construction Supervision, 2015 WL 4873062, at *3.

[162]Construction Supervision, 2015 WL 4873062, at *5.

ruptcy court first considered whether BB & T's claim constituted an administrative expense under section 503(b), which requires the expenses be actual, necessary costs and expenses to preserve the estate.[163] The bankruptcy court determined that the Debtor's use of BB & T's collateral, namely the accounts receivable, was necessary to the Debtor's reorganization; however, once the lien order was entered priming BB & T's interest in the accounts receivable and the case converted to Chapter 7, the post-conversion use of BB & T's collateral no longer provided an actual and necessary benefit to the estate.[164] Next, while the court determined that the use of BB & T's collateral during the reorganization initially benefited the estate, it held that BB & T was not entitled to superpriority for such claims because BB & T did not suffer an actual loss, such as the loss incurred by reason of a missed adequate protection payment or the deficiency of its collateral upon a sale of its collateral[165] The bankruptcy court noted that BB & T received adequate protection payments of $454,159.13, which exceeded its auditor's accessed value of the accounts receivable, and thus, was adequately protected when the cash collateral order was entered.[166] Any diminution in the value of the collateral, the bankruptcy court declared, was not the result of the use of the collateral by the debtors, but rather due to the material supplier's liens, which would have arisen irrespective of the bankruptcy.[167] Accordingly, the bankruptcy court denied BB & T's application for superpriority claims under section 507(b).[168]

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[163]Construction Supervision, 2015 WL 4873062, at *6.

[164]Construction Supervision, 2015 WL 4873062, at *6.

[165]Construction Supervision, 2015 WL 4873062, at *6.

[166]Construction Supervision, 2015 WL 4873062, at *7.

[167]Construction Supervision, 2015 WL 4873062, at *7.

[168]Construction Supervision, 2015 WL 4873062, at *7.