

In the United States Bankruptcy Court

for the Northern District of Iowa

LARKEN HOTEL LIMITED
PARTNERSHIP

Bankruptcy No. 94-10388KC

Debtor(s).

Chapter 11

RULING ON DEBTOR'S MOTION FOR ORDER PERMITTING DEBTOR TO REIMBURSE

The above-captioned matter came on for hearing on March 25, 1994 pursuant to assignment. All parties and counsel appeared of record as indicated in a previously filed proceeding memo. The matter before the Court is a hearing on Debtor's Motion for Order Permitting Debtor to Reimburse Midwest Employee Leasing for Payment of Prepetition Payroll Obligations. An objection to the Motion was filed by the U.S. Trustee's Office. The Unsecured Creditors' Committee and certain financial institutions which assert security interests in Debtor's cash collateral have also stated their positions on the issue. Evidence was presented, arguments of counsel were considered and the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A).

FINDINGS OF FACT

Midwest Employee Leasing is an employee leasing company which employs all individuals who operate Debtor's business. It pays their salaries, workman's compensation benefits, health insurance premiums, and associated benefits. Midwest Employee Leasing then leases these employees back to the Debtor. The cost to the Debtor for this service is the actual payroll obligation plus a percentage fee for the service provided. Midwest Employee Leasing is not related to Debtor although the principals of Midwest Employee Leasing are former employees of Debtor's parent corporation, Larken, Inc.

Debtor has an agreement with Midwest Employee Leasing to reimburse it for the payroll obligations incurred by the employees. The agreement under which Debtor reimburses Midwest arises out of a contract entered into between Midwest Employee Leasing and Larken, Inc. Under this agreement, Larken, Inc. has assumed the obligation to pay Midwest Employee Leasing the percentage fee for the services provided by Midwest Employee Leasing.

Debtor filed its Chapter 11 petition on January 28, 1994. On that date, Debtor had an obligation to reimburse Midwest for payroll checks previously issued in the total amount of \$559,713.98. Debtor paid this amount to Midwest after the petition was filed and prior to the hearing on the present motion. An "Agreed Order" which was negotiated between Debtor and several secured creditors named in the order ("the Banks") budgeted a payment for payroll in an amount larger than the amount Debtor paid to Midwest. Counsel for the Banks states that the Banks approved of the payment.

Debtor presented evidence attempting to establish that the employees may have left the job and brought Debtor's operations to a halt if it had not made the payment. Debtor's witnesses stated that

Midwest would have been forced to recoup its prepetition payout from future payroll if Debtor had not reimbursed it. Debtor asserts that these circumstances made postpetition reimbursement to Midwest essential.

Debtor requests an Order retroactively authorizing its payment to Midwest. Debtor makes alternative arguments. First, it states that the payment should not be considered a payment of a prepetition debt as the payment was based on postpetition invoices. Second, Debtor argues that the Order is authorized under the "doctrine of necessity" through the Court's equitable powers under § 105(a). Third, Debtor argues, and creditor Banks concur, that the payment has administrative expense priority under § 507(a)(3).

The U.S. Trustee asserts that Debtor's obligation to reimburse Midwest is a prepetition debt. Assistant U.S. Trustee Reasoner argues that both the doctrine of necessity and § 507(a)(3) have no applicability. She asks the Court not to retroactively approve Debtor's unauthorized payment of a prepetition claim which occurred without notice to interested parties. The Unsecured Creditors' Committee's position is similar to the U.S. Trustee's. It also feels that payment should not be authorized if a third party, such as Larken, Inc., could potentially be liable under principles of indemnification.

CONCLUSIONS

Debtor first argues that the payment may be considered a postpetition obligation. However, the record is undisputed that the invoices in question covered payroll obligations for employees' services which were paid prepetition. Because of this, the Court rejects the Debtor's argument that its obligation to Midwest is not a prepetition debt. On this record, Debtor became obligated to reimburse Midwest when Midwest paid its employees. Midwest paid the employees prepetition. The fact that Midwest did not invoice Debtor until after the filing of the petition does not transform this obligation into a postpetition debt.

Second, Debtor argues the "doctrine of necessity" under which a Court may authorize payment of a prepetition obligation prior to confirmation of a plan where such payment is essential to the debtor's reorganization. In re Financial News Network, Inc., 134 B.R. 732, 735 (Bankr. S.D.N.Y. 1991). The doctrine originated in railroad cases and has been applied in limited circumstances in the Chapter 11 context, although such application is not without substantial criticism. Id.

Courts applying the doctrine have held that § 105(a) authorizes payment where it is necessary to permit the greatest likelihood of survival of the debtor as well as payment to the most creditors. In re Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991). It is a narrow exception applied only under the most exigent circumstances where it is in the best interest of the debtor and of the other creditors and the debtor has articulated a compelling business justification. In re NVR L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992). The doctrine is most often utilized by debtors seeking preapproval of payment of a critical prepetition debt. See Eagle-Picher, 124 B.R. at 1022; NVR L.P., 147 B.R. at 127.

The "doctrine of necessity" is premised solely upon authority contained in § 105(a). This section allows the Court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). However, while § 105 expresses broad power, the equitable powers of the Courts are not unlimited. Whatever equitable power exists under 11 U.S.C. § 105 must be defined after consideration of other substantive bankruptcy code provisions. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2d 169 (1988). To do otherwise,

would subsume all substantive provisions of the Code within the equitable powers of § 105. As this was clearly not intended, the Court must evaluate § 105 and the "doctrine of necessity" in light of other applicable provisions of the Bankruptcy Code. In re Grand Valley Sport & Marine, Inc., 143 B.R. 840, 850 (Bankr. W.D. Mich. 1992).

Here, the issue is impacted by 11 U.S.C. § 362. Debtor's postpetition payment to Midwest can be characterized as a transfer in violation of the § 362(a) automatic stay. In re Germansen Decorating, Inc., 149 B.R. 517, 521 (Bankr. N.D. Ill. 1992) (acceptance of debtor's voluntary postpetition payment of prepetition debt is act in violation of stay). The Bankruptcy Court has the power to annul the automatic stay and grant nunc pro tunc relief in limited circumstances under § 362(d). In re Barker-Fowler Elec. Co., 141 B.R. 929, 936 (Bankr. W.D. Mich. 1992). However, such relief should only be granted to protect innocent creditors and third parties who have detrimentally changed their positions, or as a weapon against debtor fraud. In re Williams, 124 B.R. 311, 316 (Bankr. C.D. Cal. 1991). The power must be exercised sparingly and applied only in extreme circumstances. Id.

Debtor is requesting retroactive approval of its payment to Midwest. Advance authorization of the court is necessary if postpetition payments are made on prepetition debts. In re Carlson, 55 B.R. 124, 125 (Bankr. W.D. Mo. 1985) (holding that payment was avoidable under § 549(a)); see also In re Quality Interiors, Inc., 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991) (stating that in no event may postpetition payment of prepetition payroll be made without prior authority from court). Even if a creditor has a valid administrative claim, retroactive approval of payment is disfavored because of the § 363(b) requirement of notice to interested parties before authorization of postpetition transfers outside the ordinary course of business. In re Photo Promotion Assoc., Inc., 881 F.2d 6, 9 (2d Cir. 1989). The court must assess the facts and equities of each case, taking into account whether the debtor honestly believed payment was authorized and whether an emergency existed. Id.

In the context of nunc pro tunc approval of postpetition loans, courts have considered the following three elements: 1) confidence that approval would have been granted by the court if the debtor made timely application for approval, 2) no creditors are harmed, and 3) the debtor and the creditor involved had the good faith belief that they had authority to enter into the transaction. In re Grand Valley Sport & Marine, Inc., 143 B.R. at 850.

The three factors articulated in Grand Valley provide guidance in this case. The U.S. Trustee and the Unsecured Creditors Committee assert that unsecured creditors may be harmed by approval of the payment. Debtor asserts that it believed it was authorized to pay Midwest the payroll obligation based on the Agreed Order negotiated with the Banks.

On the record presented, the Court is not confident that approval would have been granted had Debtor waited for court authorization before paying Midwest. While the doctrine of necessity arguably would have applied, the fact remains that the employees had already been paid so there was no immediate threat of a walk-out. The contract between Midwest and Larken, Inc. was not presented to the Court as evidence so the issue of possible indemnity by Larken, Inc. remains unanswered.

In a similar situation, the three factor test was applied in In re J.L. Graphics, Inc., 62 B.R. 750, 755 (Bankr. D.N.H. 1986), aff'd, 818 F.2d 1027 (1st Cir. 1987). The court considered whether to retroactively authorize an agreement between the debtor and a creditor regarding use of cash collateral prior to hearing on the issue. The court held that although the debtor and creditor had agreed, other creditors may have objected. The court declined to exercise its equitable powers by sanctioning retroactive approval. Id. at 756. It determined that to do otherwise would be to rewrite the Bankruptcy

Code contrary to its clear intent by validating a postpetition transfer on agreement of the parties, rather than after notice and hearing. Id.

Based upon the foregoing, this Court concludes that retroactive approval of postpetition transfers should be granted only in extraordinary and unusual circumstances. The doctrine of necessity must be applied sparingly. Here, no necessity presently exists because of Debtor's unauthorized payment to Midwest. Therefore, the Court declines to retroactively approve the payment on the basis of this doctrine.

The third basis which Debtor and the Banks assert to support authorization of the payment to Midwest is that it has priority status as wages under § 507(a)(3). This position is fairly debatable in light of cases such as In re Mel-Hart Products, Inc., 156 B.R. 606, 607 (Bankr. E.D. Ark. 1993), which hold that priority status is applicable only to claims of individual employees and not to claims of entities such as Midwest who supply a debtor with employees. A claim by a company who pays a debtor's payroll obligations is merely a general unsecured claim. Id. at 608; see also In re Grant Indus., Inc., 133 B.R. 514, 515 (Bankr. W.D. Mo. 1991) (claim by creditor who provided temporary employees is based on fees earned on contract, not wages earned by individual workers); In re Alroco, Inc., 92 B.R. 523, 525 (Bankr. M.D. Fla. 1988) (creditor who provided administrative services regarding debtor's employees was independent contractor; claim was for breach of contract, not for wages). While an ultimate determination of this issue would require consideration of facts beyond the scope of the record, this Court can conclude that Debtor's position on this issue is not at all certain.

In summary, this Court concludes, based upon the record made, that the obligations in dispute constitute prepetition obligations. Second, § 105 equitable powers should not be invoked utilizing the doctrine of necessity based upon the facts of this case. Finally, it is the conclusion of this Court that Midwest payment is not entitled to priority status under § 507(a)(3) with any degree of certainty.

As such, for all of the reasons stated herein, the circumstances of this case do not warrant retroactive approval of Debtor's payment to Midwest for reimbursement of payroll obligations. The Court declines to exercise its equitable powers to ratify a transfer arguably made in violation of the automatic stay. The approval of the payment by the Banks through the Agreed Order does not justify retroactive approval by this Court. On the present record, the Court is not confident that it would have approved the payment prospectively considering the possible harm to unsecured creditors and possible liability of Debtor's parent corporation for the payroll obligation. No party has yet filed an action to recover the payment, which must be brought by adversary complaint. Fed. R. Bankr. P. 7001 (1). As such, that matter is not now before the Court.

WHEREFORE, Debtor's Motion for Order Permitting Debtor to Reimburse Midwest Employee Leasing for Payment of Prepetition Payroll Obligations is DENIED.

SO ORDERED this 28th day of April, 1994.

Paul J. Kilburg
U.S. Bankruptcy Judge