UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

ROSCOE WOODWORKING, INC. — CASE NO. 95-60119

Debtor — Chapter 7

JAMES C. COLLINS, TRUSTEE

Plaintiff

vs. — ADV. PRO. NO. 96-70323A

PORTER CAPITAL CORPORATION

Defendant

APPEARANCES:

JAMES C. COLLINS, ESQ.
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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

Presently before the Court is a motion filed on April 7, 1997, on behalf of Porter Capital Corporation ("Porter") seeking summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), incorporated by reference in Rule 7056 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), in the adversary proceeding commenced by the

chapter 7 trustee, James C. Collins ("Trustee"). Porter requests dismissal of the Trustee's complaint, alleging he has failed to state a claim on which relief may be granted. In addition, Porter seeks an order directing the Trustee to turnover $25,000 in his possession.[1]

The Trustee's complaint, filed November 15, 1996, pursuant to §§ 544 and 547 of the Bankruptcy Code (11 U.S.C. §§ 101-1330) ("Code") seeks to avoid an alleged preferential transfer in connection with the execution of a security agreement by Porter and the Debtor.[2] For a first cause of action, the Trustee seeks "turn-over to the Trustee of the security agreement and all claim to the assets and property of the debtor Corporation and any proceeds resulting therefrom." For a second cause of action, the Trustee seeks a judgment "voiding the security agreement between the Debtor and Porter as to the Trustee and turn-over to the Trustee of the right to all collateral thereunder . . . ." Finally, the Trustee requests judgment against Porter "voiding the transfer of Roscoe to Porter of October 20, 1994 and the collateral securing the security agreement to the Trustee as an asset of the debtor estate . . . ."

Porter's motion was heard by the Court at its regular motion term on May 5, 1997, in Binghamton, New York. Following oral argument, the matter was submitted for decision by the

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[1] On August 12, 1996, the Trustee filed a motion requesting that $25,000 being held by the attorney for Roscoe Woodworking, Inc. ("Debtor") pursuant to a prior order of the Court, dated February 28, 1996, be turned over to the Trustee. On September 25, 1996, the Court directed Debtor's attorney to turnover the monies to the Trustee to be held pending resolution of Porter's claim that the $25,000 was its cash collateral.

[2] On October 29, 1994, Porter and the Debtor executed a Commercial Financing Agreement which was to provide short-term financing to the Debtor. Simultaneous with the execution of that agreement, the parties also executed a security agreement granting Porter a security interest in all of the Debtor's personal property, including inventory, equipment, trade fixtures and accounts receivable. According to the Trustee, a UCC-1 financing statement allegedly was filed by Porter on November 14, 1994, with the Tompkins County Clerk's office.

Court.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b), 157(a), (b)(1) and (b)(2)(E), (F), (H) and (K).

FACTS

The Debtor filed a voluntary petition ("Petition") seeking relief pursuant to chapter 11 of the Code on January 13, 1995. Prior to filing its Petition the Debtor was in the business of manufacturing and installing custom millwork. The Debtor continued to operate its business postpetition as debtor-in-possession pursuant to Code §§ 1107 and 1108 until June 18, 1996, when the case was converted to one under chapter 7. The Trustee was appointed thereafter on July 2, 1996.

In the initial stages of the case, the Debtor sought approval of an agreement with Porter for postpetition financing pursuant to Code § 364. After notice and a hearing, the Court signed an order approving the financing agreement on May 11, 1995 ("Financing Order"). *See* Exhibit B of Porter's Motion. According to the terms of the Financing Order, Porter was granted a "continuing first priority lien and security interest in and to all of the Debtor's prepetition and postpetition existing and after-acquired accounts receivables, contract rights, general intangibles merchandise, returns, inventory and equipment (except such property, or replacements thereto,

of the debtor which is pledged pursuant to a valid pre-petition security interests [sic] to other creditors) together with the proceeds and products of the foregoing . . . " to secure repayment of any loans and advances made to the Debtor postpetition. *See id.* at 3. The Financing Order also provided that in the event that the case was converted to one under chapter 7, Porter was entitled, subject to Court approval, to "take any and all actions and remedies which it may deem appropriate to proceed against and realize upon the property of the Debtor or the estate of the Debtor and upon any other collateral upon which it has been granted liens, security interest and mortgages and to obtain repayment of the obligations and indebtedness owed to it . . ." *See id.* at 8. Included in the Financing Order is a provision stating that it "will survive any order which may be entered . . . converting this proceeding from a Chapter 11 case to a Chapter 7 case, and the terms and provisions of this Order, as well as the priorities, liens and security interests created hereunder, shall continue in this or any other superseding case under the Code . . . ." *See id.* at 9-10. The Financing Order specifically states that its terms shall be binding on "any trustee . . . which may be appointed in this . . . case . . . ." *See* id. at 11. Porter alleges that it extended in excess of $300,000 to the Debtor in postpetition financing in reliance on the Financing Order for which it is entitled to seek recovery as a secured creditor.

ARGUMENTS

It is the Trustee's position that all prepetition assets of the Debtor, including the $25,000 in his possession which he alleges was part of the Debtor's general operating account at one time, are subject to his possessory interest. *See* ¶ 9 of Complaint, filed November 15, 1996 and ¶ 4 of

Trustee's Reply, filed January 29, 1997. The Trustee contends that the execution of the security agreement in October 1994 within 90 days prepetition constituted a preference which is voidable pursuant to Code § 547. The Trustee also alleges that Porter failed to properly perfect its security interest in the Debtor's collateral prepetition.

Porter argues that the Trustee has failed to state a cause of action and that his complaint should be dismissed. In particular, Porter points out that the Trustee is focusing on the security agreement between Porter and the Debtor which was executed prepetition. It is Porter's position that the Financing Order entered postpetition approved the creation of a newly perfected security interest in the Debtor's assets, and that the Trustee was bound by the Order. Porter contends that the monies it advanced to the Debtor postpetition pursuant to the Financing Order were secured by both pre- and postpetition collateral, including the $25,000 now in the Trustee's possession.

At the argument of the motion, the Trustee asserted that the Court's Order converting the case from chapter 11 to chapter 7 ("Conversion Order") specifically provides for "attachment" by the Trustee of all collateral in which a security interest had not been properly perfected.[3] The Trustee also argued that the terms of the Financing Order became subordinate to the terms of the Conversion Order and as long as there were lien creditors of the Debtor that had not received notice of the request for postpetition financing, the Court "was not in a position to support the [Financing] Order" issued prior to conversion of the case.

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[3] The expressed language of the Conversion Order provides for the "turnover to the Chapter 7 trustee of all records and property of the estate under Debtor's custody and control." Specifically deleted from the language of the Conversion Order are the words "including the funds presently being held in trust by the Debtor's attorney . . . ."

DISCUSSION

A motion to dismiss the complaint for failure to state a claim is to be made as one for summary judgment when "'matters outside the pleadings are presented to and not excluded by the court.'" *See In re Medlin*, 201 B.R. 188, 191 (Bankr. E.D. Tenn. 1996), quoting 5A Charles A. Wright & Arthur R. Miller, FEDERAL PRACTICE & PROCEDURE § 1366 (1990); *see also In re Desrosiers*, 212 B.R. 716, 718 (Bankr. D .Mass. 1997). In this instance, Porter appropriately has filed its motion pursuant to Fed.R.Bankr. P. 7056 and provided the Court with a copy of the Financing Order, as well as copies of the financing agreement and security agreement for its consideration. When considering whether to dismiss a complaint, the Court must assume all the facts in the complaint are true and then determine whether the facts would entitle the plaintiff to relief. *See Staron v. McDonald's Corp.*, 51 F.3d 353, 355 (2d Cir. 1995). Dismissal is inappropriate unless the Court finds beyond a reasonable doubt that there are no facts that the plaintiff could prove that would entitle him to the relief he seeks. *See id.*, citing *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 101-102, 2 L.Ed.2d 80 (1957).

As an initial matter, the Court must examine the legal basis for Porter's alleged security interest in both pre- and postpetition assets of the Debtor. Specifically, Code § 364 provides a means by which a debtor may obtain credit after the commencement of the case. Unless a debtor is seeking to obtain unsecured credit in the ordinary course of business pursuant to Code § 364(a), a debtor is required to provide notice and an opportunity for a hearing in seeking court authorization for secured financing, including what has been labeled "cross-collateralization." *See* 11 U.S.C. § 364(b). Cross-collateralization has been described as the practice by which

> in return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order and those created in the course of the Chapter XI proceeding not only for the new loans, the propriety of which is not contested, but for existing indebtedness to it.

Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.), 596 F.2d 1092, 1094 (2d Cir. 1979)[4]; *see also In re Antico Mfg. Co., Inc.*, 31 B.R. 103, 105 (Bankr. E.D.N.Y. 1983) (noting that by securing postpetition debt with both pre- and postpetition collateral the lender "is not improving the position of an existing claim, but is merely exacting as security for future advances a lien or interest in what may well be the only tangible assets the debtor can offer.").

Whether to allow postpetition financing is a matter of the Court's discretion. *See In re Ames Dept. Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990). Generally, a debtor will be permitted to exercise reasonable business judgment in seeking financing. *See id.* at 40. In this regard, so long as the financing agreement does not contain terms that leverage the bankruptcy process and is found to be in the best interest of the estate it is likely to be approved by the Court. *Id.* Not surprising, Porter was willing to assume the risk of providing the Debtor with additional financing on a postpetition basis under very limited circumstances. Porter's counsel asserts that prior to the Court's approval of the Financing Order notice was given to the Debtors' creditors and as a result of certain objections the language of the Financing Order was, in fact, modified. A review of the record of the case indicates that there was no appeal of the Financing Order sought. Indeed, Porter alleges that in reliance on the Financing Order it advanced more

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[4] While not expressly prohibiting it, the court in *Texlon* indicated that a financing order obtained in a chapter 11 securing *prepetition* debt with *both* pre- and postpetition assets was unenforceable in a subsequent chapter 7 proceeding under circumstances in which it was obtained on an *ex parte* basis. *See Texlon*, 596 F.2d at 1098 (emphasis added).

than $300,000 to the Debtor postpetition. Code § 549 expressly prohibits a trustee from avoiding a transfer of property of the estate postpetition which was authorized by the court under title 11. *See Vogel v. Russell Transfer, Inc.*, 852 F.2d 797, 800 (4th Cir. 1988). Therefore, the Trustee is without authority to avoid Porter's interest in either the Debtor's pre- or postpetition assets securing its postpetition claim.[5].

The Court's conclusion that Porter holds a perfected security interest in both the pre- and postpetition assets of the Debtor with respect to its postpetition claim does not address Porter's argument that the Trustee's complaint, which focuses on Porter's alleged prepetition security interest, should be dismissed. A trustee in bankruptcy not only succeeds to the assets owned by a debtor at the time of filing but also has the power to enhance the value of the debtor's estate by recovering prepetition transfers of the debtor which are subject to some infirmity. *See* 11 U.S.C. §§ 541(a)(3) and 544. Preferential transfers, which enable a creditor to receive more than it would have received had the transfer not occurred and had it participated in the distribution of assets by the trustee, are subject to the trustee's avoidance powers pursuant to Code § 547. *See generally In re Lan Yik Foods* Corp., 185 B.R. 103, 107-108 (Bankr. E.D.N.Y. 1995) (stating that the trustee's authority is intended to foster the Code's policy that there be equality of distribution among creditors). In this case, Trustee alleges that the execution of the security agreement within 90 days prepetition constituted a preference which is voidable pursuant to Code § 547. The Trustee also alleges that Porter failed to properly perfect its security interest in the Debtor's collateral prepetition.

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[5] Indeed, the Trustee acknowledges that the Financing Order created a valid security interest with respect to the postpetition financing. *See* Trustee's Reply at ¶3.

The Financing Order provides that Porter's prepetition security interests "are approved, affirmed, ratified and adopted and are deemed to be and the same in full force and effect . . . ." *See* Financing Order at 3. It does not expressly provide that the security interests were deemed properly perfected. However, a subsequent provision in the Financing Order states that "the Debtor hereby waives and agrees not to . . . challenge the validity, priority, enforceability or perfection of the liens and security interests encumbering Porter's pre-petition collateral securing the [pre-petition obligations] . . . ." *See id.* at 11. The Financing Order also provides that its terms are to be binding on "any trustee . . . which may be appointed in this . . . case . . . ." *Id.*

A similar provision was found in the case of *Unsecured Creditors' Committee v. First Nat'l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co., Inc.),*834 F.2d 599 (6th Cir. 1987). In that case, the debtors' agreement with the bank in connection with postpetition financing included the provision that the debtors agreed "to settle all controversies regarding the validity of the Banks' security interest . . . by waiving any objection they may have with respect thereto . . . ." *See id.* at 600-601. The creditors' committee argued that the protection afforded the prepetition loans in the amount of $4 million in exchange for a postpetition advance of $60,000 in cash and the availability of $175,000 through letters of credit was unreasonable and beyond the scope of Code § 364. *See id.* at 602. However, the creditors' committee had failed to seek a stay of the bankruptcy court's order pending appeal. The Sixth Circuit Court of Appeals found that whether or not the order exceeded the scope of Code § 364(c), it was entitled to the protection of Code § 364(e) as long as the debtors and the bank had relied on the order and it had

been obtained in good faith. *Id.*[6]

As one commentator has noted,

> Waiving the estate's claims and defenses with respect to prepetition transactions as a condition for postpetition financing is among the most effective tools for *steering clear of avoidance actions*. This is particularly true if appropriate procedural safeguards are employed, allowing other creditors a fair opportunity to review the arrangement (citations omitted). . . . Presenting such an arrangements [sic] early in the case, allowing other creditors a fair opportunity to review it, and making a strong argument for the need for such a provision as a reasonable inducement for postpetition financing, will all stand a lender in good stead. (citations omitted) (emphasis added).

Jeff Bohm & David B. Young, *Preferences and Fraudulent Transfers: A Lender's Perspective*, 752 PLI/Comm. 971, 1062 (1997).

In this case, the Debtor sought approval of the postpetition financing approximately three months after commencement of the chapter 11 case. Notice and an opportunity for a hearing were provided to creditors and there was no evidence presented at that time that other less onerous forms of credit were available. Although the Trustee was not involved until after conversion of the case and, therefore, had no opportunity to appeal the Court's Order, the Court finds no basis for disturbing the provisions contained in the Financing Order, including that specifically binding the Trustee upon conversion of the case from chapter 11 to chapter 7. *See Armstrong v. Norwest Bank, Minneapolis, N.A.*, 904 F.2d 797, 801 (8th Cir. 1992) (indicating that "[c]reditors must be able to deal freely with debtors-in-possession, within the confines of the

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[6] Code § 364(e) provides that "[t]he reversal or modification on appeal of an authorization under this section . . . does not affect the validity of any debt so incurred, or any priority or lien so granted . . . unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal."

bankruptcy laws, without fear of retribution or reversal at the hands of a later appointed trustee."). Under these circumstances, the Court concludes that the Trustee has failed to state a cause of action for which he is entitled to obtain relief and dismissal of his complaint is, therefore, appropriate. In complying with the due process requirements set forth in Code § 364, and there having been no stay sought or appeal filed by any of the creditors participating in the financing approval process, Porter effectively precluded the Trustee from recovering any alleged preferences with respect to its prepetition security interest.

With respect to Porter's request for turnover by the Trustee of the $25,000 in his possession, the Trustee acknowledges that the monies represent part of the Debtor's general operating account and, therefore, are subject to Porter's security interest. Porter's entitlement to the recovery of said monies is subject to the terms of the Financing Order, however, which expressly provides that "pursuant to Section 364(c) of the Code any and all obligations and liabilities of the Debtor to Porter arising after the date of this Order shall have priority in payment over any obligations or liabilities now in existence or incurred hereafter by the Debtor and all expenses of the kind specified in Sections 503(b), 506(c), 507(b) and 552(b) of the Code, except commissions due the United States Trustee and Chapter 7 Trustee's fees . . . ." *See* Financing Order at 6.

Based on the foregoing, it is hereby

ORDERED that Porter's motion seeking summary judgment and the dismissal of the Trustee's complaint is granted, and it is further

ORDERED that the Trustee, within 30 days of the date of this Order, shall apply to this Court, on appropriate notice, for an order approving payment of any United States Trustee

commissions and chapter 7 Trustee's fees that may be due and owing, and it is finally

ORDERED that in the event the Trustee shall fail to file the aforementioned application within 30 days of the date of this Order, the Trustee shall immediately remit to Porter the sum of $25,000 with any and all interest accrued thereon.

Dated at Utica, New York

this 11th day of February 1998

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge