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.[1] Section 507 of the Bankruptcy Code sets forth the manner that these claims are given priority by Congress over other unsecured claims when an estate cannot pay all creditors in full.[2] "Statutory priorities are to be narrowly construed because the presumption in bankruptcy cases

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[*]Michael T. Driscoll is a trial attorney with the Office of the United States Trustee for the Southern District of New York. The views expressed in this article do not necessarily represent the views of the United States Department of Justice or the United States Trustee Program.

[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) solely applies to Chapter 9 case. *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) 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).

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;

(3) claims under Section 502(f) of the Bankruptcy Code;[6]

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

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[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 (2005).

[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).

(5) claims for contributions to an employee benefit plan;
(6) claims by grain producers and U.S. fishermen;
(7) claims by individual customers for deposits;
(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 the motor vehicle or vessel while intoxicated.

Section 507(b) allows a "superpriority" administrative expense to a secured creditor where adequate protection payments prove insufficient to compensate for the diminution of the value of its collateral.[7] Section 507(c) accords priority status to erroneous refunds 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) to (9) from asserting a priority position; however, this subsection does not bar assignees from asserting priority treatment.[9]

The dollar figures cited in section 507(a)(4), (5), (6), and (7) are adjusted at 3-year intervals based on the Consumer Price Index as determined by the U.S. 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] The dollar figures cited in this chapter are in effect until April 1, 2016.

The purpose of this chapter is to provide an update on the

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[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), opinion modified on denial of reh'g, In re Scopac, 649 F.3d 320 (5th Cir. 2011).

[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).

[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).

subsections of Section 507 that have received recent treatment by courts. Section 507(a)(2), (a)(3), (a)(5), (a)(6), (a)(10), (c), and (d) are omitted from this chapter because courts have not recently addressed these subsections.

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."[13] With the enactment of BAPCPA, domestic support obligations moved from a seventh priority to a first priority.[14] The term "domestic support obligation" is defined by section 101(14A).[15] "The label applied to the obligation by the court or the parties is not necessarily controlling for Bankruptcy Code purposes."[16] Instead, courts examine the intended purpose the obligation was designed to serve.[17] Certain courts have adopted multi-factor tests to determine intent of the obligation while others will apply a totality of circumstances examination.[18]

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 rel-

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[13]11 U.S.C.A. § 507(a)(1).

[14]Pub. L. No. 109-8 (2005).

[15]*See* 11 U.S.C.A. § 101(14A).

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

[17]*In re Smith*, 586 F.3d 69, 74, 62 Collier Bankr. Cas. 2d (MB) 1288, Bankr. L. Rep. (CCH) P 81620 (1st Cir. 2009); *In re Brody*, 3 F.3d 35, 38 (2d Cir. 1993).

[18]*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) (overruled by, In re Bammer, 131 F.3d 788, 31 Bankr. Ct. Dec. (CRR) 930, Bankr. L. Rep. (CCH) P 77558 (9th Cir. 1997)) (applying a four-factors); *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-factors); *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 four-factors); *In re Phegley*, 443 B.R. 154, 158, 64 Collier Bankr. Cas. 2d (MB) 1672 (B.A.P. 8th Cir. 2011) (adopting a six-factors); *In re Horner*, 222 B.R. 918, 922 (S.D. Ga. 1998) (applying nine-factors); *In re Daulton*, 139 B.R. 708, 710 (Bankr. C.D. Ill. 1992) (applying twenty-factors).

ative arising by an agreement, divorce decree, or court order.[19] Section 507(a)(1)(B) grants a second priority to those claims that have been assigned to a "governmental unit."[20] Section 507(a)(1)(C) establishes a priority over the previous subsections where a trustee incurs administrative expenses administering assets to pay the domestic support obligations.[21]

Ashworth v. Cohen

In *Ashworth v. Cohen*, the Bankruptcy Appellate Panel (the "BAP") for the Ninth Circuit considered whether the bankruptcy court for the Central District of California erred when it determined that the debtor's former spouse was entitled to priority status under section 507(a)(1).[22] In this Chapter 13 case, the debtor's former spouse filed a proof of claim asserting priority status under section 507(a)(1).[23] The debtor objected to the priority treatment because, he argued, the claim arose from a personal injury settlement and not from a concurrent divorce settlement.[24] After conducting an evidentiary hearing on the claim, the bankruptcy court, applying controlling Ninth Circuit authority, determined that the settlement was a domestic support obligation because it was intended to provide support to the former spouse.[25] The Chapter 13 debtor appealed to the BAP.[26]

In reviewing the legal determinations *de novo* and the factual determinations for clear error, the BAP reiterated the well-established rule that courts must examine the intent of the parties to determine whether a domestic support obligation arises from a settlement agreement.[27]

The BAP also noted that court examining domestic support obligations rely on pre-BAPCPA case law construing the phrase

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[19]11 U.S.C.A. § 507(a)(1)(A).

[20]11 U.S.C.A. § 507(a)(1)(B).

[21]11 U.S.C.A. § 507(a)(1)(C).

[22]*In re Ashworth*, 2013 WL 6620863, *3 (B.A.P. 9th Cir. 2013).

[23]Ashworth, 2013 WL 6620863 at *1.

[24]Ashworth, 2013 WL 6620863 at *1.

[25]Ashworth, 2013 WL 6620863 at *1.

[26]Ashworth, 2013 WL 6620863 at *1.

[27]Ashworth, 2013 WL 6620863 at *3.

under section 523(a)(5), which exempts domestic support obligations from discharge.[28]

Relying on the Ninth Circuit decision in *Friedkin v. Sternberg*,[29] a pre-BAPCPA case affirming a determination of the nondischargeability of spousal support under section 523(a)(5), the BAP noted that a bankruptcy court should consider several factors in determining the intent of the parties including: whether the spouse actually needed the spousal support at the time of the divorce; whether the obligation terminates upon death or remarriage of the former spouse; and whether the payments are made directly to the recipient former spouse and paid in installments over time.[30] The BAP further noted that the bankruptcy courts should examine the labels given to the payments.[31]

In applying these factors to the case, the BAP found no clear error by the bankruptcy court.[32] The BAP determined that the debtor did not offer any evidence to rebut the bankruptcy court's conclusions that the factors, viewed together, supported the finding that the settlement agreement constituted a domestic support obligation.[33] Noting the debtor's failure to raise the issue before the bankruptcy court, the BAP declined to consider the debtor's argument that the former spouse no longer needed the financial support.[34] Accordingly, finding no clear error, the BAP affirmed the bankruptcy court's conclusion that the former spouse's claim was entitled to priority treatment under section 507(a)(1).[35]

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[28]Ashworth, 2013 WL 6620863 at *4 ("Courts addressing the issue of whether a debt is actually in the nature of alimony or support rely on pre-BAPCPA case law construing the phrase as contained in § 523(a)(5).").

[29]*In re Sternberg*, 85 F.3d 1400, Bankr. L. Rep. (CCH) P 76999 (9th Cir. 1996) (overruled by, In re Bammer, 131 F.3d 788, 792, 31 Bankr. Ct. Dec. (CRR) 930, Bankr. L. Rep. (CCH) P 77558 (9th Cir. 1997)) (*en banc*) (requiring a *de novo* standard of review for mixed questions of law and fact).

[30]Ashworth, 2013 WL 6620863 at *3–4.

[31]Ashworth, 2013 WL 6620863 at *3–4.

[32]Ashworth, 2013 WL 6620863 at *6.

[33]Ashworth, 2013 WL 6620863 at *4–5.

[34]Ashworth, 2013 WL 6620863 at *5.

[35]Ashworth, 2013 WL 6620863 at *6; *see also In re Bub*, 494 B.R. 786, 798, 69 Collier Bankr. Cas. 2d (MB) 1484 (Bankr. E.D. N.Y. 2013), order vacated, 508 B.R. 552 (E.D. N.Y. 2014) (finding the claim of a former spouse was a domestic support obligation because it arose from a settlement agreement where the debtor agreed to ensure that the former spouse had shelter following the divorce); *In re Thomas*, 2013 WL 5493214, *10 (Bankr. E.D. Ky. 2013), order aff'd, 2014 WL 2460003 (B.A.P. 6th Cir. 2014) (finding that a domestic support

III. SECTION 507(A)(4)—CLAIMS FOR WAGES, SALARIES, AND COMMISSIONS

Section 507(a)(4) grants a fourth priority to allowed unsecured wages, salaries, and commissions that were earned within 180 days of the filing of a petition or the cessation of the debtor's business, whichever event occurs first.[36] Priority claims under this subsection may not exceed the statutory cap, which is currently set at $12,475.[37] An individual creditor's wage claim under section 507(a)(4) may include vacation, severance, and sick leave.[38] 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 75% of its salary from the debtor during the preceding 12 months.[39]

The purpose of this priority is to alleviate the financial hardship on a worker who loses some or all of his or her salary as a result of an employer's bankruptcy.[40] 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 pay the prepetition priority wage claims at the beginning of the case with a "first day order."[41] Courts have authorized the payment of these wage obligations under the

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obligation arose from both mortgage debt and judgment liens). *But see In re Jimenez*, 2013 WL 4055856, *4 (B.A.P. 9th Cir. 2013) (affirming bankruptcy court's denial of priority status because the appellant, the former spouse of the debtor, did not attach a transcript of the hearing adjudicating her claim); *In re Ludwig*, 502 B.R. 466, 470 (Bankr. W.D. Va. 2013) (denying the priority claim of a former spouse because "the obligation, and the Agreement as a whole, exhibits a quid-pro-quo characteristic that is more akin to a property settlement and not in the nature of alimony, support, or maintenance.").

[36]11 U.S.C.A. § 507(a)(4).

[37]11 U.S.C.A. § 507(a)(4). As noted in Section I of this chapter, the priority wage cap is in effect until April 1, 2016.

[38]11 U.S.C.A. § 507(a)(4)(A).

[39]11 U.S.C.A. § 507(a)(4)(B).

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

[41]*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

rationale that a Chapter 11 debtor's reorganization is dependent on the employee's performance, which, in turn, is dependent on the timely and uninterrupted payment of wages.[42]

In re Bender Ship Building & Repair Company

In *In re Bender Ship Building & Repair Company*, the bankruptcy court for the Southern District of Alabama considered whether a creditor may assert a priority wage claim for the wages that it paid prepetition for the temporary workers employed by the debtor.[43] Prior to the commencement of an involuntary Chapter 7 case, B&D Contracting Inc. ("B&D") executed an agreement to provide temporary workers to the debtor, Bender Ship Building & Repair Company.[44] After the conversion of the case to Chapter 11, B&D filed a proof of claim asserting a priority wage claim in the amount of $495,019.77 for the prepetition payment of its temporary workers at the debtor's place of business.[45] Prior to the confirmation of the Chapter 11 plan of liquidation, B&D obtained documents from the temporary workers that assigned

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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., No. 08-45057-DML-11, WL 4857954, at *4 (Bankr. N.D. Tex. Nov. 7, 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, 213, 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).

[42]*See* Tusa-Expo Holdings, Inc., 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 Comm'ns Corp., 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 the case and/or the estate if their pay and benefits remain intact and uninterrupted.").

[43]Bender Shipbuilding, 2013 WL 3546296 at *3.

[44]Bender Shipbuilding, 2013 WL 3546296 at *2.

[45]Bender Shipbuilding, 2013 WL 3546296 at *1.

any claims owed to the temporary workers by the debtor to B&D.[46] The post-confirmation debtor filed an objection to the proof of claim on the ground that the claim was not entitled to priority.[47]

In determining whether B&D was entitled to assert a priority claim, the bankruptcy court applied a three-prong test to determine: (1) whether B&D received valid assignments of; 2) valid wage priority claims owed to the temporary workers which were; 3) employees of the debtor.[48] The bankruptcy court ultimately determined that B&D was not entitled to a priority wage claim on behalf of its temporary employees.[49] While the bankruptcy court noted that U.S. Supreme Court precedent in *Shropshire, Woodliff & Co. v. Bush*[50] allowed the assignment of a priority wage claim, this case was distinguishable from *Shropshire* because B&D paid the temporary worker's wages prior to the commencement of the bankruptcy case.[51] The bankruptcy court noted that the purpose of section 507(a)(4) was to protect individual employees from the harmful effects of bankruptcy of the employer.[52] When B&D paid the prepetition wages, the temporary workers no longer needed the protection of the statute, and, accordingly, B&D was not entitled to priority status for the payment of the temporary workers' wages.[53]

In re Hinesley Family Limited Partnership No. 1

In *In re Hinesley Family Limited Partnership No. 1*, the Bankruptcy Court for the District of Montana considered whether a creditor was entitled to priority status for lost wages that arose after employment his terminated.[54] Charles Hinesley, Jr. was employed by the debtor, Hinesley Family Limited Partnership No. 1, but was terminated prior to the bankruptcy on September

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[46]Bender Shipbuilding, 2013 WL 3546296 at *2.

[47]Bender Shipbuilding, 2013 WL 3546296 at *1.

[48]Bender Shipbuilding, 2013 WL 3546296 at *3.

[49]Bender Shipbuilding, 2013 WL 3546296 at *3.

[50]*Shropshire, Woodliff & Co. v. Bush*, 204 U.S. 186, 27 S. Ct. 178, 51 L. Ed. 436 (1907).

[51]Bender Shipbuilding, 2013 WL 3546296 at *4.

[52]Bender Shipbuilding, 2013 WL 3546296 at *4.

[53]Bender Shipbuilding, 2013 WL 3546296 at *4.

[54]*In re Hinesley Family Ltd. Partnership No. 1*, 2013 WL 4040756, *1 (Bankr. D. Mont. 2013).

9, 2009.[55] On June 29, 2010, an arbitrator ordered the debtor to pay Hinesley $38,200 because it had failed to comply with a previous arbitration order concerning Hinesley's employment.[56] Thereafter, the debtor filed for bankruptcy under Chapter 11.[57] Hinesley filed a proof of claim that included a priority wage claim up to the statutory cap.[58] When the case was converted to Chapter 7, the Chapter 7 trustee objected to the priority wage claim.[59]

The bankruptcy court first determined that Hinesley's claim was precluded on *res judicata* grounds; however, for the purpose of completeness the bankruptcy court also sustained the trustee's objection on the priority wage claim issue.[60] In determining the claim, the bankruptcy court noted that an employee asserting a priority claim for wages or salary must be a direct employee of the debtor and have a direct claim arising from such employment.[61] Noting that state law determines whether the individual is an employee, the bankruptcy court examined two Montana statutes and Montana State Supreme Court case law interpreting both statutes.[62] The bankruptcy concluded that under Montana law Hinesley was not an employee at the time of the arbitrator's order, and consequently, his wage claim was not entitled to a priority status under section 507(a)(4).[63]

IV. SECTION 507(A)(7)—CLAIMS FOR INDIVIDUAL CUSTOMER DEPOSITS

Section 507(a)(7) grants a seventh priority to individuals for the unsecured claims arising from the prepetition deposit of money in connection with a purchase, lease or rental of property, or the purchase of services that were not delivered or provided.[64]

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[55]Hinesley, 2013 WL 4040756 at *2.

[56]Hinesley, 2013 WL 4040756 at *2.

[57]Hinesley, 2013 WL 4040756 at *1.

[58]Hinesley, 2013 WL 4040756 at *1.

[59]Hinesley, 2013 WL 4040756 at *2.

[60]Hinesley, 2013 WL 4040756 at *2.

[61]Hinesley, 2013 WL 4040756 at *3.

[62]Hinesley, 2013 WL 4040756 at *3.

[63]Hinesley, 2013 WL 4040756 at *3.

[64]11 U.S.C.A. § 507(a)(7). These claims were originally afforded a fifth priority but were recodified as a sixth, then seventh priority with the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 and BAPCPA. *See In re WW Warehouse, Inc.*, 313 B.R. 588, 594 n.8, 43 Bankr. Ct.

Priority claims under this subsection may not exceed $2,775.[65] Congress established this priority to protect consumers that may not realize that they were extending credit to the business through a deposit for goods or services.[66]

The term "deposit" is not defined by the Bankruptcy Code.[67] Bankruptcy courts have found a deposit arising in the context of gift certificates, lay away items, and merchandise arrangements.[68] Both partial and full payments may be viewed as deposits.[69] Whether a payment constitutes a deposit pursuant to section 507(a)(7) is typically a fact-intensive analysis by the bankruptcy court.[70]

In re Nittany Enterprises, Inc.

In *In re Nittany Enterprises, Inc.*, the bankruptcy court for the Western District of Virginia addressed whether a $500 payment toward a membership fee constituted a deposit pursuant to section 507(a)(7).[71] Prior to the filing of this Chapter 7 case, Daniel Porter entered into a membership agreement (the "Membership Agreement") with the debtor and paid $500 toward a $5,000 membership fee.[72] The Membership Agreement entitled a customer of the debtor, a national buying organization, access to lower prices for home furnishings and home goods.[73] After the commencement of the debtor's Chapter 7 case, Porter filed a proof of claim asserting priority treatment under the Bankruptcy Code.[74] The Chapter 7 trustee objected.[75]

The bankruptcy court found two factors relevant in rejecting Porter's priority claim. First, the Membership Agreement did not

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Dec. (CRR) 149, 52 Collier Bankr. Cas. 2d (MB) 1370 (Bankr. D. Del. 2004); Pub. L. No. 109-8, § 212 (2005).

[65]11 U.S.C.A. § 507(a)(7).

[66]WW Warehouse, 313 B.R. at 594.

[67]WW Warehouse, 313 B.R. at 592.

[68]WW Warehouse, 313 B.R. at 590 n.5.

[69]WW Warehouse, 313 B.R. at 590 n.5; *In re Nittany Enterprises, Inc.*, 502 B.R. 447, 455 (Bankr. W.D. Va. 2012).

[70]*See, e.g.*, Nittany Enters., 502 B.R. at 455.

[71]Nittany Enters., 502 B.R. at 455.

[72]Nittany Enters., 502 B.R. at 450–51.

[73]Nittany Enters., 502 B.R. at 450.

[74]Nittany Enters., 502 B.R. at 451. Porter did not assert a specific Bankruptcy Code section as a basis for his priority claim; however, the bankruptcy court assumed that Porter intended to move under section 507(a)(7). Nittany Enters., 502 B.R. at 450 n.1.

establish an expectation that the membership fee would be refunded.[76] Second, once Porter paid the initial $500, he was vested with full membership even before paying the remaining fee.[77] The court noted that the temporal relationship between the when consideration is given and when the right to use or possess is vested is critical.[78] Here, Porter had full membership rights once he signed the Membership Agreement and paid the initial fee.[79] Accordingly, he had no deposit under section 507(a)(7) and his claim was relegated to a general unsecured claim.[80]

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 units for seven categories of prepetition tax and custom duty obligations.[81] These categories are: (A) taxes measured by income or gross receipts; (B) property taxes; (C) trust fund taxes;[82] (D) employment taxes; (E) excise taxes; (F) custom duties; and (G) tax or custom penalties arising from an actual pecuniary loss.[83] Congress first recognized a priority for prepetition taxes when it enacted the Bankruptcy Act of 1898.[84]

The terms "tax" and "custom duties" are not defined by section

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[75]Nittany Enters., 502 B.R. at 451. The Chapter 7 trustee objected on multiple grounds; however, for brevity, the nonpriority discussion is omitted.

[76]Nittany Enters., 502 B.R. at 455.

[77]Nittany Enters., 502 B.R. at 455–56.

[78]Nittany Enters., 502 B.R. at 455.

[79]Nittany Enters., 502 B.R. at 456.

[80]Nittany Enters., 502 B.R. at 456.

[81]11 U.S.C.A. § 507(a)(8); s*ee also* 11 U.S.C.A. § 101(27) (defining "governmental unit").

[82]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;" however, courts 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).

[83]11 U.S.C.A. § 507(a)(8).

[84]*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

101.[85] 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."[86] In *U.S. v. Reorganized CF & I Fabricators of Utah, Inc.*, the U.S. 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 a priority under section 507(a).[87] 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 imposed by statute as punishment for an unlawful act."[88]

A tax that is given priority under section 507 is also excepted from discharge under section 523(a)(1).[89] As noted in section I of this chapter, section 507(c) accords priority status to erroneous refunds of a governmental unit under section 507(a)(8).[90]

In re Whitson

In *In re Whitson*, the bankruptcy court for the Eastern District of Tennessee considered whether a refund arising from the debtor's erroneous claims to public assistance credits entitled the Internal Revenue Service (the "IRS") to a priority claim under section 507(a)(8) and (c).[91] The debtor filed federal tax returns that claimed entitlement to the earned income tax credit ("EITC") and the additional child tax credit ("CTC").[92] As a result of these claimed entitlements, the IRS issued a tax refund to the debtor, but later determined that the debtor was not entitled to claim

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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).

[85]*See* 11 U.S.C.A. § 101.

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

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

[88]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).

[89]11 U.S.C.A. § 523(a)(1); *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), judgment rev'd, 253 B.R. 570, 44 Collier Bankr. Cas. 2d (MB) 1812 (M.D. Ala. 2000).

[90]11 U.S.C.A. § 507(c); Old Carco LLC, 451 B.R. at 114.

[91]*In re Whitson*, 2013-2 U.S. Tax Cas. (CCH) P 50583, 112 A.F.T.R.2d 2013-6838, 2013 WL 5965745, *1 (Bankr. E.D. Tenn. 2013).

[92]Whitson, 2013 WL 5965745 at *1.

the tax credits.[93] The IRS subsequently issued a Notice of Deficiency that informed the debtor of the tax liability.[94] An assessment was later carried out by the IRS on this debt within 240 days of the bankruptcy petition.[95] The IRS filed a proof of claim asserting that the erroneous refund related to a tax and therefore was entitled to priority under section 507(a)(8) and (c).[96] The debtor objected to the proof of claim on the ground that the IRS was attempting to recover an erroneously paid public assistance benefit rather than an erroneously refunded tax credit.[97]

The bankruptcy court, in examining the issue, acknowledged that EITC and CTC were created by the Internal Revenue Code to provide assistance to low income taxpayers.[98] The bankruptcy court, however, rejected the debtor's attempt to characterize the tax credits as anything other than taxes or relating to taxes.[99] A tax credit's status as a public assistance benefit did not alter its status as a tax or related to a tax.[100]

In overruling the debtor's objection, the bankruptcy court was persuaded by both Internal Revenue Code sections and bankruptcy and nonbankruptcy cases in deeming the tax credits as taxes or relating to taxes.[101] First, two provisions of the Internal Revenue Code provide that deficiencies or erroneous tax refunds are taxes imposed by Title 26.[102] Moreover, the U.S. Tax Court in *Forrester v. Commissioner of Internal Revenue*,[103] a nonbankruptcy proceeding, sustained the IRS's determination of a tax deficiency arising from an erroneous EITC claim.[104] Furthermore, in *U.S. v. Frontone*,[105] the Seventh Circuit reversed and remanded the decision of the bankruptcy court that found that an erroneous

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[93]Whitson, 2013 WL 5965745 at *1.

[94]Whitson, 2013 WL 5965745 at *1.

[95]Whitson, 2013 WL 5965745 at *1.

[96]Whitson, 2013 WL 5965745 at *1.

[97]Whitson, 2013 WL 5965745 at *1.

[98]Whitson, 2013 WL 5965745 at *4.

[99]Whitson, 2013 WL 5965745 at *4.

[100]Whitson, 2013 WL 5965745 at *4 ("The two categories are not mutually exclusive . . ..").

[101]Whitson, 2013 WL 5965745 at *5–7.

[102]Whitson, 2013 WL 5965745 at *5.

[103]*Forrester v. Comm of Internal Revenue*, 80 T.C.M. (CCH) 559, at *2 (2000).

[104]Whitson, 2013 WL 5965745 at *5.

[105]*U.S. v. Frontone*, 383 F.3d 656, 52 Collier Bankr. Cas. 2d (MB) 1683, 94 A.F.T.R.2d 2004-5853 (7th Cir. 2004).

tax refund was dischargeable.[106] The Seventh Circuit held that where the erroneous refund was not related to the IRS's error, the tax was not dischargeable.[107] Similar to *Frontone*, the bankruptcy court determined that, due to the debtor's error, the IRS proofs of claims were entitled to priority status under section 507(a)(8) and (c).[108]

In re Community Memorial Hospital

In *In re Community Memorial Hospital*, the bankruptcy court for the Eastern District of Michigan considered whether a government agency was entitled to priority under section 507(a)(8) for an employment reimbursement owed by the debtor.[109] In this Chapter 11 case, the debtor, a non-for-profit, sold substantially all of its assets shortly after the commencement of the case.[110] Some, but not all of the debtor's employees were hired by the purchaser.[111] The remaining employees were laid off and thereafter certain of those former employees sought unemployment benefits from the Michigan Unemployment Insurance Agency (the "MUIA").[112] The MUIA filed two proofs of claim that asserted priority status under section 507(a)(8) for the payments made to the debtor's former employees.[113] In support, the MUIA argued that its reimbursement claims were exactions constituting an excise tax.[114] The debtor objected to the proofs on claim on the grounds that MUIA was not entitled to a priority status.[115]

In adjudicating these claims, the bankruptcy court conducted a comprehensive analysis of precedent concerning priority tax treatment. The court first examined two Sixth Circuit decisions that considered whether Ohio was entitled to priority claims for paying the worker's compensation benefits owed by debtor.[116] In *Yoder v. Ohio Bureau of Workers' Compensation (In re Suburban*

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[106]Whitson, 2013 WL 5965745 at *6.

[107]Whitson, 2013 WL 5965745 at *6.

[108]Whitson, 2013 WL 5965745 at *7.

[109]*In re Community Memorial Hosp.*, 494 B.R. 906, 909 (Bankr. E.D. Mich. 2013).

[110]Cmty. Mem'l Hosp., 494 B.R. at 909.

[111]Cmty. Mem'l Hosp., 494 B.R. at 909.

[112]Cmty. Mem'l Hosp., 494 B.R. at 909.

[113]Cmty. Mem'l Hosp., 494 B.R. at 906.

[114]Cmty. Mem'l Hosp., 494 B.R. at 909.

[115]Cmty. Mem'l Hosp., 494 B.R. at 909.

[116]Cmty. Mem'l Hosp., 494 B.R. at 909.

Motor Freight, Inc.) ("Suburban I"),[117] the Sixth Circuit adopted a four-part test for determining whether a workers' compensation claim constituted a tax for priority purposes: i) whether the exaction was an involuntary burden; ii) imposed by a legislature; iii) for a public purpose; and iv) under the taxing and spending power of the state.[118] In *Suburban I*, the Sixth Circuit, in applying the above elements, determined that unpaid worker's premiums were taxes for bankruptcy purposes.[119]

In a subsequent case by the Sixth Circuit, *Yoder v. Ohio Bureau of Workers' Compensation (In re Suburban Motor Freight, Inc.) ("Suburban II")*,[120] the Sixth Circuit enunciated two additional elements for determining whether reimbursement of workers' compensation claims were taxes: i) that the pecuniary obligations be universally applicable to similarly situated entities and ii) that according priority treatment would not disadvantage private creditors with similar claims.[121] Ultimately, the Sixth Circuit held that the workers' compensation reimbursement claims were not taxes because the facts showed that Ohio failed both additional elements.[122]

In re Community Memorial Hospital, the bankruptcy court, in determining that workers' compensation reimbursement was analogous to the unemployment reimbursement at issue, adopted the elements set forth in *Suburban I* and *Suburban II*.[123] The MUIA failed one element of these tests because there existed the possibility that private creditors would be disadvantaged as they could not assert priority claims under the definition of section 507(a)(8).[124] The bankruptcy court also found persuasive authority from the First and Third Circuits and the BAP for the Sixth Circuit, which each affirmed bankruptcy courts that rejected attempts to characterize unemployment reimbursement obligations

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[117]*In re Suburban Motor Freight, Inc.*, 998 F.2d 338, 24 Bankr. Ct. Dec. (CRR) 750, 29 Collier Bankr. Cas. 2d (MB) 217, Bankr. L. Rep. (CCH) P 75332 (6th Cir. 1993).

[118]Cmty. Mem'l. Hosp., 494 B.R. at 910.

[119]Cmty. Mem'l. Hosp., 494 B.R. at 910.

[120]*In re Suburban Motor Freight, Inc.*, 36 F.3d 484, 26 Bankr. Ct. Dec. (CRR) 56, 31 Collier Bankr. Cas. 2d (MB) 1539, Bankr. L. Rep. (CCH) P 76100, 1994 FED App. 0331P (6th Cir. 1994).

[121]Cmty. Mem'l. Hosp., 494 B.R. at 910.

[122]Cmty. Mem'l. Hosp., 494 B.R. at 910.

[123]Cmty. Mem'l. Hosp., 494 B.R. at 915.

[124]Cmty. Mem'l. Hosp., 494 B.R. at 915.

as taxes for priority treatment.[125] Accordingly, the bankruptcy court sustained the debtor's objections that the reimbursement claims were not priority claims under section 507(a)(8).[126]

In re Towler

At issue before the bankruptcy court for the District of Colorado in *In re Towler* was whether an overpayment of unemployment benefits was entitled to priority under section 507(a)(8).[127] In *Towler*, the debtor filed a Chapter 13 plan seeking to categorize a nondischargeable debt owed to the State of Colorado as a priority claim pursuant to section 507(a)(8) on the grounds that it was an employment tax, an excise tax, or a tax penalty.[128] The debt to Colorado arose from the debtor's failure to disclose certain part-time work while receiving state unemployment benefits.[129] Under a Colorado statute, the debtor was required to repay the overpayment, and, because Colorado determined that the nondisclosure was willful, pay a 50% penalty of the overpayment amount.[130] The Chapter 13 trustee objected to the plan because of the debtor's proposed preferential treatment of this nondischargeable debt.[131]

Applying the functional approach enunciated in *CF & I Fabricators*, the bankruptcy court reviewed the language of the Colorado statute both requiring repayment of the benefits received and assessing a 50% penalty.[132] As to both, the bankruptcy court determined that the charges were punitive in nature because they were not exacted on an individual to fund the cost of the

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[125]Cmty. Mem'l. Hosp., 494 B.R. at 915 (citing *In re Boston Regional Medical Center, Inc.*, 291 F.3d 111, 39 Bankr. Ct. Dec. (CRR) 187, Bankr. L. Rep. (CCH) P 78669 (1st Cir. 2002); *In re United Healthcare System, Inc.*, 396 F.3d 247, 44 Bankr. Ct. Dec. (CRR) 56, Bankr. L. Rep. (CCH) P 80228, Unempl. Ins. Rep. (CCH) P 22331, 95 A.F.T.R.2d 2005-703 (3d Cir. 2005); *In re Albion Health Services*, 339 B.R. 171, 46 Bankr. Ct. Dec. (CRR) 76, Unempl. Ins. Rep. (CCH) P 22354 (Bankr. W.D. Mich. 2006), decision aff'd, 360 B.R. 599, Unempl. Ins. Rep. (CCH) P 22360, 2007 FED App. 0004P (B.A.P. 6th Cir. 2007).

[126]Cmty. Mem'l. Hosp., 494 B.R. at 918.

[127]*In re Towler*, 493 B.R. 239, 242 (Bankr. D. Colo. 2013).

[128]Towler, 493 B.R. at 241.

[129]Towler, 493 B.R. at 241.

[130]Towler, 493 B.R. at 242–43.

[131]Towler, 493 B.R. at 241.

[132]Towler, 493 B.R. at 243.

government generally.[133] Rather, the bankruptcy court noted, unemployment benefits in Colorado are raised from employer premiums and state and federal funds and not from individuals.[134] As a result, the debt owed to Colorado did not arise from a tax or penalty from a tax, and accordingly, was not entitled to priority under Section 507(a)(8).[135]

VI. SECTION 507(A)(9)—CLAIMS BASED ON COMMITMENT TO A FEDERAL DEPOSITORY INSTITUTIONS REGULATORY AGENCY

Section 507(a)(9) provides a ninth priority to unsecured claims based upon a debtor's commitment to a federal depository institutions regulatory agency (or predecessor agency) to maintain the capital of an insured depository institution.[136] The term "federal depository institutions regulatory agency" includes the Federal Reserve Board, the National Credit Union Administration, Federal Deposit Insurance Corporation, and the Resolution Trust Corporation.[137]

Although the Bankruptcy Code does not define the term "commitment," it has been defined as "an agreement or pledge that the parties to the transaction intended to be binding and enforceable."[138] In this respect, it broadly encompasses "any commitment."[139]

Congress originally set forth an eighth priority for these commitments with its enactment of the Crime Control Act of 1990; however, it downgraded this type of claim to its current ninth

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[133]Towler, 493 B.R. at 243.

[134]Towler, 493 B.R. at 243.

[135]Towler, 493 B.R. at 243. The bankruptcy court ultimately denied the Chapter 13 plan on the ground that it unfairly discriminated against unsecured creditors; however, this discussion is omitted. *See* Towler, 493 B.R. at 244–248.

[136]11 U.S.C.A. § 507(a)(9).

[137]*See* 11 U.S.C.A. § 101(21B); *In re Vineyard Nat. Bancorp*, 69 Collier Bankr. Cas. 2d (MB) 1162, 2013 WL 1867986, *2 n.1 (Bankr. C.D. Cal. 2013); *see also* 11 U.S.C.A. § 101(35) (defining "insured depository institution").

[138]Vineyard, 2013 WL 1867986 at *3; *see also In re Firstcorp, Inc.*, 973 F.2d 243, 247, 23 Bankr. Ct. Dec. (CRR) 483, Bankr. L. Rep. (CCH) P 74802 (4th Cir. 1992) ("Although the term is defined in neither § 365(o) nor its legislative history, the common definition of commitment is '[a]greement or pledge to do something . . ..' ") (citing *Black's Law Dictionary* 248 (5th ed. 1979)).

[139]*See* Vineyard, 2013 WL 1867986 at *2 ("The commitment can be any commitment.") (internal quotations omitted).

priority under the Bankruptcy Reform Act of 1994.[140] It is important to note the interplay between section 507(a)(9) and two other Bankruptcy Code provisions. First, in Chapter 11 cases, section 365(o), prevents the trustee (or debtor-in-possession) from evading any commitments to a federal depository institutions regulatory agency to maintain capital reserve requirements.[141] The trustee or debtor-in-possession, under section 365(o), must "immediately cure" any such deficit or risk conversion to Chapter 7.[142] A breach of a commitment results in a claim pursuant to section 509(a)(9).[143]

Second, section 523(a)(12), closely paralleling the language of section 507(a)(9), exempts from discharge any "malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution."[144] In contrast to section 523(a)(12), a federal depository institutions regulatory agency does not need to demonstrate the requisite intent to assert a priority claim pursuant to section 507(a)(9).[145]

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[140]*See* Pub. L. No. 101-647; Pub. L. No. 103-394.

[141]Firstcorp, 973 F.2d at 246.

[142]11 U.S.C.A. § 365(o); *see also* Firstcorp, 973 F.2d at 247 ("If a debtor cannot 'immediately' cure a deficit under a capital maintenance commitment that exists at the time of a bankruptcy filing, then § 365(o) requires that debtor to proceed not under Chapter 11 but under Chapter 7, to which § 365(o) does not apply.")

[143]*See In re Colonial BancGroup, Inc.*, 436 B.R. 713, 738 n.24 (Bankr. M.D. Ala. 2010) ("The court is not holding that, because the bank closed, there can be no claim for any prepetition breach of an enforceable commitment. The court is holding merely that section 365(o) does not apply to such commitments, and any claim for a prepetition breach must be addressed through 11 U.S.C. § 507(a)(9).").

[144]11 U.S.C.A. § 523(a)(12). The use of "malicious" and "reckless" under Section 523(a)(12) appears to arise from a conscious disregard for the harm or from negligence. *See First Weber Group, Inc. v. Horsfall*, 738 F.3d 767, 774, 58 Bankr. Ct. Dec. (CRR) 242, Bankr. L. Rep. (CCH) P 82565 (7th Cir. 2013) (defining "maliciousness, which requires that the debtor acted in conscious disregard of [his] duties or without just cause or excuse; it does not require ill-will or specific intent to do harm" in the context of a Section 523(a)(6) action) (internal quotation omitted); *Kawaauhau v. Geiger*, 523 U.S. 57, 61, 118 S. Ct. 974, 140 L. Ed. 2d 90, 32 Bankr. Ct. Dec. (CRR) 240, 38 Collier Bankr. Cas. 2d (MB) 1629, Bankr. L. Rep. (CCH) P 77643 (1998) (distinguishing "intentional" acts from "negligent or reckless" acts in the context of a Section 523(a)(6) action).

[145]*See* 11 U.S.C.A. § 507.

Sharp v. Federal Deposit Insurance Corporation (In re Vineyard National Bancorp)

In *Sharp v. Federal Deposit Insurance Corporation (In re Vineyard National Bancorp)*, the bankruptcy court for the Central District of California considered whether a debtor's proposal to fund its subsidiary's capital maintenance obligation constituted a commitment under sections 507(a)(9) and 365(o).[146] In this Chapter 11 case, the Federal Deposit Insurance Corporation (the "FDIC"), in its capacity as receiver for the debtor, Vineyard National Bancorp, filed a proof of claim asserting a priority claim under section 507(a)(9).[147] The FDIC claimed that the debtor failed to comply with certain statutory requirements under 12 U.S.C.A. § 1831o, which required compliance with capital maintenance obligations and providing cash infusions to its subsidiary, Vineyard Bank, N.A. ("Vineyard Bank").[148] The FDIC also asserted that the debtor failed to satisfy certain binding commitments with the capital maintenance plans it proposed to government regulators.[149]

The FDIC argued that the commitment by the debtor arose when the debtor entered into an agreement (the "Written Agreement") with the Federal Reserve Board to submit "an acceptable written plan to maintain sufficient capital position at the consolidated organization and [Vineyard] Bank."[150] The debtor and Vineyard Bank subsequently submitted a memorandum and a "Capital Plan," which was contingent upon raising necessary capital, to government regulators that detailed how capital would be raised for Vineyard Bank to comply with capital ratio requirements.[151] The liquidating trustee of the confirmed Chapter 11 plan of reorganization moved to disallow the FDIC's claim through a motion for summary judgment.[152]

The bankruptcy court noted that pursuant to section 507(a)(9), the FDIC had the burden of demonstrating that the debtor had made a "commitment" to a "regulatory agency" to "maintain

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[146]Vineyard, 2013 WL 1867986 at *1.

[147]Vineyard, 2013 WL 1867986 at *2.

[148]Vineyard, 2013 WL 1867986 at *2.

[149]Vineyard, 2013 WL 1867986 at *2.

[150]Vineyard, 2013 WL 1867986 at *2.

[151]Vineyard, 2013 WL 1867986 at *3.

[152]Vineyard, 2013 WL 1867986 at *1.

capital of" Vineyard Bank.[153] The bankruptcy court noted that while the term "commitment" was not defined by the Bankruptcy Code, courts had interpreted it to mean an agreement or pledge.[154] The bankruptcy court first determined that the Written Agreement did not create a commitment by the debtor that implicated section 507(a)(9) or 365(o).[155] The Written Agreement only bound the debtor to submit a Capital Plan and it did not include a provision requiring the debtor to maintain Vineyard Bank's capital.[156] The Capital Plan, too, did not contain an enforceable commitment because such plans were contingent on raising the necessary capital and such contingency never arose.[157] Accordingly, the bankruptcy court found that the debtor had no obligation to "cure any deficit" under section 365(o) and that the FDIC was not entitled to a priority claim under section 507(a)(9).[158]

VII. SECTION 507(B)—SUPERPRIORITIES

Section 507(b) allows a "superpriority" administrative expense where adequate protection payments prove insufficient to compensate a secured creditor for the diminution of the value of its collateral.[159] "It is an attempt to codify a statutory fail-safe system in recognition of the ultimate reality that protection previously determined the 'indubitable equivalent' . . . may later prove inadequate."[160] Section 507(b) is designed "to fund claims arising from the inadequacy of adequate protection to fully compensate a

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[153]Vineyard, 2013 WL 1867986 at *2.

[154]Vineyard, 2013 WL 1867986 at *3; *see also Resolution Trust Corp. v. Firstcorp, Inc.*, 973 F.2d at 247.

[155]Vineyard, 2013 WL 1867986 at *2.

[156]Vineyard, 2013 WL 1867986 at *3.

[157]Vineyard, 2013 WL 1867986 at *4.

[158]Vineyard, 2013 WL 1867986 at *4.

[159]*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).

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

secured creditor for erosion in the value of its property interest during the course of a bankruptcy case."[161]

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).[162]

In re Genesis Press, Inc.

At issue in *In re Genesis Press, Inc.* was whether a lessor was entitled to a superpriority claim under section 507(b) when the debtor failed to make payments on the lease of property.[163] In this case, the debtor filed a Chapter 11 petition and retained leased equipment.[164] The debtor and the lessor drafted a settlement order whereby the debtor would, among other provisions, make monthly adequate protection payments and cure the post-petition arrearage.[165] The settlement order was not entered prior to the conversion of the case to Chapter 7.[166] The Chapter 7 trustee filed an objection when the lessor asserted a superpriority under section 507(b) for the postpetition lease payments.[167]

The bankruptcy court for the District of South Carolina determined that the lessor was not entitled to a superpriority claim for two reasons. First, citing the language of section 507(b), the bankruptcy court noted that the lessor was not a "holder of a claim secured by a lien on property of the debtor."[168] Only a secured creditor could assert a superpriority claim.[169] Second, the bankruptcy court found that, because the settlement order entitling the lessor to adequate protection payments was never

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

[162]*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).

[163]*In re Genesis Press, Inc.*, 2014 WL 25717, *2 (Bankr. D. S.C. 2014).

[164]Genesis Press, 2014 WL 25717 at *1.

[165]Genesis Press, 2014 WL 25717 at *1.

[166]Genesis Press, 2014 WL 25717 at *1.

[167]Genesis Press, 2014 WL 25717 at *2. The Chapter 7 trustee did not dispute the lessor's entitlement to an administrative expense, but did dispute the lessor's entitlement to a superpriority over other administrative creditors.

[168]Genesis Press, 2014 WL 25717 at *2.

[169]Genesis Press, 2014 WL 25717 at *2.

entered, the lessor was not entitled to adequate protection, which is required under section 507(b).[170] As a result, the lessor was not entitled to a superpriority administrative claim.[171]

In re Netal, Inc.

In *In re Netal, Inc.*, the BAP for the Eight Circuit considered whether the bankruptcy court for the District of Nebraska abused its discretion when it denied the IRS an opportunity to conduct discovery relating to its motion to approve a section 507(b) superpriority administrative expense.[172] During the Chapter 11 bankruptcy case, the IRS and the debtor entered into an agreement concerning cash collateral, which the IRS claimed was encumbered by a federal tax lien.[173] Pursuant to the cash collateral agreement, the IRS authorized the use of cash collateral in return for a replacement lien on postpetition cash collateral and entitlement to a superpriority administrative claim under section 507(b) if the lien was inadequate to protect against the diminution of the collateral.[174] After the case was converted to Chapter 7, the IRS filed a motion seeking approval of the superpriority administrative expense.[175] The union benefit plans covering the debtor's employees objected to the motion on the grounds that, under section 724(b), the payments owed to the benefit plans within 180 days of the bankruptcy filing had priority over the IRS claim.[176]

The bankruptcy court, adopting the position of another bankruptcy court in the Northern District of Illinois, in *In re Bino's*

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[170]Genesis Press, 2014 WL 25717 at *3.

[171]Genesis Press, 2014 WL 25717 at *3. The bankruptcy court, however, did grant an allowed administrative claim to the lessor under sections 503(b) and 365(d)(5).

[172]*In re Netal, Inc.*, 498 B.R. 225, 228, 58 Bankr. Ct. Dec. (CRR) 119 (B.A.P. 8th Cir. 2013).

[173]*In re Netal, Inc.*, 68 Collier Bankr. Cas. 2d (MB) 921, 2012 WL 4482800, *1 (Bankr. D. Neb. 2012), rev'd, 498 B.R. 225, 58 Bankr. Ct. Dec. (CRR) 119 (B.A.P. 8th Cir. 2013).

[174]Netal, 2012 WL 4482800 at *1.

[175]Netal, 2012 WL 4482800 at *1.

[176]Netal, 2012 WL 4482800 at *1. The Chapter 7 trustee also objected to the IRS motion; however, this objection was resolved when the IRS agreed to subordinate the superpriority claim below that of the Chapter 7 trustee's postconversion administrative and priority claims.

Inc.,[177] held that cash collateral agreements may not alter the priority scheme of section 724(b).[178] As a result, the bankruptcy court denied the IRS motion and subordinated its claim below the union benefit plans' claims.[179] The bankruptcy court also denied an IRS motion to conduct discovery and produce evidence relating to the section 507(b) that was filed shortly before the bankruptcy court adjudicated the section 507(b) claim.[180]

The IRS appealed the bankruptcy court's denial of the section 507(b) motion to the BAP.[181] At oral argument, the IRS conceded that the secured portion of its claim was subordinate to the other claims pursuant to section 724(b).[182] The IRS stated that it was asserting a superpriority claim pursuant to section 507(b) on the unsecured portion of the claim.[183] The BAP reversed and remanded the lower court's decision on the grounds that it abused its discretion when it ruled that section 724(b), which governs the order of distribution of interests subject to a lien, applied to the unsecured portion of the IRS claim.[184] The BAP further held that the bankruptcy court should have permitted the IRS to conduct discovery prior to its ruling on the section 507(b) claim to determine the amount of the IRS claim.[185]

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[177]*In re Bino's Inc.*, 182 B.R. 784, 27 Bankr. Ct. Dec. (CRR) 296, 33 Collier Bankr. Cas. 2d (MB) 749 (Bankr. N.D. Ill. 1995).

[178]Netal, 2012 WL 4482800 at *2.

[179]Netal, 2012 WL 4482800 at *2.

[180]*See* Netal, 498 B.R. at 226.

[181]Netal, 498 B.R. at 226.

[182]Netal, 498 B.R. at 228.

[183]Netal, 498 B.R. at 228.

[184]Netal, 498 B.R. at 228–29.

[185]Netal, 498 B.R. at 229.