UNITED STATES BANKRUPTCY COURT
DISTRICT OF ALASKA

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| In re<br><br>GOLD KING MINES, INC.,<br><br>Debtor(s) | Case No. 3-84-00175-HAR<br>In Chapter 7<br><br>AMENDED MEMORANDUM DECISION DISMISSING TRUSTEE'S § 502(d) DEFENSE TO PROOF OF CLAIM NOS. 41-45 [Atkinsons][1] |

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[1] This memorandum relates to a motion objecting to the Atkinsons' claims filed at Docket Entry 633, which the court has already ruled on at Docket Entry 648. This amendment is filed to correct an error where, in the original memorandum, the court referred to 11 USC § 726 at times, when it meant § 725.

1. INTRODUCTION- The Atkinsons[2] have filed secured claims based on judgment liens. They were for about $240,000 in 1984, but now total about $900,000 with interest. The trustee sold the estate's interest in mining claims free and clear of the Atkinsons judgment liens, which attached to the sale proceeds of about $678,000. Virtually all the cash held by the estate is from this sale.

The statute of limitations for preference actions to avoid the judgment liens has expired, but the trustee seeks to disallow any distribution to the Atkinsons unless they give up their judgment liens, arguing that the fact that the judgment liens are preferential under the Deprizio case can be used defensively.

The trustee contends that § 502(d)[3] requires the cancellation of the judgment liens as a condition to payment of the Atkinsons' as unsecured claimants. In other words, the trustee is willing to pay the Atkinsons the $240,000 as a general unsecured claim, without the postpetition interest, but only if they give up their judgment liens. Without § 502(d), these judgment liens would be paid $678,000, less any surcharges for preserving and disposing of the mining claims under § 506(c).[4] If they refuse to give up their judgment liens, the trustee says the paradoxical result is that the Atkinsons get nothing.

Whether the secured claims are allowed or disallowed is superfluous, since the judgment liens must be paid from the cash proceeds under § 725[5] without regard to allowance of the secured claims.

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[2] For simplicity, the various claims will be subsumed under the name "Atkinson," but they are variously held by George E. Atkinson, Jr., James P. Atkinson, and A&G Construction Co., Inc.

[3] 11 USC § 502(d).

[4] 11 USC § 506(c).

[5] 11 USC § 725.

2. BACKGROUND- This 20year old bankruptcy case was wending its way to final distribution, when, as has often happened, it took a bizarre turn. Although a 20 year old bankruptcy case might seem to be evidence of the inefficiency of the bankruptcy system or courts, the delays in this case were largely beyond the trustee's and court's control and the trustee, in fact, has been exceptionally diligent and creative in finally liquidating the mining claims, the major asset of the estate.

The mining claims in Denali National Park were finally sold for $1,000,000 to the federal government in a sale approved in July 2002. The co-owners of the claims were paid, and the estate's share of the sale price is about $678,000. At the time of the sale, the mining claims were encumbered by the Atkinsons judgment liens. The Atkinsons had filed timely secured claims in this case for about $240,000,[6] but the this claims has increased to about $900,000 due to interest.[7]

The sale was free and clear of the Atkinsons' judgment liens, with their liens to attach to the proceeds. The Atkinsons supported the sale. It was anticipated at the time of the sale that all of the proceeds would go to the Atkinsons to pay their secured claims (or judgment liens), net of the administrative expenses allowable as surcharges under § 506(c). These surcharges are largely composed of the trustees' attorney fees. The administrative expenses claimed for trustees' fees, trustees' attorney fees, and accounting fees were about $427,000.[8] This would have left the Atkinsons with only about $252,000.

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[6] Amended Proofs of Claim Nos. 41-45, filed on February 23, 1999.

[7] See , the memorandum and order resolving the surcharge issue filed on September 27, 2004, at Docket Entries 5118 and 5120.

[8] Id.

The Atkinsons sought to limit the large bite of the trustees' attorney fees under § 506(c) by arguing most of them were not reasonable, necessary and beneficial to them.[9] Out of the blue, the trustee moved to disallow the Atkinsons' secured claims under the Deprizio[10] doctrine, which has been adopted by the 9th Circuit in In re Sufolla,[11] He sought to use Diprizio in combination with 11 USC § 502(d), which provides that a trustee does not have to pay a dividend to a claimant who has received a preference from the debtor, unless the claimant has first repaid the amount of the preference or transferred the property back to the trustee.

The practical effect of the trustee's argument is to relegate the Atkinsons to unsecured creditor status. In other words, the trustees seek to allow the Atkinson claims as unsecured at about $240,000, avoiding the payment of any of the postpetition interest which has accrued over the years.

The Atkinsons were irate at this blind-side attack, and filed a brief to show that the trustee could never have proved a preference in the first place due to the solvency of the debtor at the time of the transfers.[12] The trustee responded that the solvency issue is more convoluted and closer than the Atkinsons conceded. At a hearing on June 20, 2003, the court determined that the solvency issue could not be determined without an evidentiary determination.

The court was nonetheless troubled by the trustee's argument, feeling that this was not a typical § 502(d) case. Upon further reflection after the June 20th hearing, the court

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[9] Atkinson's Opposition to Trustee's Motion to Recover Under 506(c), Docket Entry 629.

[10] Levit v Ingersoll Rand Financial Corp. (In re V.n. Deprizio Construction Co.), 874 F2d 1186 (7th Cir 1989).

[11] In re Sufolla, Inc., 2 F3d 977 (9th Cir 1993).

[12] 11 USC § 547(b)(3).

determined that the silver bullet to kill the trustee's new § 502(d) argument was not a fact-intensive review of the debtor's solvency as proposed by the Atkinsons, but in the requirement that chapter 7 trustees pay secured liens under § 725,[13] without regard to § 502(d)[14] or the allowance or disallowance of secured claims in general.

The court has already entered an order denying the trustee's § 502(d) gambit,[15] but also indicated that a memorandum would be issued later explaining the rational. The delay in issuing this memorandum was for the specific purpose of insuring that the order would not be considered final[16] so that any appeal of the § 502(d) ruling could track an appeal of the order on the § 506(c) surcharge issue which was entered on September 27, 2004.[17]

3. ISSUES- Is the trustee entitled to a defense to the payment of the Atkinsons secured claims by virtue of 11 USC § 502(d)?

4. LEGAL ANALYSIS-

4.1. Deprizio (Sufolla)- The principal holding of 1989 Deprizio case in the 7th Circuit[18] was that payment made after 90 days, but within one year of the bankruptcy petition, to a non-insider creditor (a commercial bank) whose loan was guaranteed by an insider of the debtor (a principle shareholder of a corporate debtor), is a preference (if all the other conditions for a preference under § 547(b) were met). In such a case, a judgment for repayment could recovered under § 550(a) from the non-insider (the "outside" creditor).

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[13] 11 USC § 725.

[14] 11 USC § 502(d).

[15] Docket Entry 648.

[16] Cf, Wayne v Santa Clara Valley Transportation Authority, 98 Fed Appx578, 579 (9th Cir 2004), Docket Entry 651.

[17] Docket Entries 5118 and 5120.

[18] Levit v Ingersoll Rand Financial Corp. (In re V.n. Deprizio Construction Co.), 874 F2d 1186 (7th Cir 1989).

The outside creditor in Deprizio seemed relatively innocent and the recovery seemed somewhat unfair because there was no direct preference to outsider (the bank), but only to the insider guarantor (the shareholder).

Deprizio was quite a shock to the commercial lending community, especially when it was adopted by a number of other circuits, including the 9th Circuit.[19]

In the present case, the Atkinsons took judgments against both the debtor corporation and its principal shareholders, Eric and Paul Wieler. For the purposes of this memorandum, I will assume that this creates a tri-lateral Deprizio situation, since a judgement lien on the debtor's property is a transfer benefiting its insiders, Eric and Paul.[20]

4.2. The 1994 Amendment to Fix Deprizio Was Incomplete- Congress attempted to reverse the effect of Deprizio, but did not do an efficient job. Its method of fixing the situation was to modify 11 USC § 550(c) in the Bankruptcy Reform Act of 1994 to read:

> (c) If a transfer made between 90 days and one year before the filing of the petition -
>
> (1) is avoided under section 547(b) of this title; and
>
> (2) was made for the benefit of a creditor that at the time of such transfer was an insider;
>
> the trustee may not recover under subsection (a) from a transferee that is not an insider.

Thus, if the outsider bank received a preference under § 547(b), even though it benefitted an insider guarantor, the trustee could not recover damages because of the transfer made more than 90 days, but within a year of the petition date.

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[19] In re Sufolla, Inc., 2 F3d 977 (9th Cir 1993).

[20] In re Sevitski. 151 BR 590, 596 (Bankr ND Okla 1993); and, compare, In re Ishaq, 129 BR 206 (Bankr D Or 1991).

The statute left some loopholes, however. If a trustee did not have to resort to § 550 to "recover" the property or its equivalent in damages, but could accomplish the avoidance by merely getting a judgment under section § 547(b), than the 1994 amendment did not foreclose a Deprizio result.

Also, the 1994 amendment does not apply retroactively.[21] So, Deprizio may apply to the 1984 Gold King Mines case if the trustee can prove a case under § 547(b).

4.3. Even if Deprizio (Sufolla) is Applicable to This Case, Proving a Direct Preference is Time-Barred- The trustee cannot directly attack the judgment liens because the time to do so has long passed. The trustee had at most until the later of 2 years after the order for relief (1984) or the appointment of a chapter 7 trustee in October 1998, to file a preference action against the Atkinsons.[22] The statute may actually have run years before, 2 years after a debtor-in-possession first came into existence.[23]

4.4. A § 502(d) Defense is Valid Even If the Statute for A Direct Preference Action Has Run- Section 502(d)[24] provides:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

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[21] In re Whitacre Sunbelt, Inc., 206 BR 1010, 1016-17 (ND Ga 1997).

[22] 11 USC § 546(a)(1).

[23] In re Sahuaro Petroleum & Asphalt Co., 170 BR 689, 690-93 (CD Cal 19

[24] 11 USC § 502(d).

The trustee may utilize § 502(d) as a defense to a creditor's prepetition claims against the estate, even though the time to bring a preference action has expired.[25]

In American West Airlines,[26] a factually similar 9th Circuit chapter 11 case (as far as the facts are disclosed in the opinion), a creditor, the City of El Paso, filed a secured claim based on a tax lien which would have been avoidable under § 545(2),[27] had the debtor-in-possession brought an avoidance action within the statutory period. The DIP sought to disallow the El Paso secured claim on the basis of § 502(d), because the city refused to relinquish its liens.[28]

What is troubling about the analysis is the failure to discuss where this left El Paso – could it nonetheless enforce its lien rights, even with a disallowed claim? Nor are the facts adequately set forth to really know what happened to the parties. Was the property encumbered by the tax lien sold subject to the liens? If so, did the liens attach to the sale proceeds, as they did in the Gold King Mines case?

The trustee's argument in the Atknson situation is also shored up by another statute, 11 USC § 506(d), which say:

> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless–
>
> > (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
> >
> > (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

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[25] In re American West Airlines, Inc., 217 F3d 1161, 1167-68 (9th Cir 2000).

[26] Id.

[27] 11 USC § 545(2).

[28] Id, at 1168.

This could be read as saying where a claim is "disallowed" under § 502(d) because the claimant has not disgorged a preferential transfer, such disallowance makes the lien "void" under § 506(d).because the latter section has no specific exception for a § 502(d) disallowance.

4.5. Sec 725 Trumps §§ 502(d) and 506(d)- In my view, however, the trustee's victory under § 502(d) is of no consequence to the outcome in this case. We are talking about the right to a fund of cash derived from the sale of property subject to the Atkinsons' liens. Had the Atkinsons never filed proofs of claims, their liens would have "ridden through" the bankruptcy. If the trustee had abandoned the property, they would still be there. When the trustee sold the property, they attached to proceeds.

A chapter 7 trustee has the duty to liquidate the estate as promptly as the trustee reasonably can.[29] If the trustee does not disposed of property otherwise (such as by a sale or abandonment),[30] he/she must dispose of it under § 725.[31] Section 726(a),[32] which discusses distribution of the cash that the trustee receives is substantially devoid of any discussion about what to do about the secured claims.[33]

The bankruptcy court in In re Talbert[34] said:

> . . . the claims allowance procedure is meaningless in a Chapter 7 proceeding even if the trustee is disposing of property which is subject to a creditor's lien. While both practitioners and the courts are accustomed to describing parties who hold liens in the property owned by a Chapter 7 debtor as "secured creditors" and the debt secured by

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[29] 11 USC § 704(1).

[30] 11 USC § 554.

[31] 11 USC § 725.

[32] 11 USC § 726(a).

[33] 11 USC § 726(a)(4) does discuss secured claims for fines, penalties, and forfeitures.

[34] In re Talbert, 268 BR 811, 815-16 (Bankr WD Mich 2001).

> those liens as "secured claims," these labels are misleading. A Chapter 7 trustee does not make distributions to lien holders on account of an allowed secured claim which that lien holder may have against the estate. Section 726 is quite clear that distributions by the Chapter 7 trustee are generally to be limited to only creditors having an allowed priority or non-priority unsecured claims against the estate: [quoting § 726(a)].
>
> The visceral reaction to Section 726's clear language is that it is incorrect; that somewhere within this section or elsewhere within the Bankruptcy Code must lie a provision which provides for the allowance and payment of secured claims from property of the Chapter 7 estate. However, careful analysis of Chapter 7 reveals that the Chapter 7 trustee is not to deal with lien holders as creditors with claims against property of the estate but as competing interest holders who must be dealt with as the trustee liquidates the estate property for distribution to the debtor's unsecured creditors.

5. CONCLUSION- The trustee's request for disallowance of the Atkinsons' Proofs of Claim Nos. 41-45 pursuant to 11 USC § 502(d) will be denied by an order which has been filed separately at Docket Entry 648.

DATED: September 29, 2004

HERB ROSS
U.S. Bankruptcy Judge