UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF VIRGINIA
LYNCHBURG DIVISION

In re MINOR FAMILY HOTELS, LLC,	)	Case No. 10-62543-LYN
	)	
Debtor.	)	
	)	Chapter 11

MEMORANDUM AND ORDER

This matter comes before this Court on a motion by Minor Family Hotels, LLC, ("the Debtor") for an order permitting the distribution of $131,008.22 to its counsel from funds now held in trust by the Debtor. The motion will be granted in part and denied in part.

Specialty Finance Group, by oral motion, seeks an order directing that any such distribution be pro rata between the secured creditors. That motion will be denied.

Jurisdiction

This Court has jurisdiction over this matter. 28 U.S.C. § 1334(a) & 157(a). This proceeding is a core proceeding. 28 U.S.C. § 157(b)(2)(A). This Court may enter a final order. This

memorandum shall constitute the Court's findings of fact and conclusions of law as required by Fed. R. Civ. P. 52, which is made applicable in this proceeding by Fed. R. Bankr. P. 7052.

Facts

In 2005, Hotel Charlottesville, LLC, ("the Developer") began a project ("the Project") to build a hotel ("the Hotel Property") on the downtown mall in Charlottesville, Virginia. The Hotel Property consists of both land ("the Project Land") and improvements ("the Project Improvements"). Halsey Minor is the sole owner of the Debtor. Mr. Minor and the Debtor (collectively "the Owners") provided equity in the approximate amount of $7,000.000.00 to partially finance the project. In March of 2008, Specialty Finance Group ("SFG") agreed to loan the Debtor $23.69 million to fund the balance of the Project.

A dispute occurred between the Owners and SFG causing work on the Project to cease. Litigation ensued that eventually included the Owners, SFG, the Developer, Clancy and Theys Construction Company ("the Clancy & Theys")[1], and numerous sub-contractors, including R. D. Jones[2], Southern Air, Inc. ("Southern Air")[3], Capital Interior Contractors, Inc. ("Capital Interior")[4], Century Concrete, Inc. ("Century Concrete")[5], and Bat Masonry Company, Inc. ("Bat Masonry")[6]. Clancy & Theys and the subcontractors are referred to herein as "the Mechanic's

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[1] Clancy & Theys has filed a proof of secured claim in the amount of $2,169,776.22, and a proof of unsecured claim in the amount of $443,423.49. The total amount of the claim is $2,613,199.71.

[2] R. D. Jones has filed a secured proof of claim for $176,550.14.

[3] Southern Air has filed a secured proof of claim for $355,810.00.

[4] Capital Interior has filed a secured proof of claim for $355,810.00.

[5] Century Concrete has filed a secured proof of claim for $474,180.56.

[6] Bat Masonry has filed a proof of secured claim in the amount of $124,005.50.

Lien Holders".

On September 1, 2010, the Debtor filed a petition in bankruptcy initiating the above-styled case. The Court approved the employment of Woods Rogers PLC ("Woods Rogers") as counsel for the Debtor.

The partially completed Hotel Property sold at auction for $6,250,000.00. The Debtor now holds $6,089,100.34 ("the Escrow Funds") in escrow from the sale of the Hotel Property. At the hearing on this matter, it was represented by the parties that SFG holds a claim against the Debtor in the approximate amount of $16,000,000.00, that Clancy & Theys holds a claim against the Debtor in the approximate amount of $2,700,000.00, and that R. D. Jones holds a claim against the Debtor in the approximate amount of $200,000.00[7]. All of these claims were secured by the Hotel Property and are now secured by the Escrow Funds.

The Circuit Court for the City of Charlottesville ("the Circuit Court") ruled concerning the priority of the claims of the Mechanic's Lien Holders and SFG. A copy of that ruling has not been offered as evidence in this bankruptcy case. It appears from references made at the hearing on this matter that the Circuit Court ruled that the Mechanic's Lien Holders were held to have a first priority claim on both the Project Land and the Project Improvements ("the Circuit Court Ruling"). SFG, however, has appealed the Circuit Court Ruling to the Supreme Court of Virginia. The Debtor now holds the Escrow Funds pending the appeal of the Circuit Court Ruling by the Supreme Court of Virginia.

On September 17, 2012, the Debtor filed a Fourth Application for Compensation for Woods Rogers in the amount of $46,205.12. The motion was granted. On September 19, 2012,

[7] The exact amount of these claims is not relevant to the resolution of the matter before the Court.

the Debtor filed a Motion for Distribution that sought an order permitting the Debtor to pay Woods Rogers from the Escrow Funds. Woods Rogers' total fees and costs through the Fourth Application was $131,008.22.

Clancy & Theys filed an opposition to the Motion for Distribution. The opposition was joined by SFG and subcontractors R. D. Jones and Associates, Inc., Southern Air, Inc., Century Concrete, Inc., and Bat Masonry Company.

Discussion

There are two issues before the court. The first concerns whether the Debtor may be reimbursed for any of Woods Rogers' fees and costs from the Escrow Funds. The second concerns whether any such distribution should be paid pro rata by SFG and the Mechanic's Lien Holders.

I.

The Debtor seeks to pay Woods Rogers from the Escrow Funds. Such a motion is properly brought under 11 U.S.C. § 506(c) which provides:

> (c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.

As debtor-in-possession, the Debtor has all of the rights of a Chapter 11 trustee, with certain exceptions not relevant here. *See* 11 U.S.C. § 1107(a). Included in those rights is the right to recover property securing allowed secured claims under Section 506(c).

The burden of proving entitlement to recover under Section 506(c) is on the trustee, *In re Modica*, 55 B.R. 605 (Bankr. W.D.Va. 1985), or debtor-in-possession. *See, e.g. In re Settles*, 75 B.R. 229 (Bankr. D.C.Ill. 1987).

Section 506(c) requires the Debtor to prove two elements. First, the expenses must be reasonable. The Court has previously approved counsel's application for fees and expenses. In doing so, the Court held that the fees were reasonable.

The second element that must be proved by the Debtor is that the incurred expenses were necessary to preserve or dispose of the creditor's collateral. One United States District Court has summarized this element under Section 506(c) as follows.

> Section 506(c) narrowly confines recovery to the extent of any benefit to the secured creditor. To recover, the debtor-in-possession must expend the funds primarily to benefit the creditor, who must in fact directly benefit from the expenditure. *In re Sonoma V*, 24 B.R. 600 (Bkrtcy.App. 9th Cir.1982). Expenses undertaken to improve the position of the debtor-in-possession, although indirectly benefit[t]ing the creditor, are not recoverable. *In re Codesco, Inc*., 18 B.R. 225 (Bkrtcy.S.D.N.Y.1982). Several courts require the debtor-in-possession or trustee to establish a quantifiable, rather than qualitative or speculative, benefit. *See, e.g., In re Flagstaff Foodservice Corporation*, 29 B.R. 215 (Bkrtcy.S.D.N.Y.1983). In sum, courts construing 506(c) appear to require the debtor-in-possession, who bears the burden of proving benefit, to show that absent the costs expended the property would yield less to the creditor than it does as a result of the expenditure, although the provision does not expressly impose such a requirement. *Dozoryst v. First Financial Savings and Loan of Downers Grove*, 21 B.R. 392 (D.C.N.D.Ill.1982).

Brookfield Production Credit Ass'n v. Borron, 36 B.R. 445 (Mo. 1983), *aff'd, Brookfield Production Credit Ass'n v. Borron*, 738 F.2d 951 (8th Cir. 1984). To summarize, the expenditure must have been made primarily to benefit the creditor and must, in fact, have directly benefitted the creditor. Expenditures undertaken to benefit the debtor-in-possession are not recoverable even if they indirectly benefit the creditor.

The Debtor has separated the services rendered by counsel into eight categories: (1) Case Administration; (2) General Case Work; (3) Mechanic's lien litigation; (4)Response to Motion for Relief by SFG; (5) Plan Formation; (6) Sale of the Hotel Property; (7) Insurance; and (8) Costs.

The expenses incurred in selling the Hotel Property directly concern the disposition of an asset of the estate that is collateral of secured creditors.[8] Those expenses directly benefitted the creditors whose claims were secured by the Hotel Property. They are properly paid for from the sale proceeds of the Hotel Property under Section 506(c). The expenses incurred in insuring the Hotel Property directly concern the preservation of an asset of the estate that is collateral of secured creditors. Those expenses directly benefitted the creditors whose claims were secured by the Hotel Property. They are properly paid for from the sale proceeds of the Hotel Property under Section 506(c).

The Debtor argues that the work on plan formation was integral in keeping prospective buyers interested in the Hotel Property. The conclusion is not supported by reason. Any party interested in the Hotel Property would have been so because of the nature of that property, not because the Debtor was engaged in formulating a plan to sell it. Further, the plan formation did not contribute to the marketing of the property. The plan formation did not confer a benefit on the Secured Creditors.

The expenses incurred for Case Administration, General Case Work, the Mechanic's Lien Litigation, and the Response to Motion for Relief by SFG were incurred primarily, if not wholly, for the benefit of the Debtor. They did not benefit the secured creditors. To the extent that they may have benefitted the secured creditors, they did so remotely and only incidentally to the goals of the Debtor.

Finally, some of the costs incurred by the Debtor may have been incurred in selling and insuring the Hotel Property. The Debtor, however, has failed to demonstrate that such is the

[8] Neither Clancy & Theys nor R. D. Jones nor SFG objects to the payment of the services rendered in selling the Hotel Property from the Escrow Funds.

case.

II.

The second issue concerns whether the above distribution should be paid pro rata from the claims of secured creditors. This issue was raised in the first instance by SFG on an oral motion at the hearing on this matter. The Circuit Court ruled that the Mechanic's Lien Holders have a first priority lien on both the Project Land and the Project Improvements. SFG argues that if the Circuit Court Ruling is upheld by the Supreme Court, SFG would be paid from the Escrow Funds only after the Debtor were paid any allowed surcharge and after the Mechanic's Lien Holders were paid in full. This order of distribution would cause SFG to ultimately bear the full burden of any surcharge payment made to the Debtor from the Escrow Funds. SFG argues that requiring SFG to bear the full burden of any surcharge would be unfair and that this Court should declare that the burden of any surcharge should be borne pro rata by SFG and the Mechanic's Lien Holders.

While the Circuit Court Ruling is not final for purposes of distribution and the amounts of the claims of the mechanic's lien holders may not have been finally resolved, the issue of whether the burden of the surcharge should be borne on a pro rata basis is matter of law, not fact. Consequently, it may be considered at this time. SFG argues that it would be unfair to require it to bear the burden of the surcharge alone. It argues that there is nothing in Section 506(c) that prohibits a pro rata distribution and that this Court may impose the same under Section 105(a). SFG cites no statute or opinion that would allow such a pro rata distribution. Without such a basis in law, Section 105(a) cannot be applied to render the relief requested.

Further, the leading treatise on bankruptcy has concluded that such a pro rata distribution

is not proper under the Bankruptcy Code.

> . . . [W][here the proceeds from the sale of collateral are more than sufficient to pay in full both the secured creditor's claim and the necessary expenses associated with preserving and disposing of the collateral, the proceeds should be used first to pay the relevant expenses; second to pay the creditor's secured claim; and thereafter to pay junior lienors (if any), with any residual amount going to the estate to pay other claims.

4 Collier on Bankruptcy, "Determination of Secured Status", ¶ 506.05[10] (16th ed. rev.) (Citing *In re West Post Road Props. Corp.*, 44 B.R. 244, 247 (Bankr. S.D.N.Y. 1984). In this case, SFG alleges facts under which the Mechanic's Lien Holders are the senior lienholders and the sale proceeds are more than sufficient to pay their claims and the surcharge. The payment scheme presented in Collier requires that payment be made first to the Debtor in the amount of it's surcharge for expenses as allowed above, and then to those creditors whose claims are secured by the Escrow Funds in the order determined under applicable law.

Conclusion

The expenses incurred for disposing of the Hotel Property ($48,033.00) and insuring the Hotel Property ($2,735.00) are properly payable from the Sale Proceeds. The motion for a pro rata application of the surcharge will be denied.

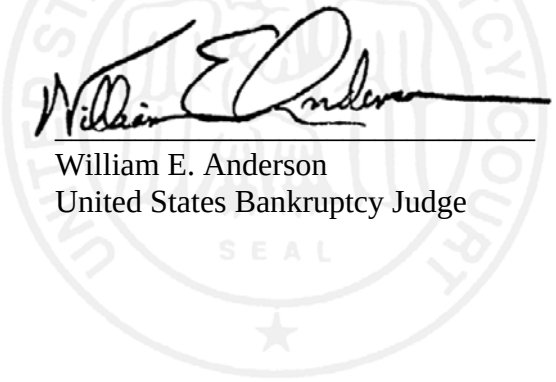
ORDER

For the reasons stated above, the Debtor's Motion for a distribution from the funds now held in escrow by the Debtor shall be, and hereby is, granted to the extent of $50,768.00. The Debtor may distribute this amount from the proceeds of the sale of the Hotel Property. The Debtor may distribute the Escrow Funds thereafter to claim holders in the order of priority when, and as, determined under applicable law.

So ORDERED.

Upon entry of this memorandum the Clerk shall forward copies of this memorandum and order to Craig B. Young, Esq., Richard Maxwell, Esq., William H. Schwarzchild, III, Esq., Nathaniel L. Story, Esq., William E. Schmidheiser, Esq., H. David Gibson, Esq., Dennis T. Lewandowski, Esq., John H. Maddock, III, Esq., and the United States trustee.

Entered on this 3rd day of December, 2012.



William E. Anderson
United States Bankruptcy Judge