

**UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE FIRST CIRCUIT**

BAP No. MW 00-104

**IN RE: TITAN INDUSTRIES, INC.,
Debtor.**

**BOSTON FINANCIAL CORPORATION,
Appellant,**

v.

**JOHN J. BUSH, JR. AND BRIAN C. BUSH,
Appellees.**

**Appeal from the United States Bankruptcy Court
for the District of Massachusetts
(Hon. Joel B. Rosenthal, U.S. Bankruptcy Judge)**

**Before
LAMOUTTE, VAUGHN, CARLO, U.S. Bankruptcy Appellate Panel Judges**

David M. Nickless and Nickless and Phillips, P.C., for the Appellant.

John J. Bush, Jr., for the Appellees.

June 29, 2001

Per curiam. Boston Financial Corp. (hereinafter "BFC") appeals from an order issued by the United States Bankruptcy Court for the District of Massachusetts (the "Bankruptcy Court") granting John Bush, Jr. and Brian C. Bush (hereinafter collectively referred to as "Bush") a security interest with first priority in an unfinished boat to the extent of \$32,000, allowing BFC a second priority security interest and Bush a third priority security interest for a prepetition debt. For the reasons set forth below, we reverse.

JURISDICTION AND STANDARD OF REVIEW

The Bankruptcy Appellate Panel has jurisdiction to review final decisions of the United States Bankruptcy Court pursuant to 28 U.S.C. §§ 158(a) and (b). The bankruptcy court's conclusions of law are reviewed de novo. Grella v. Salem Five Cent Savings Bank, 42 F.3d 26, 30 (1st Cir. 1994).

BACKGROUND

Titan Industries, Inc. (hereinafter "Titan") filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on May 20, 1999. Prior to Titan's filing, on November 21, 1997, BFC lent money to Titan and obtained a security interest in all of Titan's assets. On March 3, 1999 and April 5, 1999, Titan executed two promissory notes in favor of Bush. Bush recorded the financing statements obtaining a security interest in all of Titan's assets.

On June 1, 1999, after the filing of this bankruptcy petition, Titan filed a motion for authority to borrow on a secured and priority basis from Bush. The motion failed to

mention BFC's security interest in Titan's assets. The motion requested that Bush be granted priority pursuant to 11 U.S.C. §§ 503(b) and 507(a)(1). The motion also requested that Bush be granted a security interest pursuant to 11 U.S.C. § 364(c)(1). The motion did not request a lien superior to that of BFC pursuant to 11 U.S.C. § 364(d)(1).

By margin order entered on June 29, 1999, the Bankruptcy Court allowed the motion. Bush disbursed funds to Titan post-petition from June 7, 1999 to January 7, 2000. On May 17, 2000, the case was converted to Chapter 7.

Apparently, a dispute arose as to the relative priorities of the liens held by BFC and Bush. On July 6, 2000, BFC filed a motion to revoke the order authorizing superpriority borrowing or in the alternative to subordinate the Bush lien. On July 19, 2000, this motion was allowed. The Bankruptcy Court scheduled a hearing to consider the debtor's motion for authority to borrow.

On July 28, 2000, Bush filed a motion to reconsider the order revoking the approval of the motion to borrow and an objection to BFC's motion to revoke the order authorizing the borrowing. After a hearing, the court vacated its order granting BFC's motion to revoke the order authorizing the borrowing, restoring the status quo to June 29, 1999, and scheduled an evidentiary hearing. After the evidentiary hearing, the court issued a final order granting Bush a security interest with first priority to the extent of \$32,000, allowing BFC a second priority

security interest and Bush a third priority security interest for pre-petition debt.

DISCUSSION

If the trustee is unable to obtain unsecured credit as a priority, the Bankruptcy Code allows the creation of a lien on unencumbered property of the estate or a junior lien on property that is subject to a lien. See 11 U.S.C. §§ 364(c)(2) and 364(c)(3). However, to obtain a senior lien, the Code's requirements are more stringent. Section 364(d)(1) authorizes the obtaining of credit secured by a senior lien when the trustee is unable to obtain credit and there is adequate protection of the senior lien holder's interest in the property. See 11 U.S.C. § 364(d)(1).

As explained by one bankruptcy court,

Bankruptcy Code § 364 was structured with an escalating series of inducements which a debtor in possession may offer to attract credit in the post-petition period. First, creditors who are willing to extend unsecured credit in the ordinary course of business are offered the inducement of an administrative priority under 11 U.S.C. § 364(a). If a creditor is willing to extend unsecured credit, but not in the ordinary course of business, such credit may be authorized by the court, after notice and a hearing, pursuant to 11 U.S.C. § 364(b). If creditors are unwilling to extend unsecured credit to a debtor in possession, further inducements are offered, with court approval after notice and a hearing, including super priority administrative expenses under 11 U.S.C. § 364(c)(1); secured liens on unencumbered property pursuant to 11 U.S.C. § 364(c)(2); junior liens on encumbered property in accordance with 11 U.S.C. § 364(c)(3), or senior or equal liens pursuant to 11 U.S.C. § 364(d).

Sapir v. CPQ Colorchrome Corp. (In re Photo Promotion Associates, Inc.), 87 B.R. 835, 839 (Bankr. S.D.N.Y. 1988), *aff'd*, No. 88 Civ.

7015 (S.D.N.Y. Dec. 2, 1988), *aff'd*, 881 F.2d 6 (2nd Cir. 1989).

The Bankruptcy Code section governing superpriority liens provides:

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if-

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

11 U.S.C. § 364(d).

... The important question, in determination of whether the protection to a creditor's secured interest is adequate, is whether that interest, whatever it is, is being unjustifiably jeopardized. *In Re Aqua Associates*, 123 B.R. 192, 196 (Bkrtcy.E.D.Pa.1991) (citations omitted). *See also In Re Sky Valley, Inc.*, 100 B.R. 107, 113, 21 C.B.C.2d 1 (Bkrtcy.N.D.Ga.1988) (pursuant to § 364(d), Debtor must show (1) the Debtor is unable to obtain credit otherwise; and (2) the senior lienholder, which will be supplanted, or "primed," by the superpriority lienholder, is adequately protected).

In re Plabell Rubber Products, Inc., 137 B.R. 897, 899 (Bankr. N.D.Ohio 1992). The requirement of providing adequate protection cannot be circumvented. In re T.M. Sweeney & Sons LTL Services, Inc., 131 B.R. 984, 990 (Bankr. N.D.Ill. 1991) ("the court can only grant a 'superpriority' lien on property already subject to a lien if 'there is adequate protection of the interest of the holder of the lien. . . .'" 11 U.S.C. § 364(d) (1) (B)). *See also In re Au Natural Restaurant, Inc.*, 63 B.R. 575, 581 (Bankr. S.D.N.Y. 1986).

Titan's motion seeking authority to borrow from Bush requested that Bush be granted a security interest in all of Titan's personal property. While the Bankruptcy Court faults BFC for failing to object to the borrowing motion, we conclude that BFC had no obligation to object because there was no request for a priming lien. See In re T.M. Sweeney & Sons LTL Services, Inc., 131 B.R. at 991 (creditor did not consent to grant of superior lien by failing to object when motion to borrow did not request a superpriority lien.) Titan's motion to borrow makes no mention of the priority of the security interest requested nor of BFC's security interest. Titan never requested that Bush be granted a superpriority lien. A creditor seeking to borrow under one section of the Code cannot later claim that the credit was extended under another section. Rather, a creditor is relegated to the protection sought. See In re Sobiech, 125 B.R. 110, 115 (Bankr. S.D.N.Y. 1991), *aff'd* 131 B.R. 917 (S.D.N.Y. 1991). Titan also never satisfied the Bankruptcy Code requirements for the granting of a senior lien, including showing that it was unable to obtain the credit otherwise and demonstrating that BFC's lien was adequately protected. As a result Bush should not be entitled to a lien senior to BFC's lien.

In addition, Titan's motion to borrow requested that the debt to Bush be granted unsecured priority pursuant to 11 U.S.C. §§ 364(c)(1), 503(b) and 507(a)(1). Section 364(c)(1) grants a "priority over any or all administrative expenses of the kind specified in Section 503(b) and 507(b)." 11 U.S.C. § 364(c)(1).

None of these sections allow a senior lien on property, they only allow unsecured priority. "Administrative expenses . . . do not have priority over secured claims." Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A., 120 S.Ct. 1942, 1946 (2000) (citing §§ 506, 725-726, 1129(b) (2) (A); United Sav. Assn. Of Tex. v. Timbers of Inwood Forest Associates, Ltd., 108 S.Ct. 626 (1988)). As the First Circuit Court of Appeals has stated:

[T]he distribution scheme of section 726 (and, by implication, the priorities of section 507) does not come into play until all valid liens on the property are satisfied. *See United States v. Speers*, 382 U.S. 266, 269 n. 3, 86 S.Ct. 411, 413 n. 3, 15 L.Ed.2d 314 (1965); *Goggin v. Division of Labor Law Enforcement of Cal.*, 336 U.S. 118, 126-127, 69 S.Ct. 469, 474, 93 L.Ed. 543 (1949). If a lien is perfected and not otherwise invalidated by law, it must be satisfied out of the assets it encumbers before any proceeds of the assets are available to unsecured claimants, including those having priority (such as priority tax creditors). *In re Darnell*, 834 F.2d 1263, 1265 (6th Cir.1987).

In re Spm Mfg. Corp., 984 F.2d 1305, 1312 (1st Cir. 1993).

Accordingly, we conclude that Titan's request to treat the debt to Bush as an unsecured priority did not provide a basis for the Bankruptcy Court to grant Bush a priming lien.

The Bankruptcy Court also concluded that section 552 of the Bankruptcy Code allowed the court some discretion with respect to how to treat BFC's prepetition security interest on post-petition collateral. See Trial Transcript of October 2, 2000 at p. 50. The court then concluded that it would grant Bush a first priority security interest.

Section 552 generally provides that property acquired by the estate after the commencement of a bankruptcy case is not subject

to prepetition liens. However, an exception to the general rule is found in § 552(b), which provides, with certain exceptions not present here:

if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(b)(1).

The burden to establish that the exception provided by § 552(b) applies rests with the creditor asserting a lien on postpetition proceeds, profits, products or offspring. See In re Ledis, 259 B.R. 472, 478 (D.Mass. 2001); In re Patio & Porch Systems, Inc., 194 B.R. 569, 573 (Bankr. D.Md. 1996). The transcript of the hearing before the Bankruptcy Court does not reveal any attempt by either party to establish that the unfinished boat was a proceed, profit, product or offspring arising from BFC's collateral. Nonetheless, in its ruling, the Bankruptcy Court seized on § 552, finding that "the Court does have some discretion with respect to how to treat prepetition security interest [sic] that might flow through and continue on postpetition collateral" See Trial Transcript of October 2, 2000 at p. 50. The Bankruptcy Court then subordinated the entire amount of BFC's lien, giving Bush a first priority lien to

the extent of his postpetition loan to Titan.

In his brief on appeal, Bush argues that the unfinished boat was a proceed of the prepetition collateral. The Bankruptcy Code does not define "proceeds." The term can be defined by state law. See In re Mintz, 192 B.R. 313, 319 (Bankr. D.Mass. 1996); and In re Ledis, 259 B.R. 472, 478 (D.Mass. 2001). The laws of Massachusetts indicate that "[p]roceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." Mass. G.L. c. 106 § 9-306(1). Accordingly, there must be some conversion of the prepetition collateral in order to create proceeds.

The present case began and ended with an unfinished boat. The hull existed prepetition. BFC had a security interest in it. Though Titan may have made some progress toward finishing the boat after the filing of the petition, the unfinished boat was not converted into something else. There were no postpetition proceeds of BFC's prepetition collateral. Accordingly, 11 U.S.C. § 552 does not apply. Moreover, because there were no proceeds, the Bankruptcy Court erred in weighing what it considered to be the equities of the case. See In re Cross Baking Co., Inc., 818 F.2d 1027, 1033 (1st Cir. 1987) ("[I]t is incorrect to consider the equities of the case when the contested property, as in the case at bar, does not constitute proceeds of the secured creditor's original collateral.")

Even if the unfinished boat was a product of BFC's prepetition collateral, which was never argued to the Bankruptcy

Court, § 552(b)(1) did not provide the Bankruptcy Court with authority to alter BFC's prepetition security interest in the manner that it did. The purpose of the section is not to assist another secured creditor in obtaining a priming lien, which was not properly sought.

"[T]he 'equities of the case' proviso is a legislative attempt to address those instances where expenditures of the estate enhance the value of proceeds which, if not adjusted, would lead to an unjust improvement of the secured party's position. In such cases Congress intended for courts to limit the secured party's interest in the proceeds according to the equities of the case so as to avoid prejudicing the unsecured creditors."

In re Cross Baking Co., Inc., 818 F.2d at 1033. The court, in its discretion, may alter the rights of a creditor in postpetition proceeds, profits, products or offspring in order to promote the debtor's fresh start. See In re Patio & Porch Systems, Inc. 194 B.R. at 575. Altering the order of the security interests of BFC and Bush has no effect on the rights of unsecured creditors nor does it affect the debtor's fresh start. Moreover, the Bankruptcy Court made no effort to bifurcate the prepetition collateral from the alleged postpetition product, which would be necessary under a proper § 552(b)(1) analysis. Instead, it simply gave Bush a first priority lien on their postpetition advances, resulting in the subordination of BFC's entire lien. The Bankruptcy Court should not have used § 552(b)(1) to grant Bush a priming lien, which was not properly obtained pursuant to § 364(d).

CONCLUSION

Since Titan never requested that Bush be granted a priming lien nor did it comply with the Bankruptcy Code provisions regarding the granting of a superpriority lien, Titan's motion to borrow did not provide a basis to grant Bush a first priority lien. Likewise, Titan's request to treat the debt to Bush as an unsecured priority did not provide a basis for granting Bush a first priority lien. Finally, the Bankruptcy Court improperly applied § 552(b)(1) to this case. Accordingly, to the extent that the Bankruptcy Court granted Bush a first-priority lien in the debtor's assets, the order of the Bankruptcy Court is **REVERSED**.