



Honorable Mike K. Nakagawa
United States Bankruptcy Judge



Entered on Docket
October 24, 2022

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

* * * * *

In re:)	Case No.: 16-11242-MKN
)	Chapter 7
STERNSCHNUPPE LLC,)	
)	Date: August 17, 2022
Debtor.)	Time: 2:30 p.m.
)	

**ORDER ON TRUSTEE’S MOTION TO APPROVE DISTRIBUTION
PURSUANT TO 11 U.S.C. §724(b)¹**

On August 17, 2022, the court heard the Trustee’s Motion to Approve Distribution Pursuant to 11 U.S.C §724(b) (“Distribution Motion”), brought by Chapter 7 panel trustee Troy Fox (“Trustee”). The appearances of all parties and counsel were noted on the record. After arguments were presented, the matter was taken under submission.

BACKGROUND²

On March 10, 2016, Sternschnuppe LLC (“Debtor”) filed a “skeleton” Chapter 11 petition. (ECF No. 1).

On March 25, 2016, Debtor filed its schedules of assets and liabilities along with its statement of financial affairs and other information. (ECF No. 28).

¹ In this Order, all references to “ECF No.” are to the numbers assigned to the documents filed in the above-captioned case as they appear on the docket maintained by the clerk of the court. All references to “Section” or “§§ 101-1532” are to provisions of the Bankruptcy Code, 11 U.S.C. §101, et seq. All references to “FRE” are to the Federal Rules of Evidence.

² Pursuant to FRE 201(b), the court takes judicial notice of all materials appearing on the docket in the above-captioned bankruptcy case. See U.S. v. Wilson, 631 F.2d 118, 119 (9th Cir. 1980). See also Bank of Am., N.A. v. CD-04, Inc. (In re Owner Mgmt. Serv., LLC Trustee Corps.), 530 B.R. 711, 717 (Bankr. C.D. Cal. 2015) (“The Court may consider the records in this case, the underlying bankruptcy case and public records.”).

1 On March 30, 2016, a proof of claim in the total amount of \$921,200.95 was filed by the
2 Internal Revenue Service (“IRS”). The secured portion of the claim is in the amount of
3 \$719,640.68. The secured portion is based on “all of debtor(s) right, title and interest to
4 property” under 26 U.S.C. §6321. The priority unsecured portion of the claim under Section
5 507(a)(8) is in the amount of \$189,449.26. The balance of the claim is a nonpriority general
6 unsecured claim.

7 On July 27, 2016, Debtor filed a stipulation authorizing use of cash collateral to address
8 the lien against all property and rights in property asserted by the IRS, which included
9 replacement liens against post-bankruptcy assets. (ECF No. 102).

10 On October 1, 2018, an amended proof of claim (“IRS POC”) in the total amount of
11 \$900,572.71 was filed by the IRS. The secured portion of the claim is in the amount of
12 \$719,640.68.³ The priority unsecured portion of the claim under Section 507(a)(8) is in the
13 amount of \$151,316.56.⁴ The balance of the claim is a nonpriority general unsecured claim.⁵

14 On September 19, 2019, a motion to convert the case to Chapter 7 (“Conversion
15 Motion”) was filed by the Nevada Department of Taxation (“NDOT”). (ECF No. 365).

16 On June 25, 2020, an order was entered granting the NDOT Conversion Motion after
17 multiple continuances. (ECF No. 470).

18 On July 8, 2020, the Trustee was appointed to administer the Chapter 7 estate. (ECF No.
19 476).

20
21

22 ³ According to the attachment to the IRS POC, the secured portion is based on unpaid
23 partnership taxes for 2010, unpaid withholding taxes (FICA) for 2013, 2014 and 2015, and
24 unpaid unemployment insurance taxes (FUTA) for 2014, as well as penalties and interest
assessed prior to the March 10, 2016, bankruptcy petition date.

25 ⁴ According to the attachment to the IRS POC, the priority unsecured portion is based on
26 unpaid withholding taxes (FICA) and unpaid unemployment insurance taxes (FUTA) assessed
both prior to and after the March 10, 2016, bankruptcy petition date.

27 ⁵ According to the attachment to the IRS POC, the nonpriority unsecured portion is based
28 penalties assessed after to the March 10, 2016, bankruptcy petition date, for partnership taxes
that arose both before and after the petition date.

1 On July 15, 2020, a notice was filed and served setting a Chapter 7 meeting of creditors
2 for August 26, 2020. (ECF No. 477).

3 On August 3, 2020, a motion for relief from stay (“MRAS”) was brought by 3 Kids, LLC
4 (“3 Kids”) that was noticed to be heard on September 2, 2020. (ECF Nos. 484 and 485). 3 Kids
5 was the landlord for the commercial real property located at 3855 W. Harmon Avenue, Las
6 Vegas, Nevada (“Harmon Property”), out of which the Debtor had been operating its metal
7 fabrication business.

8 On August 7, 2020, a proof of claim (“POC 25-1”) was filed by Julio G. de Blanco (“de
9 Blanco”).

10 On August 11, 2020, the Trustee filed a motion to sell the Debtor’s personal property
11 assets that were located at the Harmon Property. (ECF No. 489).

12 On August 14, 2020, a proof of claim (“POC 29-1”) was filed by Felipe Montenegro
13 Garcia (“Garcia”).

14 On September 23, 2020, an order was entered granting the MRAS. (ECF No. 516).

15 On October 13, 2020, an order was entered granting the Trustee’s request to abandon the
16 assets remaining at the Harmon Property. (ECF No. 525).

17 On November 5, 2020, another proof of claim (“POC 46-1”) was filed by Garcia.

18 On November 17, 2020, 3 Kids filed a motion for allowance of administrative claims (“3
19 Kids Claims Motion”) that was noticed to be heard on December 23, 2020 (“December 23
20 Hearing”). (ECF Nos. 533 and 534). The motion sought allowance of \$205,857.66 as a Chapter
21 11 administrative expense and \$129,257.42 as a Chapter 7 administrative expense resulting from
22 the Debtor’s nonpayment of rent due on the Harmon Property.

23 On December 23, 2020, the 3 Kids Claims Motion was heard. No written objections had
24 been filed and only counsel for the NDOT and 3 Kids appeared.⁶

25
26
27
28 ⁶ A transcript of the December 23 Hearing was filed on July 28, 2022. (ECF No. 657).

1 On January 6, 2021, an order was entered granting the 3 Kids Claims Motion in full (“3
2 Kids Claims Order”). (ECF No. 539). As a result, Chapter 11 expenses in the amount of
3 \$205,857.66 were allowed as well a Chapter 7 expenses in the amount of \$129,257.42.⁷

4 On July 13, 2021, an order was entered approving a stipulation between 3 Kids and the
5 Trustee that a certain vehicle located at the Harmon Property was abandoned by the bankruptcy
6 estate and that title could be transferred to 3 Kids. (ECF No. 568).

7 On March 14, 2022, an order was entered sustaining the Trustee’s objection to POC 25-1
8 filed by de Blanco, and reclassifying the claim as a Chapter 11 administrative claim. (ECF No.
9 628).

10 On March 14, 2022, an order was entered sustaining the Trustee’s objections to POC 29-
11 1 and 46-1 filed by Garcia, striking POC 29-1 as a duplicate and reclassifying POC 46-1 as a
12 Chapter 11 administrative claim. (ECF No. 631).

13 On June 1, 2022, the Trustee filed the instant Distribution Motion that was noticed to be
14 heard on July 13, 2022. (ECF Nos. 647 and 648).

15 On June 10, 2022, Garcia filed an opposition to the Distribution Motion. (ECF No. 650).

16 On June 10, 2022, de Blanco filed an opposition to the Distribution Motion. (ECF No.
17 651).

18 On June 23, 2022, the Trustee filed an omnibus reply to the oppositions filed by Garcia
19 and de Blanco. (ECF No. 652).

20 On July 12, 2022, 3 Kids filed a limited opposition (“Opposition”). (ECF No. 654).

21 On August 2, 2022, Trustee Fox filed a reply to the 3 Kids opposition (“Reply”). (ECF
22 No. 660).

23 On August 10, 2022, 3Kids, LLC filed a supplemental brief in opposition to the
24 Distribution Motion (“Supplemental Opposition”) along with a declaration of Mary Langsner
25 (“Langsner Declaration”). (ECF No. 665).

26
27
28 ⁷ The total amount of the allowance is \$335,115.08, with the portion of the Chapter 11
allowed amount exceeding the Chapter 7 allowed amount by \$76,600.24.

1 **DISCUSSION**

2 In the Distribution Motion, the Trustee represents that the Chapter 7 estate has
3 \$127,545.73 collected from the liquidation estate assets, see Distribution Motion at ¶ 9, that is
4 subject to the IRS tax lien. Id. at ¶ 10. He also asserts that under Section 724(b), disbursement
5 of the funds on hand “will be limited to paying the 207(a)(1)(C) (sic) and 507(a)(2) claims, and
6 then, the remaining funds will go to the IRS pursuant to their first filed lien against the assets of
7 the Debtor.” Id. at 3:22-24. Apparently based on the Trustee’s interpretation that 3 Kids would
8 receive no distribution on the administrative expense claims provided by the 3 Kids Claims
9 Order, see Limited Opposition at 2:14-17, 3 Kids maintains that its previously allowed
10 administrative expenses claims must be paid pro rata before the IRS lien claim is satisfied in this
11 case. Id. at 4:7-11. In reply, the Trustee confirms the interpretation that was expressed to 3 Kids
12 but not set forth in the Distribution Motion: “The Chapter 11 admin claim of 3Kids is not a
13 claim which will be paid prior to the IRS’s tax lien. 3Kids, like many other administrative
14 creditors is not getting paid in this matter.” Reply at 4:21-23.

15 Section 724 governs the treatment of estate property encumbered by certain liens, while
16 Section 726 governs the distribution of unencumbered estate property. Section 724(a) permits a
17 bankruptcy trustee to avoid a lien that “secures a claim of a kind specified in” Section 726(a)(4).
18 Section 726(a)(4) identifies the following kinds of claims: “for any fine, penalty, or forfeiture”
19 or “for multiple, exemplary, or punitive damages.” Those claims must arise before the earlier of
20 the filing of the bankruptcy petition or the appointment of a bankruptcy trustee. Finally, the fine,
21 penalty, forfeiture or damages must not be “compensation for actual pecuniary loss suffered” by
22 the claimant.

23 The secured portion of the IRS POC is in the amount of \$719,640.68. No objection to the
24 IRS POC has been filed and the claim is deemed allowed. See 11 U.S.C. §502(a). Likewise, the
25 Trustee has not sought to avoid the IRS lien as permitted by Section 724(a).⁸ As the IRS lien
26 against all of the Debtor’s right, title and interest in property is uncontested, the Trustee

27
28 ⁸ Prior to conversion of the case to Chapter 7, the Chapter 11 debtor under Section 1107(a) perhaps could have sought to avoid the IRS lien.

1 maintains that he is obligated to distribute the encumbered funds in accordance with Section
2 724(b), rather than under Section 726.

3 For estate property that is subject to a lien, Section 724(b) permits sequential distribution
4 in six specific categories, only one of which is the subject of the 3 Kids objection. As a model of
5 opacity, Section 724(b) states as follows:

6 [S]econd, to any holder of a claim of a kind specified in section 507(a)(1)(C)
7 or 507(a)(2) (except that such expenses under each such section, other than
8 claims for wages, salaries, or commissions that arise after the date of the filing
9 of the petition, shall be limited to expenses incurred under this chapter and
10 shall not include expenses incurred under chapter 11 of this title),
507(a)(1)(A), 507(a)(1)(B), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or
507(a)(7), of this title, to the extent of the amount of such allowed tax claim
that is secured by such tax lien.

11 11 U.S.C. §724(b)(2) (emphasis added). By its placement, the underscoring language in Section
12 724(b)(2) appears to be an exception only to claims addressed by Sections 507(a)(1)(C) and
13 507(a)(2), but not to any claims addressed by Sections 507(a)(1)(A) [domestic support
14 obligations to non-debtor dependents], 507(a)(1)(B) [domestic support obligations recoverable
15 by governmental units], 507(a)(3) [gap period claims involuntary proceedings], 507(a)(4)
16 [employment compensations claims], 507(a)(5) [employee benefit plan contributions], 507(a)(6)
17 [grain and fishing production claims], and 507(a)(7) [consumer deposits]. The latter claims also
18 are not relevant to the instant dispute. Section 507(a)(1)(C) adjusts priorities between the
19 Chapter 7 trustee and domestic support obligations, and also does not apply to the instant
20 dispute. Section 507(a)(2), however, does apply.

21 Section 507(a)(2) affords priority status to “administrative expenses allowed under
22 section 503(b) of this title, unsecured claims of any Federal reserve bank related to loans made
23 through programs or facilities authorized under section 13(3) of the Federal Reserve Act (12
24 U.S.C. 343), and any taxes and charges assessed against the estate under chapter 123 of title 28.”

25 11 U.S.C. §507(b)(2) (emphasis added). The allowed claim of 3 Kids is not by a “Federal
26 reserve bank” and are not taxes and charges assessed against the estate. There is no dispute that
27 3 Kids previously sought allowance of unpaid post-petition rents on the Harmon Property as
28 administrative expenses under Section 503(b)(1). See 3 Kids Claims Motion at ¶11. Payment of

1 the post-petition rents was required by Section 365(d)(3). Id. at ¶¶ 13 and 14. No party in
 2 interest opposed 3 Kids’ request and it was granted in its entirety by the 3 Kids Claim Order.
 3 Because all of the expenses requested by 3 Kids were allowed under Section 503(b)(1), the
 4 allowed claims fall under Section 507(a)(2). That section encompasses “administrative expenses
 5 allowed under section 503(b) of this title.” 11 U.S.C. §507(a)(2) (emphasis added).

6 Because 3 Kids has allowed administrative expenses under Section 507(a)(2), the
 7 distribution of the lien property to “such expenses” under Section 724(b) is cabined by the
 8 language that “such expenses...other than claims for wages, salaries, or commissions that arise
 9 after the date of the filing of the petition, shall be limited to expenses incurred under this chapter
 10 and shall not include expenses incurred under chapter 11 of this title.”⁹ The claim of 3 Kids is
 11 not for wages, salaries, or commissions, and that language is immaterial. The limitation of
 12 expenses allowed under Section 507(a)(2) to those “incurred under [Chapter 7] and shall not
 13 include expenses incurred under chapter 11” is material.

14 It is clear that the 3 Kids Claims Order allowed recovery of Chapter 11 expenses of
 15 \$205,857.66 as well as Chapter 7 expenses of \$129,257.42. Contrary to the Trustee’s belief, the
 16 so-called “plain language” of Section 724(b) as underscored limits the distribution to the Chapter
 17 7 expenses allowed to 3 Kids and excludes only the Chapter 11 expenses allowed to 3 Kids.
 18 Similarly, contrary to 3 Kids’ belief, the so-called plain language of Section 724(b) limits the
 19 distribution to its allowed Chapter 7 expenses, and excludes allowed Chapter 11 expenses.¹⁰

20 ⁹ There is no dispute that in cases converted from Chapter 11 to Chapter 7, the allowed
 21 administrative expenses of the Chapter 7 proceeding are paid in full before payment of allowed
 22 Chapter 11 expenses. See 11 U.S.C. §726(b) (“...in a case that has been converted to [Chapter
 23 7] under section 1112...of this title, a claim allowed under section 503(b)...incurred...after such
 24 conversion has priority over a claim allowed under section 503(b)...before such conversion...”).
 The treatment of certain liens under Section 724 is not limited to converted cases, but Section
 724(b) does impose certain limits to certain payments in converted cases.

25 ¹⁰ Both the Trustee and 3 Kids justify their respective positions by reference to policy
 26 reasons for distribution to tax liens instead of priority administrative expenses. Compare Reply
 27 at 3:24 to 4:17 with Supplemental Opposition at 8:3-21. Perhaps overlooked is the disparity in
 28 remedies available to the affected parties in this case. A substantial portion of the IRS lien is
 allocated to unpaid employee withholding taxes incurred well before the commencement of this
 proceeding. See note 3, supra. Priority administrative expense status is afforded to induce
 parties to do business with a debtor or trustee during a bankruptcy to facilitate payment of

1 In this instance, the total Chapter 7 expenses allowed to 3 Kids (\$129,257.42) appears to
2 exceed the total estimated amount collected by the Trustee (\$127,545.73). Unfortunately, the
3 Trustee does not specify the total amount of other allowed Chapter 7 administrative expenses
4 that might be of priority equal to 3 Kids. Where a bankruptcy case is administratively insolvent,
5 allowed administrative expense claims, including claims for unpaid rent, are paid pro rata with
6 other allowed administrative claims. See 11 U.S.C. §726(b); see generally 6 COLLIER ON
7 BANKRUPTCY, ¶ 726.03 (Richard Levin and Henry J. Sommer, eds., 16th ed. 2022) (“The
8 requirement that claims within a particular class are to be paid pro rata applies only where there
9 are inadequate funds to pay holders of claims of a particular class in full.”). There is no evidence
10 before the court, however, indicating whether 3 Kids would be paid some or substantially all of
11 its allowed Chapter 7 administrative expense claim. In other words, it may make no difference at
12 all whether 3 Kids’ allowed Chapter 11 administrative expense claim is considered in any
13 distribution of the \$129,257.42 collected by the Trustee.

14 Under these circumstances, the Distribution Motion will be denied to the extent the
15 Trustee seeks to distribute the \$127,545.73 on hand to the IRS without consideration of the
16 Chapter 7 administrative expense claim of 3 Kids. This denial of the suggested distribution,
17 however, is without prejudice.¹¹

18
19
20 claims. See Microsoft Corp. v. DAK Industries, Inc. (In re DAK Industries, Inc.), 66 F.3d 1091,
21 1097 (9th Cir. 1995) (“§503’s principal purpose is to induce entities to do business with a debtor
22 after bankruptcy by insuring that those entities receive payment for services rendered.”); Siller v.
23 Big Hill Logging, etc. (In re CWS Enterprises, Inc.), 2015 WL 3651541, at *5 (B.A.P. 9th Cir.
24 June 12, 2015). Pursuant to 26 U.S.C. §6672(a), the IRS may seek a penalty assessment against
25 individuals who are responsible for the payment of withholding taxes by a bankrupt fictitious
26 entity. See, e.g., United States v. Hartman, 896 F.3d 759 (6th Cir. 2018) (co-owner of corporate
27 entity personally liable for other co-owner’s failure to remit payroll taxes). No similar statutory
28 remedy is available for 3 Kids after it was induced to continue allowing the bankruptcy estate to
use of the Harmon Property by the promise of administrative priority.

26 ¹¹ The claims of Garcia and de Blanco have been allowed as Chapter 11 administrative
27 claims as a result of the Trustee’s prior objections. Because it appears that there are no funds
28 available to reach any of the allowed Chapter 11 administrative expenses, the opposition raised
by Garcia and de Blanco to the instant Distribution Motion are likely moot. Because the instant
motion is denied, however, it is unnecessary to decide the issues raised by those claimants.

1 **IT IS THEREFORE ORDERED** that the Trustee’s Motion to Approve Distribution
2 Pursuant to 11 U.S.C §724(b), brought by Chapter 7 trustee Troy Fox, Docket No. 647, be, and
3 the same hereby is, **DENIED WITHOUT PREJUDICE.**

4
5 Copies sent via CM/ECF ELECTRONIC FILING

6 Copies sent via BNC to:
7 STERNSCHNUPPE LLC
8 ATTN: OFFICER OR MANAGING AGENT
9 3325 W. SUNSET ROAD STE. E
10 LAS VEGAS, NV 89118

###

11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28