

UNITED STATES BANKRUPTCY COURT  
DISTRICT OF MINNESOTA

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In re:

Midwest Asphalt Corporation,

Court File No. 17-40075 (WJF)  
Chapter 7

Jointly Administered with:

MAR Farms, LLC, and  
Delta Milling, LLC

Bky. Case No. 17-41371  
Bky. Case No. 17-41372

Debtors.

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Mark Welty,

Plaintiff,

vs.

Adv. Case No. 18-04022

Callidus Capital Corporation and  
Midwest Asphalt Services, LLC,

Defendants.

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**FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER FOR JUDGMENT**

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This order resolves an adversary proceeding between Plaintiff Mark Welty (“Mr. Welty”) and Defendants Callidus Capital Corporation (“Callidus”) and Midwest Asphalt Services, LLC (“Midwest”). The trial occurred on December 20 and 21, 2018. Alexander J. Beeby and R. Henry Pfutzenreuter appeared on behalf of Plaintiff Mr. Welty. Doron Yitzchaki and Christopher J. Harayda appeared on behalf of Defendants Callidus and Midwest. No post-trial briefs were submitted by the parties and the matter was taken under advisement on December 21, 2018.

Mr. Welty, in bringing this action, seeks a declaration that he had a “valid and properly perfected first-position security interest up to the value of approximately \$1,727,000 in the following assets sold to Midwest”: (1) \$242,000 in cash collateral; (2) a \$133,000 insurance refund (“Insurance Refund”); (3) titled vehicles owned by the Debtor Midwest Asphalt Corporation (“MAC”) and sold to Midwest (“Titled Vehicles”); and (4) the cash surrender value of two life insurance policies (“Life Insurance Policies”). [Dkt. 65 at 45, 64]. He also seeks a declaration that his lien rights survived the sale of assets to Midwest. Id. Finally, he seeks an order subordinating Callidus’s claim to his claim. [Dkt. 27 at 8-9]. The Court denies the Plaintiff’s request for a declaration confirming that he retained a first-position security interest in certain assets sold to Midwest because the total diminution in the value of cash collateral between January 12, 2017, the day MAC filed for bankruptcy relief (“Petition Date”) and January 19, 2018, the day of the closing of the sale of the Debtors’ assets to Midwest (“Closing Date”), exceeded the value of Mr. Welty’s lien in the sold assets. The Court also declines to subordinate Callidus’s claim to Mr. Welty’s claim because Mr. Welty failed to establish that the use of equitable subordination is appropriate in this case.

#### **PROCEDURAL BACKGROUND**

Debtor MAC filed for bankruptcy on January 12, 2017. See “Chapter 11 Voluntary Petition” (“Petition”), In re Midwest Asphalt Corp., No. 17-40075, at 9 (Bankr. D. Minn. Jan. 12, 2017) [Dkt. 1]. Subsequently, on May 8, 2017, Debtors MAR Farms, LLC and Delta Milling, LLC also filed for bankruptcy and all three cases were administratively joined. See “Order Granting Motion for Joint Administration,” In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. June 28, 2017) [Dkt. 220]. Of the three Debtors, only MAC possessed cash collateral (cash, inventory, and receivables), which was subject to Callidus’s liens.

On April 19, 2017, the Court approved a post-bankruptcy debtor-in-possession loan (“post-petition loan”) in the form of a demand note to MAC from MAC Investments-Chanhassen (“MAC Investments”), a Minnesota limited liability company owned by MAC’s primary shareholder, Blair Bury (“Mr. Bury”), in the amount of \$500,000 (“DIP Loan One”). See “Order Approving Post-Petition Secured Loan and Granting Administrative Priority” (“Order Approving DIP Loan One”), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Apr. 19, 2017) [Dkt. 152]. MAC Investments’ lien was junior only to the liens of Callidus and (unless they were determined to be invalid or avoidable) the liens of those lenders with pre-petition perfected liens on the Debtor’s equipment (the “Equipment Lien Holders”), whether arising pre-petition or post-petition. MAC Investments was also given a super-priority administrative claim pursuant to 11 U.S.C. § 364(c)(1).

On May 11, 2017, the Court approved a debtor-in-possession loan (post-bankruptcy lien) in the form of a demand note to MAC from Mr. Welty in the amount of \$2,000,000 (“DIP Loan Two”). See “Order Approving Post-Petition Secured Loan and Granting Administrative Priority” (“Order Approving DIP Loan Two”), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. May 11, 2017) [Dkt. 184]. DIP Loan Two was given the same priority position as DIP Loan One.

On November 22, 2017, the Debtors filed a motion pursuant to 11 U.S.C. § 363 seeking authority to sell substantially all their assets free and clear of liens, claims, and encumbrances to Callidus or its designee on a credit bid (a bid reducing the amount of Callidus’s security interest), but subject to any higher and better bids the Debtor might receive through auction. See “Motion to Sell Property Free and Clear of Liens” (“Sale Motion”), In re Midwest Asphalt Corp., 17-40075 (Bankr. D. Minn. Nov. 22, 2017) [Dkt. 319]. A joint objection was filed to this motion on December 8, 2017 by MAC Investments and Mr. Welty. See “Objection by Creditors MAC

Investments-Chanhassen LLC, Mark Welty” (“Joint Objection”), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Dec. 8, 2017) [Dkt. 328]. The objecting parties requested that the Court “enter an order approving the auction and the eventual sale but reserving the rights of [MAC Investments] and [Mr. Welty], upon completion of the sale, to receive their rightful share of the proceeds from the sale assets in which they hold a superior interest.” Id. at 3. On December 12, 2017, MAC Investments, Mr. Welty, MAC and Callidus filed a stipulation stating, in part, “that the reservation of rights objection of MAC Investments and [Mr.] Welty filed on December 8, 2017 is not ripe at this time.” See “Stipulation Filed by MAC Investments-Chanhassen LLC and Mark Welty, Callidus Capital Corporation, Debtor” (“Stipulation”), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Dec. 12, 2017) [Dkt. 330].

On December 18, 2017, the Court entered an order pursuant to 11 U.S.C. § 363 of the Bankruptcy Code authorizing the Debtors to sell all their assets, subject to exceptions listed in the sale order or as an excluded asset in the final purchase agreement, to Callidus or its assignee or designee for (a credit bid of) \$13,500,000. See “Order Granting Motion to Sell Property Free and Clear of Liens” (“Sale Order”), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Dec. 18, 2017) [Dkt. 344]. The Debtors and Midwest executed an Asset Purchase Agreement (“APA”) on January 19, 2018. [Dkt. 30 at 18]. Midwest is the designee and subsidiary of Callidus “that was formed for the purpose of acquiring the assets from the Debtor.”

This adversary proceeding was commenced on March 9, 2018. [Dkt. 1]. In the initial complaint, Mr. Welty asserted four separate counts against Callidus and Midwest. Id. Both Count I and Count II sought a money judgment in the amount of \$1,726,833.30 pursuant to 11 U.S.C. § 364. Id. Count III sought a money judgment in the same amount pursuant to 11 U.S.C. § 510(c), the provisions of equitable subordination, and Count IV sought a money judgment based on

“equitable estoppel.” Id. On April 2, 2018, Callidus and Midwest filed a motion to dismiss the adversary proceeding for failure to state causes of action. [Dkt. 6]. A hearing was held on May 22, 2018. The Defendants’ motion was granted in part pursuant to an order dated May 23, 2018. [Dkt. 11]. Counts I, II, and IV were dismissed without prejudice. Mr. Welty was allowed leave to file a second amended complaint in an attempt to remedy the deficiencies of Count III.

A Second Amended Complaint was filed on June 11, 2018. [Dkt. 17]. Mr. Welty asserted two separate counts against Callidus and Midwest. Id. Count I sought a declaration that: (1) Mr. Welty held a valid lien in the assets or proceeds of MAC; (2) cash collateral and working capital assets increased in value; and (3) these rights survived the sale to Midwest. Id. Count II sought a money judgment pursuant to 11 U.S.C. § 510(c)(1) (equitable subordination). Id. On June 25, 2018, Callidus and Midwest filed a motion to dismiss the adversary proceeding based on the following grounds: (1) lack of subject matter jurisdiction over Count I; and (2) failure to state a claim upon which relief could be granted on Count II. [Dkt. 19]. A hearing was held on July 18, 2018 and the motion was denied by the Court. During the hearing and in its subsequent written order, the Court cited several cases in support of its ruling that it had subject matter jurisdiction to resolve Count I. [Dkt. 22]. As to Count II, the Defendants acknowledged that Mr. Welty had stated a claim upon which relief could be granted as he sought equitable subordination for purposes of distribution. Mr. Welty was allowed leave to amend the Second Amended Complaint on narrow grounds to clarify in Count I whose assets Mr. Welty sought a valid lien upon and to modify the request for relief. [Dkt. 22].

A Third Amended Complaint was filed on July 25, 2018. [Dkt. 27]. Count I sought a declaration of “the existence, validity, priority, and value” of Mr. Welty’s lien, and declaring the extent of that lien, on certain assets of Midwest. Id. Count II sought a judgment pursuant to 11

U.S.C. § 510(c), granting Mr. Welty's lien priority over Callidus's claim to the extent of the outstanding debt on the loans. Id. The Defendants filed their answer on July 26, 2018, in which they denied all liability under the complaint and cited various affirmative defenses. [Dkt. 28].

On July 31, 2018, the Defendants filed a Motion for Partial Summary Judgment as to Count I of the Third Amended Complaint. [Dkt. 30]. Among other things, the Defendants argued that the Joint Objection filed by MAC Investments and Mr. Welty did not preserve Mr. Welty's right to claim a lien on any of the assets sold in the sale. Id. The Defendants asserted that Mr. Welty preserved a purported right "to recover [his] rightful share of the proceeds from the sale of assets in which [he] hold[s] a superior interest." Id. However, they claimed there were not "proceeds from the sale" to which Mr. Welty's lien could attach. Mr. Welty filed a cross-motion for partial summary judgment on August 15, 2018. [Dkt. 38].

A hearing was held on the motions on August 22, 2018. At the hearing, the Court found Mr. Welty's use of the phrase "proceeds from the sale of assets" to be ambiguous when construed with the remainder of paragraph 9 of the Joint Objection. The Court denied both motions. [Dkt. 40].

A trial was held on December 20 and 21, 2018. The Court received testimony from the following witnesses: (1) Mark Welty, Plaintiff; (2) Blair Bury, former President and Owner of Debtor MAC; (3) Gregg Prest, former Chief Financial Officer for Debtor MAC; (4) Jeffrey Johnston, Managing Director of AlixPartners; and (5) Ron Schiferl, Chief Financial Officer and Treasurer of Midwest. Numerous exhibits were also admitted. The matter was taken under advisement on December 21, 2018.

## JURISDICTION

This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157, and it is a core proceeding under 28 U.S.C. § 157(b)(2). This order contains findings of fact and conclusions of law pursuant to Federal Rule of Bankruptcy Procedure 7052. The parties consented to and do not dispute this Court's authority to enter a final order in this matter.

## FINDINGS OF FACT

The Court makes the following findings of fact based upon all the evidence, the credibility of witnesses, the files, records, and proceedings. The following findings of fact and conclusions of law constitute the Court's findings of fact and conclusions of law for the purposes of Federal Rule of Bankruptcy Procedure 7052. To the extent any findings of fact are conclusions of law, they are adopted as such. To the extent any conclusions of law are findings of fact, they are adopted as such.

1. Callidus is a publicly traded Canadian Corporation organized under the Ontario Business Corporations Act. It was a pre-petition lender to MAC and had a secured interest in MAC's pre-petition cash collateral. Stipulation of Facts Not in Dispute ("Stipulation of Facts") [Dkt. 63 at 2]; see "Chapter 11 Completion for Non-Individual Filed by Midwest Asphalt Corporation," In re Midwest Asphalt Corp., No. 17-40075, at 2 (Bankr. D. Minn. Feb. 7, 2017) [Dkt. 57].
2. On January 16, 2017, MAC filed its first motion for use of cash collateral. See "Motion for Expedited Relief and for an Order Authorizing Use of Cash Collateral on a Preliminary and Final Basis" ("Motion for Cash Collateral"), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Jan. 16, 2017) [Dkt. 8]. It stated that the proposed use of cash collateral was to "carry on its business activities, to pay for its current operations, including purchases, insurance, utilities, payroll, and payroll taxes." Id. at 7.
3. On January 23, 2017, the Court granted the Debtors' motion for use of cash collateral. See "Interim Order for Use of Cash Collateral Pending Final Hearing" ("January 23, 2017 Cash Collateral Order"), In re Midwest Asphalt Corp., No. 17-40075, at 1-2 (Bankr. D. Minn. Jan. 23, 2017) [Dkt. 27]. For purposes of adequate protection, Callidus was granted the following:
  - (i) a replacement lien in the Debtor's post-petition assets of the same type and nature as subject to Callidus's pre-petition liens, which

such replacement liens shall have the same priority and effect as Callidus held on the pre-petition property of the Debtor; and (ii) only to the extent of diminution in the value of cash collateral or other types of collateral during the pendency of the case, grants a post-petition lien to Callidus (a) on all currently unencumbered titled vehicles and rolling stock of the Debtor . . . and (b) an additional mortgage on the properties of the Debtor . . . .

January 23, 2017 Cash Collateral Order at 1-2.

4. On February 9, 2017, the Court entered an agreed order resolving the Debtor's motion for payment of certain pre-petition claims. See "Agreed Order Resolving Debtor's Motion for Payment of Certain Pre-Petition Claims," In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Feb. 9, 2017) [Dkt. 61]. This order permitted MAC, with the permission of Callidus, to pay certain pre-petition claims using Callidus's cash collateral. Id.
5. Following an evidentiary hearing on February 15, 2017, the Court entered a final cash collateral order. See "Final Order for Use of Cash Collateral," In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Feb. 15, 2017) [Dkt. 70]. For purposes of additional adequate protection, the Debtor granted the following to Callidus:

. . . only to the extent of diminution in the value of cash collateral or other types of collateral during the pendency of this case, a post-petition lien on all assets of the Debtor (and their proceeds), whether now existing or hereafter arising or acquired, whether arising or acquired pre-petition or post-petition, of every kind and nature whatsoever, including but not limited to all titled vehicles, rolling stock, causes of action under Chapter 5 . . . and any and all state-law causes of action recognized, permitted and/or incorporated therein.

Id. at 1-2.

6. On April 19, 2017, the Court approved a debtor-in-possession loan from MAC Investments to MAC in the amount of \$500,000. See Order Approving DIP Loan One, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 152]; Ex. 6. Pursuant to the order, MAC Investments was permitted:
  - (i) a post-petition lien on all of the Debtor's assets which are subject to the liens of (a) Callidus Capital Corporation and (b) those lenders having pre-petition perfected liens on the Debtor's equipment (the "Equipment Lien Holders"). MAC's Liens shall include the post-petition additional collateral granted to Callidus as adequate protection, except the Chapter 5 actions. MAC Investment's lien shall be junior only to the liens of Callidus and . . . the liens of the Equipment Lien Holders . . . .

7. On May 11, 2017, the Court approved a debtor-in-possession loan from Mr. Welty to MAC in the amount of \$2,000,000. See Order Approving DIP Loan Two, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 184]; Ex. 13. DIP Loan Two was given the same priority position as DIP Loan One.
8. An additional cash collateral order was also entered by the Court on May 11, 2017. See “Order Regarding Further Use of Cash Collateral,” In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. May 11, 2017) [Dkt. 183]. This order extended the adequate protection granted to Callidus by the Final Order for Use of Cash Collateral to include “. . . the cash value of life insurance policies held by the Bury Family Trust and Blaine M. Johnson.” Id. at 2.
9. Midwest is a Delaware limited liability company and an indirect subsidiary of Callidus. Callidus designated Midwest as the assignee or designee of Callidus’s credit bid rights during the Chapter 11 case. Stipulation of Facts at 3.
10. Mr. Welty is an individual residing in the State of Minnesota who provided \$1,200,000 in debtor-in-possession financing to MAC during its Chapter 11 case. Id. at 2.
11. Mr. Welty is also the assignee of the rights of MAC Investments, a Minnesota limited liability company owned by MAC’s primary shareholder, Mr. Bury, that provided \$500,000 in debtor-in-possession financing to MAC during its Chapter 11 case. Id.
12. Mr. Welty testified that he provided the debtor-in-possession funds after he was contacted by Mr. Bury and informed that MAC’s financing had fallen through and the company would be liquidated if Mr. Bury did not receive financial help. [Mr. Welty’s testimony].
13. Mr. Bury testified that MAC would not have been able to start seasonal operations and generate revenue without the use of cash collateral. [Mr. Bury’s testimony]. He testified that without the DIP loans, MAC could not have paid its operating bills or protected its cash collateral which would have led to liquidation. Id.
14. Mr. Welty took a personal guarantee from Mr. Bury in the DIP loans. [Mr. Welty’s testimony]. He also took collateral in certain assets of Mr. Bury including real property located in Chanhassen, Minnesota; personal vehicles; and Mr. Bury’s father’s estate. Id.
15. Mr. Welty testified that, despite his close friendship with Mr. Bury, his goal is to collect his money. Id. This means commencing collection proceedings against Mr. Bury if he is unable to recover from Callidus. Id. He explained that he initiated proceedings against Callidus first only because he thought it was fair to first collect from the entities that directly benefited from his loans. Id.
16. Following the Petition Date, the Debtors continued to operate their businesses on a going concern basis as debtors-in-possession pursuant to 11 U.S.C. §§ 1107(a) and 1108. [Mr. Bury’s testimony]. The Debtors spent the funds from the two DIP loans on business operations, enabling them to stay operative. Id.

17. Sometime around October of 2017, Mr. Welty terminated DIP Loan Two. [Mr. Welty's testimony]. Mr. Welty testified that after giving MAC \$1,200,000 in DIP financing, he was informed by Mr. Bury that the company did not need any more money. Id. Both individuals agreed that DIP Loan Two should be cancelled. Id.
18. On November 22, 2017, the Debtors filed a motion pursuant to Section 363 of the Bankruptcy Code seeking authority to sell substantially all assets free and clear of liens, claims and encumbrances to Callidus or its designee on credit bid, but subject to any higher or better bids the Debtors may receive through an auction process. Sale Motion, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 319]; Ex. 18.
19. On December 8, 2017, Mr. Welty and MAC Investments filed the Joint Objection to the Sale Motion. See Joint Objection, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 328]; Ex. 19.
20. Paragraph 9 of the Joint Objection states:

The Court should enter an order approving the auction and the eventual sale but reserving the rights of MAC Investments and Welty, upon completion of the sale, to receive their rightful share of the proceeds from the sale of assets in which they hold a superior interest.”

Id.; Ex. 19 at 3.
21. Mr. Welty testified that he did not know who prepared the Joint Objection nor did he review the document prior to it being filed with the Court. [Mr. Welty's testimony]. He testified that he believed the purpose of the Joint Objection was to protect his rights under the DIP loans and delay the sale in hopes of allowing him to receive payment. Id. More specifically, he explained paragraph 9 to mean that any funds beyond what Callidus was owed became a pool out of which he could receive payment as those funds were the “proceeds” of the sale. Id.
22. Mr. Bury testified that he could not recall whether he examined the Joint Objection prior to the document being filed with the Court. [Mr. Bury's testimony]. He testified that it was his understanding that MAC Investments did not want the sale to go through without preserving its rights to the super-priority lien. Id.
23. Mr. Bury also acknowledged during his testimony that, at the time of the Joint Objection, he was “wearing two hats”—one as President/Owner of MAC and the other as Owner of MAC Investments. [Mr. Bury's testimony]. He confirmed during his testimony that as President/Owner of MAC, he wanted the Court to approve the sale to avoid liquidation but as Owner of MAC Investments, he needed to object to protect his rights. Id.
24. On December 12, 2017, Mr. Welty, MAC Investments, the Debtors and Callidus filed the Stipulation stating “that the reservation of rights objection of [MAC Investments] and [Mr.

Welty] . . . is not ripe at this time.” Stipulation, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 330]; Ex. 21.

25. Mr. Welty testified that he understood the Stipulation to reserve his rights of collection until the Closing Date to allow for accurate calculations of amounts. [Mr. Welty’s testimony]. He testified that he did not recall reviewing the Stipulation prior to it being filed with the Court. Id.
26. Mr. Bury testified that he believed the Stipulation allowed for a calculation to be done at a later date as to the super-priority lien. [Mr. Bury’s testimony]. He testified that he did not recall reviewing the document prior to it being filed. Id.
27. On December 18, 2017, the Court entered the Sale Order pursuant to Section 363 of the Bankruptcy Code authorizing the Debtors to sell substantially all their assets to Callidus, or its designee, free and clear of liens, claims, and encumbrances, for a credit bid purchase of \$13,500,000. Sale Order, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 344]; Ex. 22.
28. The relevant paragraphs of the Sale Order are as follows:

**Paragraph 2:** All objections and responses (if any) concerning the Motion are resolved with the terms of this Order and as set forth in the record of the Sale Hearing, and to the extent any such objection or response was not otherwise withdrawn, waived, or settled, it is overruled and denied, and all reservations of rights requested therein are overruled and denied. Notwithstanding the foregoing, the Stipulation of MAC Investment-Chanhassen LLC, Mark Welty, the Debtors, and Callidus [Docket No. 330] remains in force.

**Paragraph 3:** Debtors are authorized and directed to sell the Sale Assets to Callidus free and clear of all liens, Claims, encumbrances (other than the liens of Callidus), and other interests pursuant to 11 U.S.C. § 363(f) . . . with all such liens, Claims, encumbrances, and other interests attaching only to the sale proceeds in the same validity, extent, and priority as immediately prior to the transaction, subject to any rights, claims, and defenses of Debtors and other parties in interest.

**Paragraph 4:** Upon the closing of the sale contemplated herein, all creditors (other than Callidus), employees, and equity holders of Debtors, are bound by this Order to treat Callidus and the Sale Assets as free and clear of their respective Claims, liens, encumbrances and interests, whether known or unknown, asserted or unasserted, of any kind or nature whatsoever.

**Paragraph 9:** At closing of the sale, this Order: (a) is and shall be effective as a determination that (other than the liens of Callidus), all liens, Claims, and encumbrances of any kind or nature whatsoever existing as to the Sale Assets prior to the closing have been unconditionally released, discharged, terminated, and the conveyances described herein have been effected . . . .

**Paragraph 12:** This Order shall be binding in all respects upon all creditors and equity holders of any of the Debtors . . . .

Id.; Ex. 22.

29. Mr. Welty testified that he understood paragraph 2 of the Sale Order to mean that his rights to contest payment were protected despite the sale. [Mr. Welty's testimony]. He testified that he believed that his objection would become "ripe" once the sale closed. Id.
30. Mr. Welty testified that he received the Sale Order after it had already been filed with the Court and stated that he did not recall looking at the document prior to it being filed. Id. He testified that the language used on the Sale Order was inconsistent with his intention of blocking the sale, but that he was relieved to see his rights were protected. Id.
31. MAC began the transition process the first week of January 2018. [Mr. Prest's testimony]. Mr. Schiferl, Chief Financial Officer and Treasurer of Midwest, testified that he first came on site either December 26 or 27, 2017, prior to the Closing Date. [Mr. Schiferl's testimony]. He began working on a regular basis on January 2, 2018. Id. He stated that his role between the Sale Order and the Closing Date (the "Pre-Closing Period") was to understand the assets and liabilities assumed by Midwest and gain an understanding of the financial systems in place. Id.
32. During the Pre-Closing Period, Mr. Bury and Mr. Prest retained control of MAC's finances. [Mr. Schiferl's testimony]. Mr. Prest testified that he signed the majority of checks and reviewed the majority of payments made by the company during this time period. [Mr. Prest's testimony]. Both he and Mr. Bury testified that the environment was "collaborative" during this time; however, the meaning of this was not expanded on by either individual. [Mr. Prest's testimony; Mr. Bury's testimony].
33. Mr. Schiferl testified that he was not given access to MAC's bank accounts during the Pre-Closing Period nor did he have any check writing authority (a statement that was corroborated by Mr. Bury). [Mr. Schiferl's testimony; Mr. Bury's testimony]. He testified that he only received information on MAC's accounts through communications with Mr. Bury and Mr. Prest. [Mr. Schiferl's testimony]. He stated that he did not direct anyone to report to him nor did he imply that he was in charge. Id. However, he did testify to signing Mr. Prest's timecards. Id. Mr. Schiferl further testified that Mr. Bury never sought his approval or authority to write checks on behalf of MAC. Id. He testified that he had no interactions with Mr. Bury concerning MAC's financials (i.e. cash flow, checks, paying vendors, etc.). Id. Mr. Schiferl also testified that he never directed Mr. Prest as to which vendors to pay or not pay prior to the Closing Date. Id.

34. The Court finds, based on the unequivocal nature of Mr. Schiferl’s testimony that Mr. Schiferl is credible as to the above facts. Mr. Bury and Mr. Prest merely implied there was unspecified “collaboration” with Mr. Schiferl.
35. Mr. Schiferl testified that he was not authorized to cancel checks after they had been written. [Mr. Schiferl’s testimony]. He explained that it was his understanding that once a check is written, a “stop payment” can be placed on it if it has not cleared the bank but that this does not necessarily cancel the check. Id.
36. Effective January 15, 2018, MAC Investments transferred their interest in DIP Loan One to Mr. Welty. [Mr. Welty’s testimony]. Mr. Welty then possessed a lien in the amount of \$1,700,000 stemming from his DIP loans plus any accrued interest. Id.
37. On January 19, 2018, the Debtors and Midwest (as Callidus’s designee), closed on the sale of substantially all of Debtors’ assets to Midwest pursuant to the Sale Order and the APA. See Sale Order, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 344]; [Dkt. 30 at 18].
38. Mr. Bury testified that generally all assets were included in the sale with the exception of those listed in the APA. [Mr. Bury’s testimony]. The assumed assets included inventory, accounts receivable and cash. Id. Mr. Bury testified that no liabilities were assumed through the sale. Id.
39. The APA contained the following relevant provisions:

**Section 3.11 Ordinary Course of Business.** Except as set forth in Schedule 3.11 and other than in connection with the Bankruptcy Case and taking into account exigencies arising as a result of the Sellers’ financial condition and status as a chapter 11 debtor, since January 1, 2017 (the “Reference Date”), the Sellers have conducted the Purchased Business in the ordinary course of business in all material respects.

**Schedule 1.01(a)(iii)—Permitted Encumbrances.**

...

2. Claim of Mark Welty and MAC Investments Chanhassen, LLC to liens in cash collateral, working capital and certain other assets as set forth in orders entered in the Bankruptcy Case.

[Dkt. 30 at 33; 81]; Ex. 27 at 33 and 81.

40. For the purposes of the cash collateral diminution analysis, the parties have stipulated to the following values:

	<b>PETITION DATE</b>	<b>CLOSING DATE</b>
<b>CASH</b>	\$556,000	(In Dispute)
<b>ACCOUNTS RECEIVABLE</b> (*Parties Agree On Book Value Only)	\$4,938,000 (Actual value is in dispute)	\$2,898,000 (Actual value is in dispute)
<b>INVENTORY</b>	\$1,911,000	\$1,905,000
<b>VALUE OF TITLED VEHICLES</b>	(Not Relevant)	\$1,403,000
<b>VALUE OF CHAPTER 5 ACTIONS</b>	(Not Relevant)	\$243,000
<b>ADEQUATE PROTECTION PAYMENTS TO CALLIDUS</b>	(Not Relevant)	\$120,000

Stipulation of Facts at 3.

41. Jeffrey Johnston (“Mr. Johnston”) was admitted as a valuation expert by the Court. Mr. Johnston is currently employed by AlixPartners as managing director and specializes in turnaround consulting and restructuring; business valuation; forensic accounting; and litigation consulting. Ex. P. at 1; [Mr. Johnston’s testimony]. He has been employed with AlixPartners for approximately eleven years. Ex. P at 2. Prior to his current employment, Mr. Johnston spent twenty years at a boutique restructuring valuation litigation consulting firm and four years at Deloitte Haskins and Sells. Id. Mr. Johnston holds a Bachelor of Arts degree in accounting from Michigan State University. Id. He is also a Certified Public Accountant and a Certified Fraud Examiner. Id. He is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants. Id. Mr. Welty did not dispute Mr. Johnston’s qualifications to testify as an expert on valuation of cash and accounts receivable.
42. Specifically, Mr. Johnston testified as an expert on diminution in Callidus’s cash collateral position between the Petition Date and the Closing Date. [Mr. Johnston’s testimony]. He testified that in addition to his thirty years of experience in the industry, he relied on information gathered from MAC during its bankruptcy. Id. This included background information on MAC, reviewing pleadings and financial information, and meeting with MAC’s management (including with Mr. Bury and Mr. Prest) on numerous occasions. Id. He testified that he also reviewed Mr. Prest’s diminution analysis and deposition testimony and consulted significant business valuation literature. Id.; see Ex. T.
43. Gregg Prest was presented as Mr. Welty’s expert on valuation. Mr. Prest is the former Chief Financial Officer (“CFO”) of Debtor MAC. [Mr. Prest’s testimony]. Unlike Mr. Johnston, he was not deemed a valuation expert by the Court. Rather, he was admitted as an expert on a more limited scope—on the effect of lienable payables on the collection of accounts receivable.

44. Mr. Prest graduated from the University of Minnesota in 1985 with a Bachelor of Science degree in accounting. Id. After graduation, he worked as a public accountant at KPMG for approximately four years where he eventually served as a senior accountant. Id.
45. In 1989, Mr. Prest began working at a large international company named Tetrapak. Id. He held both accounting and operational roles including working as the divisional controller for U.S. operations. Id. After eight years with Tetrapak, Mr. Prest opened Frank Consulting, which was an outsource financial leader for hire for small, growing companies. Id. Besides being one of the owners, Mr. Prest managed various accounts including VSI Construction in which he worked as the outsource CFO on a part-time basis. Id. He then sold his interest in Frank Consulting and bought Crown Marking, a manufacturer of name badges. Id. During this time-period, he continued to consult with VSI Construction. Id. Mr. Prest testified that he first began working with lienable payables in approximately 2005 during his time as a consultant with VSI Construction. Id.
46. Mr. Prest began working as a consultant for MAC in February 2011. Id. In April 2011, Mr. Prest was hired on a part-time basis as MAC's CFO. Id. In December 2017, he received his last paycheck as an employee of MAC but continued to consult throughout the Pre-Closing Period. Id. He was not retained as an employee of Midwest. Id.
47. Mr. Prest testified that he took the exam to become a Certified Public Accountant but did not pass. Id. He did not try to take it again. Id. He also testified that he does not hold any valuation-related certifications, accreditations, or designations of any kind. Id.

#### Valuation of Cash as of Closing Date

48. In reference to the value of cash at the Closing Date, Mr. Prest testified that he did not subtract any outstanding checks from his calculations. [Mr. Prest's testimony]. He testified that this was because such checks could be "cancelled" if necessary and, accordingly, were not reliable indicators of cash value. Id.
49. Mr. Welty's counsel also directed Mr. Prest to include outstanding checks when calculating the value of cash. See Ex. 33; [Mr. Prest's testimony].
50. By including the value of outstanding checks, Mr. Prest determined the value of cash on the Closing Date to be \$1,029,000. [Mr. Prest's testimony]; Ex. 44.
51. Exhibit T provided generally accepted accounting principles for outstanding checks. Ex. T. It states that "[t]he balance sheet caption 'cash' should represent an amount that is within the control of the reporting enterprise, namely, the amount of cash in banks plus the amount of cash and checks on hand and deposits in transits minus the amount of outstanding checks." Ex. T at 2.
52. Mr. Johnston testified that Mr. Prest's valuation method did not comply with generally accepted accounting principles as it did not net out outstanding checks. [Mr. Johnston's testimony]. He testified that had Mr. Prest complied with generally accepted accounting

principles when valuing available cash of Debtor MAC on the Closing Date, the value would have been equal to the opening balance sheet cash amount of Midwest, the purchaser of the assets. Id. Mr. Johnston explained that this is because Midwest, as buyer, received the exact amount of cash that MAC, as seller, had on the Closing Date net outstanding checks. Id.

53. In addition, Mr. Johnston testified that, historically, MAC included the impact of outstanding checks when computing cash value, meaning that the cash on the balance sheet was recorded net outstanding checks. Id.
54. Mr. Johnston determined the value of cash on the Closing Date to be \$287,000 (cash minus outstanding checks). [Mr. Johnston's testimony]; Ex. Q.
55. The Court finds Mr. Johnston's relevant value of cash on the Closing Date in the amount of \$287,000 to be more credible. Mr. Johnston used the cash value amount from Midwest's opening balance sheet to calculate the relevant value and included the impact of outstanding checks. [Mr. Johnston's testimony]. This is consistent with generally accepted accounting principles as demonstrated by Exhibit T as well as the historic practices of MAC.

#### Valuation of Accounts Receivable

56. Mr. Prest testified that the following equation should be used when valuing accounts receivable: MAC's total book value accounts receivable less MAC's total lienable payables. [Mr. Prest's testimony]. Mr. Prest testified that this method was necessary because lienable payables are an "impairment" that must be considered when valuing accounts receivable. Id.
57. During his testimony, Mr. Prest cited no authority to support this approach. In fact, Mr. Prest confirmed that very few accounts receivable existing as of the Petition Date were not collected post-bankruptcy. [Mr. Prest's testimony]. He stated that while he did not do a calculation of how many receivables that were on MAC's books at the Petition Date had not been collected by the Closing Date, he agreed that it "was probably not very many." Id. He testified that the collection rate was assumedly consistent with MAC's past collections of between 95% and 98%. Id.
58. For purposes of his valuation method, Mr. Prest testified that MAC did not have an exact lienable payable value from the Petition Date to use. Id. Rather, he testified that the value of lienable payables was determined through use of a spreadsheet compiled at his instruction by MAC's controller in February 2017. See Ex. 2.
59. Mr. Prest testified regarding the process used by MAC's controller in creating the February 2017 spreadsheet. [Mr. Prest's testimony]. According to Mr. Prest, the controller first downloaded the accounts payable and manually stripped out the non-lienable payables using certain factors. Id. The controller then evaluated the remaining accounts by evaluating: (1) whether they were still inside their lien rights; and (2) the likelihood that a

lien would be filed (i.e. was the company sophisticated enough to file a lien). Id. Mr. Prest testified that MAC's controller used her independent judgment in making these evaluations since they were all done manually. Id.

60. Mr. Prest confirmed that there was a 120-day "look back" used in creating the February 2017 spreadsheet. Id. He testified that this "look back" period was inconsistent with the requirements of Minnesota law because it used the invoice date rather than the last date the subcontractor was on site. Id. Mr. Prest admitted that this may have caused certain accounts to be incorrectly deemed lienable payables. Id. Additionally, Mr. Prest provided no testimony that either he or his controller reviewed every lienable payable to determine if an actual lien was filed by a subcontractor. He could not say definitively whether all entities listed in the spreadsheet (Exhibit 2) could have filed a lien under Minnesota law, a fact confirmed by Mr. Welty's counsel.
61. Mr. Prest also acknowledged that errors could have been made by MAC's controller when developing the spreadsheet. Id. On cross-examination, he testified that project number 630707 may have been included despite the filing of a lien waiver. Id.
62. Mr. Prest testified that he used Midwest's opening balance sheet for the value of lienable payables as of the closing date. [Mr. Prest's testimony]; Ex. 31. He explained that he took the value \$1,019,003 from the accounts payable claim revised balance and subtracted the \$400,000 that represented non-lienable payables. [Mr. Prest's testimony]. This left a lienable payable value of \$619,003 as of the Closing Date. Id.
63. On cross-examination, Mr. Prest testified that he has been an owner or part-owner of many businesses that incurred debts. Id. He confirmed that if a third party had paid off these debts (or some portion of them), value would have been added to the company. Id. As to MAC, he testified that its debts as to its suppliers were recognized as "payables" meaning that if a customer paid these payables (or a portion of them), value would have been added to Midwest. Id. He testified that the value would have been the reduction of the amount of the payable. Id. For example, if a customer made a \$100,000 payment to a supplier, that would add \$100,000 of value to MAC to reduce its liabilities by that amount. Id.
64. Mr. Johnston also provided testimony regarding the valuation of accounts receivable. [Mr. Johnston's testimony]. He testified that he did not consider lienable payables when valuing accounts receivable, but instead used the book value. Id. He testified that it was his belief that Mr. Prest's approach was more consistent with a liquidation scenario. Id.
65. Mr. Johnston testified that he reviewed the cash collateral motions filed by MAC in the bankruptcy and concluded that MAC intended to use cash collateral to continue operating the business. Id. He testified that he saw no indication from these pleadings that it was MAC's intent to liquidate or sell the company as of the Petition Date. Id.
66. Mr. Johnston testified that, based on certain statements during Mr. Prest's deposition, he reviewed business valuation literature to determine if any identified the approach taken by Mr. Prest of netting lienable payables against accounts receivable. Id. Mr. Johnston

testified that he was unable to locate such an approach in the materials reviewed nor had he seen it used in his thirty years in the industry. Id.

67. Mr. Prest provided testimony that he previously used the same method when advising a financial institution as to the sufficiency of its collateral position in the event of a forced liquidation. [Mr. Prest's testimony].
68. Mr. Johnston testified that, in his expert opinion, Mr. Prest did not value accounts receivable on a going concern basis or liquidation basis. [Mr. Johnston's testimony]. Mr. Johnston reasoned that Mr. Prest was valuing accounts receivable in the hands of the creditor instead of that of a debtor's and he did not believe that Mr. Prest used the proper premise of value. Id.
69. Mr. Johnston testified that MAC had not historically reduced the value of accounts receivable by the total amount of lienable payables. Id. He testified that Mr. Prest's practice did not comply with generally accepted accounting principles. Id.
70. In fact, Mr. Johnston testified that in reviewing the audited financial statements and the internal financial statements, MAC historically recorded accounts receivable consistent with generally accepted accounting principles. Id. He testified that there was a \$100,000 allowance for doubtful or uncollectible accounts which was intended to serve as a valuation adjustment of the gross book value of accounts receivable to the gross estimated net collectible amount. Id. Mr. Johnston testified that an allowance of \$100,000 properly accounted for doubtful or uncollectible accounts. Id.
71. Mr. Prest concluded, using his method (deducting lienable payables from accounts receivable), that the relevant value of accounts receivable as of the Petition Date and the Closing Date were \$2,624,000 and \$2,279,000, respectively. [Mr. Prest's testimony]; Ex. 44.
72. Using book value, Mr. Johnston determined that the relevant value of accounts receivable as of the Petition Date and the Closing Date were \$4,938,000 and \$2,898,000, respectively. [Mr. Johnston's testimony]; Ex. Q.
73. During cross-examination, Mr. Johnston testified that in valuation of a company, the collectability of receivables in a fair market going concern context is what the receivables are worth which is, in this case, reflected by their carrying value on Midwest's books. [Mr. Johnston's testimony]. He explained that value of lienable payables does not affect the fair market value of assets. Id. To illustrate, he provided an example regarding a mortgage. Id. He explained that if you have a house that has a value of \$500,000 but has a \$300,000 lien against it, saying the fair market value of the house is \$200,000 does not make any sense. Id. Instead, the fair market value of the house remains \$500,000. Id.
74. The Court finds that Mr. Johnston's valuation is more credible. Mr. Johnston has thirty years of experience in the industry and is accredited in business valuation. He is also a Certified Public Accountant.

75. Mr. Prest, on the other hand, has no experience in valuation. He is not a Certified Public Accountant, nor does he hold any valuation-related certifications, accreditations, or designations. His approach of netting out lienable payables is not supported by any authority (including generally accepted accounting principles) nor is it consistent with MAC's historic practices.
76. The Court determines the value of accounts receivable on the Petition Date and the Closing Date to be \$4,938,000 and \$2,898,000, respectively, for a diminution of \$2,040,000.
77. On May 18, 2018, Mr. Welty filed a request for allowance of an administrative expense claim in the amount of \$1,726,833.30 against the Chapter 7 estate (representing what Mr. Welty claims he is owed related to the debtor-in-possession financing), which was docketed as Claim 79-1. See "Request for Allowance of An Administrative Expense Claim for Unpaid DIP Loans" ("Claim 79-1"), In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. May 18, 2018).
78. Mr. Welty testified that no portion of the principal on either DIP Loan One or DIP Loan Two had been paid to him. [Mr. Welty's testimony]. Mr. Bury confirmed during his testimony that there had been no principal repayment on either loan. [Mr. Bury's testimony]. Mr. Bury also confirmed that some interest payments had been made by MAC but that the exact amount was unknown. Id.

#### **CONCLUSIONS OF LAW**

1. The Court denies the declaratory judgment request in Count I of the Complaint as Callidus's cash collateral decreased in excess of \$2,000,000 and, therefore, any lien held by Mr. Welty in the assets sold to Midwest was extinguished.
2. The Court denies the request for equitable subordination in Count II, as Mr. Welty did not meet his burden of establishing that he is entitled to priority over Callidus's claim based on the principles of equitable subordination under 11 U.S.C. § 510(c)(1).

#### **ANALYSIS**

To resolve this adversary proceeding, the Court must address four issues as presented by the parties. The first is whether the Court possesses subject matter jurisdiction over Count I of the Complaint. This argument was previously addressed by the Court in an order dated July 19, 2018. The second is whether the lien claim of Mr. Welty survived the Sale Order. This is a threshold issue that must be determined prior to the merits of Count I. The third, in Count I, is the existence and extent of Mr. Welty's lien on assets purchased by Midwest. And, the fourth is

whether Mr. Welty met his burden of showing that the use of equitable subordination is appropriate in Count II.

**I. The Court Has Subject Matter Jurisdiction Over Count I Of The Complaint.**

Federal Rule of Civil Procedure 12(b)(1), which is applicable to adversary proceedings by virtue of Federal Rule of Bankruptcy Procedure 7012(b), provides the means by which a party may seek dismissal of an adversary proceeding on the grounds that the bankruptcy court lacks subject matter jurisdiction. See Fed. R. Civ. P. 12(b)(1). A motion to dismiss under Rule 12(b)(1) challenges the power of a federal court to hear a claim or case. The plaintiff has the burden of showing the court has subject matter jurisdiction over the proceeding. See Osborn v. United States, 918 F.2d 724, 730 (8th Cir. 1990); Bayview Plaza Assocs. Ltd. P’ship v. Town of North East (In re Bayview Plaza Assocs. Ltd. P’ship), 209 B.R. 840, 841-42 (Bankr. D. Del. 1997). “The [c]ourt’s inquiry is limited to determining whether the challenged pleadings set forth allegations sufficient to show the [c]ourt has subject matter jurisdiction over the matter.” In re Bayview Plaza Assocs. Ltd. P’ship, 209 B.R. at 841-42.

The Defendants’ Motion to Dismiss asserted 12(b)(1) as grounds for dismissal after inquiry from the Court. [Dkt. 19]. However, even if the defense had not been properly raised by the Defendants, the Court has a duty and responsibility to raise the issue of its own jurisdiction when necessary. “Courts are obligated to examine their own jurisdiction and subject matter jurisdiction may be raised at any time, by a party or the court, sua sponte.” May v. Missouri Dep’t of Revenue (In re May), 251 B.R. 714, 719 (B.A.P. 8th Cir. 2000). Since an objection to subject matter jurisdiction goes directly to the power of the court to hear and decide a case, parties may not create or destroy jurisdiction by agreement or consent. See Neirbo Co. v. Bethlehem Shipbuilding Corp., 308 U.S. 165, 167, 60 S.Ct. 153, 154, (1939). Similarly, while litigating parties may waive

personal jurisdiction, they cannot waive subject matter jurisdiction. See Arbaugh v. Y&H Corp., 546 U.S. 500, 501, 126 S.Ct. 1235, 1237 (2006) (“[S]ubject-matter jurisdiction, because it involves a court’s power to hear a case, can never be forfeited or waived.” (quotation omitted)).

Under 28 U.S.C. § 1334(b), district courts are granted subject matter jurisdiction over all cases arising under title 11 or arising in or related to cases under title 11. Each federal court may refer all cases under title 11 or arising in or related to cases under title 11 to the bankruptcy court pursuant to 28 U.S.C. § 157(a). The United States District Court for the District of Minnesota has referred all such cases to the United States Bankruptcy Court for the District of Minnesota. Therefore, this Court has jurisdiction to hear any case that arises under title 11 or arises in or related to a case under title 11.

A proceeding “arises under” title 11 if a claim asserted is created by or based on a provision of the Bankruptcy Code. E.g., Nat’l City Bank v. Coopers & Lybrand, 802 F.2d 990, 994 (8th Cir. 1986). All proceedings typically associated with bankruptcy adjudication fit this category. A proceeding “arises in” a case under title 11 if it is not based on any right expressly created by the Bankruptcy Code but has no existence outside of the bankruptcy case. Frelin v. Oakwood Homes Corp., 292 B.R. 369, 377 (Bankr. E.D. Ark. 2003) (citing In re Chambers, 125 B.R. 788, 793 (Bankr. W.D. Mo. 1991)). This category involves proceedings that secondarily spring from a pending case such as allowance or disallowance of claims, orders regarding obtaining credit, confirmation of plans, and orders dealing with acceptance or rejection of a contract.

And, finally, a proceeding is “related to” a case under title 11 if it meets the “conceivable effect” test. In the Eighth Circuit, a court must determine whether the outcome of a proceeding could conceivably have any effect on the estate being administrated in bankruptcy. Specialty Mills, Inc. v. Citizens State Bank, 51 F.3d 770, 774 (8th Cir. 1995). Therefore, under “related to”

jurisdiction, a proceeding does not necessarily need to be against the debtor or the debtor's property. Rather, an action can be said to be "related to" bankruptcy if the outcome could alter the debtor's rights, liabilities, options or freedom of action and which in any way impacts the handling or administration of the bankruptcy estate.

In this case, the parties agreed "related to" jurisdiction applied to Count I of the Complaint. However, the Defendants argued that the Court lacked subject matter jurisdiction over Count I because Mr. Welty asserted "a lien priority and valuation dispute between two non-debtors involving non-estate property." [Dkt. 19 at 8]. The Defendants' argument relied heavily on In re Xonics, 813 F.2d 127 (7th Cir. 1987), a Seventh Circuit case that found bankruptcy jurisdiction is meant to provide a single forum for dealing with claims to the bankrupt's assets and extends no further. The court held that because the case dealt with an unrelated dispute between two creditors and had no impact on the bankruptcy estate itself, the bankruptcy court did not have jurisdiction. The Defendants also cited numerous cases to support In re Xonics's holding.

However, as previously explained at the hearing on July 19, 2018, the facts of the present case are readily distinguishable from In re Xonics and other cases cited by the Defendants. This Court has "related to" jurisdiction over Count I of the Complaint. "Related to" jurisdiction is broad and found if "the outcome of [the] proceeding could conceivably have any effect on the estate being administered in the bankruptcy." Cutcliff v. Reuter, 791 F.3d 875, 881 (8th Cir. 2015). Mr. Welty sufficiently articulated how this adversary proceeding could "conceivably effect" claims and distributions in the bankruptcy case. Pursuant to previous court orders filed in the bankruptcy case, Mr. Welty possesses a super-priority administrative claim meaning he must be paid before all or nearly all the unsecured creditors. In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 152, 184]. A favorable resolution of Count I not only eliminates or significantly reduces Callidus's

claim in the case, it would also allow Mr. Welty to exercise his lien rights against Midwest, as purchaser of the assets, reducing (or eliminating) the amount of his super-priority administrative claim and increasing the funds available to the estate for distribution to other creditors. Thus, the resolution of Count I has a profound effect on creditors. In fact, the trustee of MAC's bankruptcy estate has brought similar claims against Callidus in adversary proceedings to eliminate its claims. See "Answer and Counterclaim," Midwest Asphalt Servs. v. Stoebner, No. 18-04101 (Bankr. D. Minn. Aug. 20, 2018) [Dkt. 6]; "Complaint," Stoebner v. Callidus Capital Corp., No. 19-04008 (Bankr. D. Minn. Jan. 8, 2019) [Dkt. 1].

The Seventh Circuit also takes a more narrow view of "related to" jurisdiction compared to the Eighth Circuit, explicitly stating that the "conceivable effect" test is too broad. This difference is immaterial in this case, however, as even under this more narrow view, a matter is related to a bankruptcy case if it affects the amount of property available for distribution to creditors or the allocation of property among creditors. See In re H. King & Assocs., 295 B.R. 246, 259 (Bankr. N.D. Ill. 2003) (concluding a Chapter 7 trustee's adversary proceeding against debtor's former officers, etc., based on breaches of fiduciary duty was related to the bankruptcy case because any recovery would bring assets into the estate.). Thus, unlike In re Xonics, disposition of Count I could materially affect distribution and, therefore, there is subject matter jurisdiction.

Subject matter jurisdiction is also supported by Buffets, Inc. v. Leischow, 732 F.3d 889 (8th Cir. 2013) and GAF Holdings, LLC v. Rinaldi (In re Farmland Indus.), 567 F.3d 1010 (8th Cir. 2009) as discussed on the record at the July 18, 2018 hearing. In Buffets, Inc., the Eighth Circuit affirmed the district court's summary judgment order in favor of a bank which brought an indemnification claim against the debtor corporation, finding that the claim conceivably could

have affected the bankruptcy. 732 F.3d at 894. The Court rejected the debtor’s argument that substituting creditors could not materially impact the estate, reasoning that various potential claims against the debtor could cover more than just the amount of a judgment and may differ depending on the outcome of the action. Id. Thus, it found that the district court properly asserted “related to” jurisdiction.

In In re Farmland Indus., supra, an unsuccessful bidder in a sale of a Chapter 11 debtor’s assets appealed after a bankruptcy court dismissed the tort claims it asserted against the asset purchasers on both procedural and substantive grounds. 567 F.3d at 1015. On appeal, the bankruptcy appellate panel sua sponte determined that the bankruptcy court lacked jurisdiction over the complaint and remanded the matter for dismissal. Id. The Eighth Circuit reversed, finding that “related to” jurisdiction existed because the Liquidating Trustee was advancing money out of the bankruptcy estate to certain other defendants who were incurring legal fees in defending against the tort claims. Thus, the Court found that the indemnification claims in the case were not merely speculative in light of such payments and not only “could conceivably have an effect on the Farmland estate” but are having an effect. Id. at 1021 (emphasis omitted).

These cases are in stark contrast to a recent decision from the Eighth Circuit Bankruptcy Appellate Panel, In re McDougall, No. 17-6028, 2018 WL 3342650 at \*1 (B.A.P. 8th Cir. July 9, 2018). In In re McDougall, the Court concluded the bankruptcy court did not have jurisdiction to resolve an adversary proceeding between two non-debtor parties seeking to invalidate liens (based on state law) on non-estate property. Id. at \*3. The Court emphasized that the property in question never entered the estate and determined the parties did not adequately explain how the proceeding could affect the estate. Id. (“The alleged dispute between the McDougalls and AgCounty is a state law fraud dispute between two non-debtors about property that was never property of the

bankruptcy estate . . . .”) (emphasis in original). Unlike the cases cited above (as well as the present case), there was no allegation that claims in the estate could be affected. Accordingly, this Court has subject matter jurisdiction over Count I.

## **II. The Lien Claim Of Mr. Welty Was Preserved In The Sale Order.**

Count I of the Complaint requests a declaratory judgment that Mr. Welty holds a lien on certain assets of Midwest and asks the Court to determine the “priority and value” of the alleged lien. However, the Defendants argue that Midwest purchased MAC’s assets free and clear of Mr. Welty’s alleged lien pursuant to the plain language of the Sale Order and, therefore, the Court should declare that Mr. Welty does not hold a lien on any of Midwest’s assets. This is a threshold issue that must be resolved prior to the Court determining the merits of Count I of the Complaint. The resolution of this question turns on the interpretation of prior orders.

Section 363 of the Bankruptcy Code authorizes a trustee (or, in this case, a debtor-in-possession) to sell property of the estate free and clear of any interest in such property of an entity other than the estate if certain conditions are met. 11 U.S.C. § 363(f). The Defendants point to three provisions of the Sale Order (paragraphs 3, 4 and 9) as evidence that Mr. Welty’s lien did not survive the sale. However, such an argument ignores the existence of the Joint Objection and Stipulation filed by the parties as well as the terms of the APA.

Mr. Welty and his predecessor in interest, MAC Investments, filed a Joint Objection to the Sale Motion on December 8, 2017. See Joint Objection, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 328]. Paragraph 9 of the Joint Objection stated, in relevant part, “The Court should enter an order approving the auction and the eventual sale but reserving the rights of MAC Investments and [Mr.] Welty, upon completion of the sale, to receive their rightful share of the proceeds from the sale assets in which they hold a superior interest.” Id. A Stipulation to the Joint

Objection was then filed on December 12, 2018, stipulating that the “reservation of rights objection of MAC Investments and Welty filed on December 8, 2017 . . . is not ripe at this time.” See Stipulation, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 330]. Mr. Welty argues that these two documents were then incorporated into the Sale Order by the parties, working to preserve his lien rights until the existence and extent of those rights could be determined. To prove this, he points to paragraph 2 of the Sale Order which states “Notwithstanding the forgoing, the Stipulation of MAC Investments-Chanhassen, LLC, Mr. Welty, the Debtors and Callidus . . . remains in force.” See Sale Order, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 344]; Ex. 22.

The Defendants argue that the language of paragraph 2 is immaterial as “neither the stipulation referred to in the Sale Order, nor [Mr. Welty’s] original ‘objection’ to which the stipulation related, purported to preserve a claim of lien in any assets sold pursuant to the Sale Order.” [Dkt. 30 at 8]. Further, they claim that the objection only referred to “proceeds from the sale” and, given the nature of a credit bid (a bid by a secured party bidding only the amount of its debts), there were no cash “proceeds from the sale” to which Mr. Welty’s liens could attach. Id. However, the Court received testimony from both Mr. Welty and Mr. Bury that they understood the purpose of paragraph 2 of the Sale Order to preserve their lien rights until the existence and extent of those rights could be determined. Although neither individual recalled reviewing any of the documents (i.e. the Joint Objection, Stipulation, or Sale Order) prior to those documents being filed with the Court, their testimony did provide some evidence as to the intent of each document. No such testimony was provided by the Defendants. The Court concludes, therefore, that Mr. Bury and Mr. Welty’s statements regarding the purpose of the documents, while of not great weight, were credible and, more importantly, are supported by the inclusion of Schedule 1.01(a)(iii) within the APA as discussed below.

Schedule 1.01(a)(iii) of the APA is entitled “Permitted Encumbrances” and allows the following encumbrance on the sale: “Claim of Mark Welty and MAC Investments-Chanhassen LLC to liens in cash collateral, working capital and certain other assets as set forth in orders entered in the Bankruptcy Case.” [Dkt. 30 at 81]; Ex. 27. In closing arguments, counsel for Mr. Welty argued that such language demonstrates the parties’ intent to reserve Mr. Welty’s rights despite the fact the sale was free and clear of liens. Specifically, in reference to this schedule, he stated “there was a reservation with the APA so subsequently there was an understanding of a reservation” between the parties. This was done, he claimed, because of the nature of the distribution scheme. He asserted that because the calculation of diminution could not be done prior to the sale (and, therefore, Mr. Welty’s lien rights could not be determined), the parties intentionally preserved the right to have that discussion at a later date as evidenced by the inclusion of this schedule. [Dkt. 65 at 27; Dkt. 77, at 01:02:26-01:02:38].

The Court received no evidence from the Defendants to contradict this argument. In fact, the language used within Schedule 1.01(a)(iii) supports the idea of a reservation of rights. While the term “claim” is not defined within the APA, Section 101 of the Bankruptcy Code provides the following definition:

- (A) Right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
- (B) Right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

11 U.S.C. § 101(5). Therefore, the use of “claim” demonstrates a potential or contingent “right to payment” on behalf of Mr. Welty. This language supports Mr. Welty’s contention that his claim

to lien rights was preserved by the parties until its existence and extent could be determined. For the Court to conclude otherwise would be illogical and negate the language of Schedule 1.01(a)(iii) to the APA.

Mr. Welty's objection to the Sale Motion in order to preserve his rights, the parties' subsequent stipulation concerning his objection, and the inclusion of Mr. Welty and MAC Investments' claims as "Permitted Encumbrances" on Schedule 1.01(a)(iii) of the APA all support the conclusion that the preservation of Mr. Welty's rights were explicitly maintained in the APA.

### **III. The Court Declines To Grant A Declaratory Judgment That Mr. Welty's Liens Attach To Any Property of Midwest.**

The merits of Count I must be decided since it has been determined that the Debtors' assets were not sold to Midwest free and clear of Mr. Welty's contingent claim (that there was no diminution in the value of the cash collateral). Count I of this adversary proceeding was brought to determine the existence and extent of Mr. Welty's lien on certain assets purchased by the Defendants. The parties agree that the amount of Mr. Welty's lien is a function of the diminution of value of Callidus's cash collateral.

#### **A. The Factual Issues**

The post-petition liens were granted by the Court to protect Callidus's pre-petition security interest in cash collateral based on its value on the Petition Date. In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 27; 70; 138; 183; 232; 245; 268; and 352]. The orders granted Callidus post-petition liens in all of MAC's assets including replacement liens in post-petition cash collateral and liens in additional previously unsecured collateral (i.e. Chapter 5 claims, Titled Vehicles, and the cash value of certain Life Insurance Policies). The orders also authorized the Debtor to make adequate protection payments to Callidus. In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 70; 138; 183; 268]. There is no dispute that Callidus's post-petition liens were expressly limited to

secure the diminution in value of cash collateral. However, the amount of such diminution is critical to determination of the extent of Mr. Welty's lien. If any amount of diminution occurred, making cash collateral worth less on the Closing Date than on the Petition Date, Callidus holds a security interest in post-petition collateral securing that amount of diminution. This diminution could be anywhere up to the \$2,315,000 claimed by Callidus. The specific amount of diminution determines whether Mr. Welty is entitled to a lien on any assets sold to Midwest and in what amount. For example, if the diminution was determined to be \$600,000, Callidus would have a security interest in that \$600,000 and Mr. Welty would have a security interest in any additional post-petition collateral up to the value of that collateral. In contrast, if no diminution has occurred, Callidus would not have a security interest in any post-petition assets and Mr. Welty would be entitled to a lien on those post-petition assets sold to Midwest above the amount on the Petition Date. In that scenario, if Mr. Welty was paid in full, he would no longer have a priority claim in the bankruptcy case, freeing up property in the estate for other unsecured creditors.

For the purposes of the cash collateral diminution analysis, the parties have stipulated to the values in the charts below. For purposes of this order, all dollar amounts are rounded to the nearest \$1,000 as is consistent with the parties' trial briefs.

	<b>PETITION DATE</b>	<b>CLOSING DATE</b>
<b>CASH</b>	\$556,000	(In Dispute)
<b>ACCOUNTS RECEIVABLE</b> (**PARTIES AGREE ON BOOK VALUE ONLY)	\$4,938,000 (Actual value is in dispute)	\$2,898,000 (Actual value is in dispute)
<b>INVENTORY</b>	\$1,911,000	\$1,905,000
<b>VALUE OF TITLED VEHICLES</b>	(Not Relevant)	\$1,403,000
<b>VALUE OF CHAPTER 5 ACTIONS</b>	(Not Relevant)	\$243,000
<b>ADEQUATE PROTECTION PAYMENTS TO CALLIDUS</b>	(Not Relevant)	\$120,000

The parties agreed that only the value of cash on the Closing Date and the value of accounts receivable on the Petition Date and the Closing Date are in dispute. [Dkt. 64 at 4-5, 7; Dkt. 65 at 2, 29].

Callidus argued that the Court should consider the following values of cash and accounts receivable.

	<b>PETITION DATE</b>	<b>CLOSING DATE</b>
<b>CASH</b>	\$556,000	\$287,000
<b>ACCOUNTS RECEIVABLE</b>	\$4,938,000	\$2,898,000

Using these values, plus a stipulated loss of inventory of \$6,000, Callidus argued that cash collateral decreased in an amount of \$2,315,000 meaning that Mr. Welty's lien on transferred assets had been extinguished.

Mr. Welty, on the other hand, argued that the Court should consider the following values when completing its calculation.

	<b>PETITION DATE</b>	<b>CLOSING DATE</b>
<b>CASH</b>	\$556,000	\$1,029,000
<b>ACCOUNTS RECEIVABLE</b>	\$2,624,000	\$2,279,000

Using these values, Mr. Welty argued that cash collateral increased in the amount of \$122,000, including the loss of \$6,000 in inventory, meaning, in his view, there was no diminution in cash collateral. Mr. Welty also argued that further adjustments were necessary. First, he asserted that an additional \$120,000 reduction in Callidus’s post-petition security interest was necessary to account for adequate protection payments received during the case. Second, he argued that the \$133,000 Insurance Refund was not necessary to secure Callidus’s cash collateral interest and, therefore, Callidus had no security interest in the refund. Third, under his analysis, Callidus could receive \$243,000 in proceeds (a stipulated amount)<sup>1</sup> from its security interest in Chapter 5 claims. (Mr. Welty has no lien on those claims.)

Mr. Welty also argued that, if Callidus’s lien is eliminated, he had a priority lien on certain post-petition collateral. Specifically, Callidus received \$1,749,000 in additional collateral protection from the following sources in which it did not have a pre-bankruptcy security interest: Titled Vehicles (stipulated value of \$1,403,000); Life Insurance Policies (stipulated value of \$213,000); and an Insurance Refund (stipulated value \$133,000).<sup>2</sup>

Therefore, if Callidus’s diminution number (adjusting for the adequate protection payments (\$120,000) and Chapter 5 claims (valued at \$243,000)) is greater than the value of the

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<sup>1</sup> This is a stipulated amount estimating potential recovery of Chapter 5 claims. Subsequent to the trial, forty-six Chapter 5 (preference) cases have been filed seeking over \$1.6 million in forty-five of the cases and \$17.5 million in the forty-sixth case.

<sup>2</sup> It is not clear that Callidus agrees the Insurance Refund should be included as post-petition collateral. However, as shown below, it makes no difference in the result when included. As a result, it is included as post-petition collateral.

Titled Vehicles, Life Insurance Policies, and Insurance Refund (totaling \$1,749,000), Mr. Welty's lien is eliminated. The parties agree this is decided by determining the value of cash at the Closing Date and accounts receivable at the Petition Date and the Closing Date.

### **B. The Legal Standard of Valuation**

The parties argue slight variations as to the proper method of determining the values of cash and accounts receivable. Both agree that the correct starting point for valuation is fair market value. The Defendants argue that the proper method is "going concern fair market value" while Mr. Welty argues that the "replacement value" must be considered.

Each party cites to, among other cases, the United States Supreme Court's ruling in Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S.Ct. 1879 (1997), to support their positions. In that case, the United States Supreme Court resolved a circuit split interpreting section 506(a) in the context of a Chapter 13 "cramdown" plan under section 1325(a) (reducing the amount of a secured debt to the value of the collateral). In calculating the value of the lender's secured claim, the majority examined the second sentence of section 506(a) and focused on the "proposed disposition or use" language. 520 U.S. at 962, 117 S.Ct. at 1885. The Court held that, given this language, collateral must be valued in light of its "proposed disposition or use" for purposes of deciding whether foreclosure value, going concern value, or some alternative value is most relevant. Id. at 956, 117 S.Ct. at 1882. Based on the proposed disposition of the property in that case, the Court held that foreclosure value could not be the proper method for valuing the creditor's claim. Id. at 963, 117 S.Ct. at 1886. Rather, the Court applied replacement value, defining it as the "price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." Id. at 960, 117 S.Ct. at 1884; accord In re Hermann, 224 B.R. 101, 102 (Bankr. D. Minn. 1998) ("Under 506(a), the value of property retained in the exercise of

Chapter 13’s ‘cram down’ option is the cost the debtor would incur to obtain a like asset for the same proposed use.”). By analyzing replacement value from the debtor’s point of view, the Court in Rash equated replacement value with fair market value as opposed to foreclosure value.

The Bankruptcy Court for the Southern District of New York expanded on Rash’s holding in Official Comm. Of Unsecured Creditors v. UMB Bank, N.A. (In re Residential Capital, LLC), 501 B.R. 549 (Bankr. S.D.N.Y. 2013). In that case, the Court applied Rash in the context of a cash collateral diminution analysis in a Chapter 11 case. See In re Motors Liquidation Co., 482 B.R. 485, 492 (Bankr. S.D.N.Y. 2012) (noting that “[p]ost-Rash case law suggests that Rash can be applied to the provisions of all three reorganization chapters—11, 12, or 13—because these chapters all treat secured claims similarly.”). Applying Rash’s reasoning, the Court agreed that the proper method of valuation must account for the proposed disposition of the collateral. In re Residential Capital, 501 B.R. at 594. The Court found that the parties entered into a cash collateral stipulation to allow the sale of assets as a going concern and, thus, the Court “must apply the value based on the proposed disposition of the collateral—fair market in the hands of the debtors.” Id. at 595; accord In re Heritage Highgate, Inc., 679 F.3d 132, 142 (3rd Cir. 2012) (“Where a Chapter 11 plan of reorganization provides for a debtor to retain and use collateral to generate income with which to make payments to creditors, a § 506(a) valuation based upon a hypothetical foreclosure sale would not be appropriate . . . .”); Bank Rhode Island v. Pawtuxet Valley Prescription & Surgical Ctr., Inc., 386 B.R. 1, 4 (D.R.I. 2008) (affirming the use of going-concern value rather than liquidation value for determining whether a creditor’s cash collateral is adequately protected).

Given the holdings of these cases, the valuation must consider the collateral’s purpose and the proposed disposition of the assets. It is undisputed that MAC operated as a going concern during the pendency of its Chapter 11 case. The Debtors made it clear from their initial filings

that its proposed use of cash collateral was “to carry on its business activities, to pay for its current operations, including purchases, insurance, utilities, payroll and payroll taxes.” Motion for Cash Collateral, In re Midwest Asphalt Corp., No. 17-40075 [Dkt. 8 at 6-7]. This is also evident by the fact that MAC continued paying a substantial amount of its pre-petition expenses after the bankruptcy was filed. See “Agreed Order Resolving Debtor’s Motion for Payment of Certain Pre-Petition Claims,” In re Midwest Asphalt Corp., No. 17-40075 (Bankr. D. Minn. Feb. 9, 2017) [Dkt. 61]. Testimony received by the Court from both Mr. Bury and Mr. Johnston (who reviewed all cash collateral motions filed by the Debtors) also supports this notion. Both individuals testified that the goal was to continue operations and protect cash collateral to avoid liquidation. Mr. Welty also testified that he provided the DIP loans after being contacted by Mr. Bury who sought additional funds to continue operations. In addition, it is undisputed by the parties that MAC was sold on a going concern basis to Midwest. Therefore, the parties are correct that a foreclosure or liquidation valuation standard is not applicable in this case as neither account for the proposed disposition of the collateral as instructed under Rash and In re Residential Capital.

Mr. Welty argues that the holding in Rash dictates that “*replacement value* applies to disputes between debtor and creditor where the debtor proposes to retain the use of the collateral.” [Dkt. 65 at 31]. However, under Rash, replacement value is the amount a willing buyer would have paid a willing seller for the collateral and is not all encompassing. Rash, 520 U.S. at 960, 117 S.Ct. at 1884. Rash simply directs courts that assets’ valuation “shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property.” Id. at 961, 117 S.Ct. at 1885. Therefore, the Court determines fair market value on a going concern basis is the more appropriate standard for measuring the diminution of value of cash collateral. As demonstrated above, the Debtors’ intended use of cash collateral was to enable the Debtor to keep

operating its business. It is clear from the evidence that the parties to the sale anticipated that the business would be conducted on an on-going basis before and after the sale. See In re SK Foods, L.P., 487 B.R. 257, 262 (Bankr. E.D.Cal. 2013) (concluding a going-concern valuation is appropriate when “items were being sold with a view to selling the business substantially as an active business with future earning power”). While the correct method for valuation is fair market value on a going concern basis, it still must be determined if any diminution occurred by valuing cash and accounts receivable.

As detailed in the Findings of Fact, both parties offered valuation testimony with only the Defendants’ witness—Jeffrey Johnston—being admitted as a valuation expert. He holds a Bachelor of Arts degree in Accounting and is a Certified Public Accountant and a Certified Fraud Examiner and has been in the accounting and valuation fields for thirty years. He is also accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants. Mr. Johnston’s opinions of the value of each disputed asset was informed by generally accepted accounting principles, historic practices of MAC, and his expertise. As a result, Mr. Johnston’s conclusions regarding value were very credible.

Mr. Welty’s witness—Gregg Prest—was not deemed a valuation expert by the Court; rather, he was admitted as an expert on a more limited scope. He was permitted to provide expert testimony on the effect of the possibility of subcontractors filing liens (referred to as “liable payables”) on the collection of accounts receivable. However, even if Mr. Prest had been permitted to testify as a valuation expert, his credibility as an expert would be weak for the reasons discussed below.

### **C. Value of Cash**

It is undisputed by the parties that the value of cash as of the Petition Date was \$556,000. [Dkt. 65]. However, the parties disagree as to the value of cash at the Closing Date. The Defendants argue that the value of cash decreased to \$287,000 while Mr. Welty argues that the value of cash increased to \$1,029,000. The only difference between these calculations is the deduction of outstanding checks. Mr. Welty argues that outstanding checks should not be deducted from the amount in the bank account whereas the Defendants argue that outstanding checks should be deducted.

Mr. Welty's witness—Mr. Prest—valued cash using the assumption that outstanding checks should not be deducted from the amount in the bank account at the Closing Date. This was done at the instruction of Mr. Welty's counsel. Ex. 33 at 1. Mr. Johnston, who testified that he has examined MAC's records, testified that this instruction was not consistent with MAC's historic practices. Both MAC's past audited financial statements as well as its internal financial statements included the impact of outstanding checks when computing cash value. Specifically, Mr. Johnston testified that MAC's valuation of cash had historically complied with generally accepted accounting principles.

Generally accepted accounting principles hold that the balance sheet caption "cash" should represent an amount that is within the control of the reporting enterprise. See Ex. T. Outstanding checks, however, are out of the payer's control after mailed or delivered to the payee and should be reported as a reduction of cash. Id. By including outstanding checks now (for the first time) at the direction of counsel, Mr. Prest undermines his credibility as to the valuation of cash.

The unreliability of not deducting outstanding checks is bolstered by the fact that Mr. Prest acknowledged generally accepted accounting principles hold to the contrary but provided no

credible explanation for why they were not used in this case. In fact, no alternative theory was provided to support his method of valuing cash without deducting outstanding checks. While he insisted this method was more reliable given MAC's ability to cancel checks, he did not provide a credible explanation as to why, if that was his belief, MAC had been deducting outstanding checks in the past. Rather, the Court received credible testimony from Mr. Johnston that, had Mr. Prest complied with generally accepted accounting principles (as was the company's past practice) when valuing the available cash on the Closing Date, the value would have been equal to the opening balance sheet amount of Midwest (\$287,000). This is the exact amount of cash that MAC had in its possession at closing (as outstanding checks had to be paid).

Mr. Prest's valuation method is more consistent with that of a liquidation analysis, which the parties agree is inapplicable. It is more appropriate (if at all) to not deduct outstanding checks when valuing cash where a debtor is ceasing operations and making no payments to creditors. In that instance, a debtor might try to stop payment on checks or simply not pay expenses to maximize cash. However, that has never been the situation in this case. The Debtors' intent has always been to operate on a going concern basis.

The APA also supports the deduction of outstanding checks when valuing cash. Section 3.11 is entitled "Ordinary Course of Business" and states the following:

Except as set forth in Schedule 3.11 and other than in connection with the Bankruptcy Case and taking into account exigencies arising as a result of the Sellers' financial condition and status as a chapter 11 debtor, since January 1, 2017 (the "Reference Date"), the Sellers have conducted the Purchased Business in the ordinary course of business in all material respects.

[Dkt. 30 at 33]. Under this section, the APA specifically provides for the Debtors to run their business in the ordinary course prior to the Closing Date. By including such language within the APA, the parties anticipated that the Debtors would continue operating the business, including

proceeding normally with making all outstanding payments to creditors, between the court approval of the sale and the Closing Date. Not paying an expense would have been a default under the APA leading to possible cancellation of the sale or reduction in price.

Mr. Welty argues, however, that regardless of generally accepted accounting principles, the language of the APA, or the Debtor's historical accounting, outstanding checks should not be deducted when valuing cash because such checks can be cancelled. However, he provided no evidence to support this notion other than testimony from Mr. Prest that checks can be cancelled once issued. Cancellation of a check is not automatic. Under Article IV of the Uniform Commercial Code ("U.C.C."), a drawer of a check must ensure that certain requirements are met for the stop-payment order to be considered effective (e.g. sufficient notice to bank; ensure check has not previously been deposited; correct mode of communication and content). U.C.C. §§ 4-303; 4-403. This premise is bolstered by the testimony of Mr. Schiferl, who explained that once a check is issued, it was his belief that a "stop payment" can be placed upon it if it has not cleared the bank, but that this does not necessarily cancel the check. In fact, the Court received no evidence from the Plaintiff as to how many of MAC's outstanding checks were subject to possible stop payment orders, if any, and in what amount.

For these reasons, the Court concludes that the Defendants' valuation of cash is more credible. Mr. Johnston testified that the Closing Date cash value of \$287,000 used by the Defendants was obtained from Midwest's opening balance sheet. This figure reflects the amount of cash transferred from MAC to Midwest and deducts the amount of outstanding checks. According to credible testimony from Mr. Johnston, it is also compliant with generally accepted accounting principles and consistent with valuing an asset using fair market value on a going concern basis. Given this, the cash value on the Closing Date was \$289,000. Therefore, taking

the Petition Date cash value of \$556,000 and subtracting the Closing Date cash value of \$287,000, the total cash value diminution is \$269,000.

#### **D. Value of Accounts Receivable**

The book value of accounts receivable as of the Petition Date and the Closing Date are undisputed by the parties. Both agree that the values are \$4,938,000 and \$2,898,000, respectively, and include a \$100,000 deduction for uncollectible or doubtful accounts. The Defendants used these stipulated values for the purposes of their diminution analysis. Mr. Welty, however, argues that these values are incorrect and must be adjusted by “liable payables” to more accurately represent the total value of accounts receivable.

Minnesota law provides property owners and subcontractors with certain rights with regard to unpaid debts related to providing labor and/or materials. See Minn. Stat. §§ 514.01-.17. Subcontractors who provide labor or materials for property improvements are given lien rights against the real property if they are not paid within 120-days after completion of the improvements. Minn. Stat. § 514.011. Property owners (or customers) are statutorily permitted to withhold payment to general contractors in favor of paying subcontractors directly during the 120-day period after the subcontractors’ work is completed. Minn. Stat. § 514.07.

Thus, Mr. Welty argues, from the Debtors’ perspective, liable payables “must be paid in order for the accounts receivable to be received.” He asserts that any buyer purchasing accounts receivable would need to consider the statutory obligations and practical implications of liable payables associated with the accounts receivable. This is because a customer might not pay the company the full amount of a receivable given the risk of the subcontractor placing a lien on its property if the general contractor fails to pay the subcontractor.

This argument was made by Mr. Prest. Mr. Prest testified that his valuation of accounts receivable assumed that lienable payables were an “impairment” that must be considered. He stated that based on Minnesota law, the book value of the Debtor’s accounts receivable is tied to the associated lienable payable. He argued the total amount of lienable payables must be deducted from the book value of accounts receivable if an accurate total value is to be calculated. Mr. Prest asserted that this is because the book value of accounts receivable is inflated as not all of the money is yet “owed” to the company. Rather, as explained above, customers may pay the subcontractors directly meaning that, to collect on certain accounts, the company would need to deduct the lienable amount.

This valuation method is inconsistent with MAC’s historic practices for calculating accounts receivable as reviewed by Mr. Johnston. As stated above, Mr. Johnston was admitted as a valuation expert based on his thirty years of experience, his various certifications and his extensive review of the Debtors’ financials. Mr. Johnston explained that through his representation of Callidus in MAC’s bankruptcy, he was able to gain an understanding of how MAC historically prepared its financial statements specifically regarding accounts receivable. His testimony on this topic proved to be extremely credible. Specifically, he testified that MAC historically had not considered lienable payables when determining accounts receivable. Rather, he stated that MAC had used a \$100,000 allowance for doubtful or uncollectible accounts which was intended to serve as a valuation adjustment of the gross book value of accounts receivable to the gross estimated net collectible amount. This past practice apparently complied with generally accepted accounting principles.

Mr. Johnston further testified that the method used by Mr. Prest in valuing accounts receivable was more consistent with a liquidation valuation. He explained that if a company

decided to liquidate, one might deduct lienable payables from accounts receivable because expenses are no longer being paid. In a liquidation scenario, the liquidating contractor would assumedly stop paying its subcontractors and the burden would fall on the customers to make sure the subcontractors are paid to avoid liens on their property. But, this is not a liquidation scenario. Rather, the cash collateral motions filed by MAC in the bankruptcy and all of the evidence demonstrated an intention to continue operating the business, which occurred. As previously discussed, the United States Supreme Court has said that courts must account for the proposed disposition of collateral when determining the valuation method. See Rash, 520 U.S. at 962, 117 S.Ct. at 1885. In this case, the proper valuation method is fair market value on a going concern basis.

Therefore, Mr. Johnston testified that the \$100,000 adjustment included by MAC for doubtful or uncollectible accounts is consistent with valuing accounts receivable using fair market value on a going concern basis. When operating on a going concern basis, a company is anticipating continuing in business for the foreseeable future, which means paying expenses including subcontractors. It would be irrational for a contractor to suddenly stop paying its subcontractors who would place a lien on a customer's property. The customers would then be forced to pay the subcontractors after already paying the contractor. The customers would then assumedly not work with the contractor again, a fact testified to by Mr. Prest and Mr. Johnston. Further, when operating on a going concern basis, it is unlikely for a company to have a substantial number of customers that do not pay the contractor due to the customers' fear of liens being placed by the contractor and subcontractors. In fact, customers will pay the contractor to avoid liens by the contractor and subcontractors. This is true in this case as the Court received testimony from Mr. Prest that very few of the accounts receivable existing as of the Petition Date were not

collected. Rather, he testified that while he was unsure of the exact percentage, the collection rate was undoubtedly consistent with MAC's past collection rates of 95% to 98%.

Mr. Welty provided no evidence to support Mr. Prest's valuation method other than Mr. Prest's own testimony. In fact, Mr. Prest's valuation method was not backed by any credible authority. During his testimony, Mr. Prest was unable to cite any generally accepted accounting principles to support his valuation method nor did he provide any financial literature. In contrast, Mr. Johnston testified that he reviewed well known business valuation literature to determine if any discussed Mr. Prest's method. See Ex. T. However, he was unable to find any mention or reference to Mr. Prest's approach of netting lienable payables against accounts receivable. While Mr. Johnston could not consult every available valuation resource, the lack of reference to Mr. Prest's approach within a number of well known publications is meaningful. It demonstrates that Mr. Prest's method of valuation is not used within the industry, nor is it accepted. This is supported by Mr. Johnston's testimony that in his over thirty years of experience in the industry he had not heard of Mr. Prest's approach being used by anyone to value a company's accounts receivable on a going concern basis.

Mr. Prest is not a Certified Public Accountant. He does not have valuation experience or certifications, accreditations, or designations. While he might be a very competent financial officer, his credibility as an expert is very weak.<sup>3</sup>

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<sup>3</sup> In addition, the Court does not view Mr. Prest as a completely "independent" unbiased witness. It is undisputed that Mr. Prest and Mr. Bury have a close relationship given their time as colleagues at MAC. It is also undisputed that Mr. Bury personally guaranteed Mr. Welty's DIP loans, meaning that if Mr. Welty does not recover in this case, he will seek payment from Mr. Bury—a fact that Mr. Welty confirmed on the record. But, any lack of bias does not matter as Mr. Prest's method of valuation is incorrect.

Even if the Court did accept Mr. Prest's method of valuing accounts receivable, the Court would need to determine the amount of lienable payables. However, the Court was provided no credible way of calculating this amount. The evidence provided by Mr. Welty regarding the amount of lienable payables on the Petition Date is unreliable. It is based on a spreadsheet manually constructed (at the instruction of Mr. Prest) by MAC's controller using her independent judgment as to which accounts were subject to liens. This was based on guess work. In fact, Mr. Prest acknowledged errors could have been and were made. For example, one receivable was listed as lienable even though a lien waiver had been filed by that subcontractor.

Instead of using the definition of "look back" referenced in the statute (the period starts the last day the subcontractor worked on the project site) the controller used the invoice date, which might be a different date from the last day of work as required by Minn. Stat. § 514.08. As admitted by Mr. Prest during testimony, the spreadsheet did not strictly comply with Minnesota law and is not a definitive calculation of lienable payables. Indeed, it was no more than an educated guess. Mr. Prest provided no testimony that either he or his controller reviewed every lienable payable contained in the spreadsheet to determine if an actual lien was filed or could be filed by a subcontractor. Thus, Mr. Prest could not say definitively whether all entitles listed in the spreadsheet could (or did) file a lien under Minnesota law.

Based on this analysis, the Court concludes that Mr. Johnston's valuation of accounts receivable is more credible than that of Mr. Prest. In addition to Mr. Johnston's experience, the past practice of MAC, generally accepted accounting principles all support this position. In fact, any one of them supports his position. Therefore, the total value of accounts receivable as of the Petition Date is \$4,938,000 and \$2,898,000 as of the Closing Date. Using these values, the total diminution in the value of the accounts receivable is \$2,040,000.

Accordingly, adding the diminution of cash (\$269,000), the diminution of accounts receivable (\$2,040,000) and the diminution of inventory (\$6,000), the Court concludes that the total diminution in cash collateral between the Petition Date and the Closing Date equals \$2,315,000.<sup>4</sup>

In conclusion, the parties agreed that if the diminution in the value of cash collateral is greater than the amount of the post-petition collateral, Mr. Welty received no lien in the post-petition assets purchased by Midwest. The diminution in the value of the cash collateral was \$2,315,000, and even if reduced by the value of the Chapter 5 actions (\$243,000) and the post-petition payments made to Callidus (\$120,000), as Mr. Welty requests (without deciding whether a reduction for the \$120,000 payment is required)<sup>5</sup>, the amount of diminution is \$1,952,000. The post-petition assets are valued at: (1) \$1,403,000 in the Titled Vehicles; (2) \$213,000 in the Life Insurance Policies; and (3) \$133,000 in the Insurance Refund, as stipulated by the parties. These assets only amount to a value of \$1,749,000, which, when applied to Callidus's diminution in the value of cash collateral (\$1,952,000), leave a deficiency of \$203,000. As a result, because there are insufficient post-petition assets to satisfy Callidus's diminution in cash collateral, Mr. Welty's lien rights in the sold assets are extinguished.

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<sup>4</sup> The parties do not agree as to who has the burden of proving value. However, it is irrelevant. Assuming the Defendants have the burden, as urged by Mr. Welty, it has been easily met.

<sup>5</sup> Callidus argues the \$120,000 in adequate protection payments should not be deducted from the diminution of their position in cash collateral. Mr. Welty argues it should be considered as protection from diminution in the value of the cash collateral. It appears the payments were part of adequate protection for diminution in the value of cash collateral, as they were included in the orders guaranteeing that adequate protection. However, as Callidus points out [Dkt. 64 at 7, n.3], it makes no difference as the diminution in value exceeds the value of the post-petition collateral even if it is deducted. Thus, it will be deducted to show that if Mr. Welty is correct, it is irrelevant. Likewise, including the disputed Insurance Refund (\$133,000) as potential collateral for Mr. Welty makes no difference to the outcome. Therefore, it is included.

**IV. Mr. Welty Has Not Met His Burden Of Establishing That The Use Of Equitable Subordination Is Appropriate.**

Section 510(c) of the Bankruptcy Code permits the Court to subordinate claims under principles of equitable subordination. 11 U.S.C. § 510(c). The statute provides, “[A]fter notice and a hearing, the court may (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an interest to all or part of another allowed interest . . . .” Under this statute, secured as well as unsecured claims (or any part of them) may be subordinated to the claim of another creditor. This is a remedial, not penal measure, that should be used only sparingly. Gernsbacher v. Campbell (In re Equipment Equity Holdings, Inc.), 491 B.R. 792, 841 (Bankr. N.D. Tex. 2013). The Eighth Circuit requires three elements to be satisfied before exercise of the power of equitable subordination is appropriate:

- (i) The claimant must have engaged in some type of inequitable conduct.
- (ii) The misconduct must have resulted in injury to the creditors of the [debtor] or conferred an advantage on the claimant.
- (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.

In re Bellanca Aircraft Corp., 850 F.2d 1275, 1281 (8th Cir. 1988). These elements are implicitly endorsed by the United States Supreme Court and remain used by courts in determining whether subordination is “equitable.” United States v. Noland, 517 U.S. 535, 538-39, 116 S.Ct. 1524, 1526 (1996). Except in limited circumstances, all three elements must be satisfied. In re Duke and King Acquisition Corp., 508 B.R. 107, 151 (Bankr. D. Minn. 2014); see Schultz Broadway Inn v. United States, 912 F.2d 230, 232-33 (8th Cir. 1990) (permitting equitable subordination without inequitable conduct to subordinate priority claims to claims for pecuniary loss). The proponent of

equitable subordination has the burden of proof on all three elements. Kaler v. Bala (In re Racing Servs., Inc.), 386 B.R. 751, 755 (B.A.P. 8th Cir. 2008).

Mr. Welty argues that equitable subordination of Callidus's claims in favor of his claims is warranted because Callidus: (1) improperly manipulated cash collateral to the detriment of Mr. Welty while Callidus had de facto control over the Debtor prior to closing; (2) Mr. Welty's ability to collect on his loan was harmed and Callidus unfairly profited from the benefits of Mr. Welty's loan; and (3) the Bankruptcy Code permits equitable subordination. Claims of a claimant may be subordinated to others when the claimant exerted substantial control over the debtor. See Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 323, 59 S.Ct. 543, 550 (1939) (subordinating the claim of a parent company-creditor based on equity because of the control exercised over the debtor); Capitol Bank & Tr. Co. v. 604 Columbus Ave. Realty Tr. (In re 604 Columbus Ave. Realty Tr.), 968 F.2d 1332, 1359 (1st Cir. 1992) (indicating equitable subordination generally occurs in three situations: "when a fiduciary of the debtor misuses his position to the disadvantage of other creditors; when a third party dominates or controls the debtor to the disadvantage of others; or when a third party defrauds the other creditors"); Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Servs., Inc.), 29 B.R. 139, 170 (Bankr. E.D.N.Y. 1983) (indicating a creditor's claim may be subordinated under equitable principles if the creditor "exercises such control over the decision-making processes of the debtor as amounts to a domination of its will").

However, Mr. Welty does not meet his burden in seeking equitable subordination. Mr. Schiferl of Midwest provided credible, unequivocal testimony regarding his very limited role with MAC during the Pre-Closing Period. While the Court received testimony from Mr. Bury and Mr. Prest that there was a "collaborative" environment, there is nothing to suggest that Mr. Schiferl (or

any other representative of the Defendants) engaged in any type of inequitable conduct or exercised any type of control over MAC prior to the Closing Date.

In fact, the Court received credible testimony from Mr. Schiferl that prior to the Closing Date he was not in charge of MAC's financials, had no check writing authority for MAC, and could not independently access any of MAC's financial accounts. Further, he testified that no one from MAC was instructed to directly report to him. Taken together, this testimony demonstrates a lack of control by Callidus over MAC prior to closing. Furthermore, nothing in the record supports the idea that Callidus acted to intentionally harm MAC prior to the Closing Date or supports any of the elements of equitable subordination. Moreover, under the APA (sections 3.11 and 5.01), the Debtor was required to pay expenses during its operation. [Dkt. 30 at 33, 35-36].

Mr. Welty also argues that Callidus benefited from his loans because they allowed the Debtors to stay in business, avoiding a liquidation which assumedly reduces the value of Callidus's collateral. As a result, Mr. Welty argued that Callidus's claim should be equitably subordinated. However, Mr. Welty cites no misconduct by Callidus, a requirement for equitable subordination. His argument would allow subordination in nearly every case where a priority secured creditor benefits from subordinate credit extended during the case. For example, a secured creditor benefits by an unsecured creditor extending credit to the debtor if that credit helps avoid liquidation. Mr. Welty argues, in effect, that the priority secured creditor should be subordinated to that post-petition unsecured creditor if the unsecured creditor is not paid. Every party that extends credit post-petition runs the risk of not being paid and benefiting a superior creditor. Mr. Welty assumed that risk and protected himself by taking property of Mr. Bury as collateral. Allowing subordination in this situation would turn the bankruptcy creditor priorities upside down and must be rejected absent proof of misconduct.

Therefore, based on the evidence admitted at trial, the Court concludes that Mr. Welty did not meet his burden of establishing any of the elements of equitable subordination and, therefore, no part of Callidus's remaining deficiency claim against the bankruptcy estate will be equitably subordinated to any part of Mr. Welty's claim.

**ORDER**

1. The Court denies the Plaintiff's request for a declaration confirming that he retained a first-position security interest in the post-petition assets Midwest Asphalt Corporation sold to Midwest Asphalt Services, LLC. The total diminution in cash collateral between the Petition Date and the Closing Date exceeded the value of the Plaintiff's liens on the post-petition assets Midwest Asphalt Corporation sold to Midwest Asphalt Services, LLC, and, therefore, the Plaintiff's liens on those sold assets are extinguished.
2. Mr. Welty did not meet his burden of establishing that the use of equitable subordination is appropriate and, therefore, his request in Count II for equitable subordination is denied.

LET JUDGMENT BE ENTERED ACCORDINGLY

Dated: *March 29, 2019*

By the Court:

*/e/William J. Fisher*

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William J. Fisher  
United States Bankruptcy Judge