FILED
U.S. BANKRUPTCY COURT
W.D. DISTRICT OF N.C.

APR 23 1996

BARON GROSHON
BY: KLV
Deputy Clerk

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

In Re:	)	Case No. 95-31507
	)	Chapter 11
MIDDLE PLANTATION LIMITED PARTNERSHIP,	)	
	)	
Debtor.	)	
	)	

JUDGEMENT ENTERED ON APR 23 1996

ORDER DENYING APPLICATION FOR INTERIM ATTORNEY FEES

This Matter is before the court on the Application for Payment of Interim Attorney Fees and Expenses filed by the attorney for the Debtor in Possession on March 8, 1996. After hearing held on March 27, 1996, review of the record and applicable statute and case law, the court finds that the Application should be denied at this time. However, since the application is before the court on an interim basis, the movant is not prejudiced from bringing a further interim or final request in accordance with this Order. The court makes the following Findings of Fact and Conclusions of Law and enters its Order:

1. This case was commenced by the filing of an involuntary petition against the debtor on October 11, 1995 under Chapter 11 of the Bankruptcy Code. Neither the debtor, nor either of its general partners, objected to the entry of such relief and an order for relief under Chapter 11 was entered on November 14, 1995. The debtor continues to operate its business as Debtor-in-Possession pursuant to §§1107 and 1108 of the Code.

2. The Debtor's principal asset is a 124-unit apartment complex in Charlotte, Mecklenburg County, North Carolina, commonly known as Middle Plantation Apartments ("the property").

3. Condor One, Inc. is the current holder of the Deed of Trust Note dated April 29, 1986, in the original principal amount of $3,150,000.00 and the Deed of Trust and Assignment of Rent, Profits and Income of the same date.

4. A Plan of Reorganization was filed by the debtor on March 25, 1996 which listed Condor One as the sole secured creditor of the debtor, that security including all of the real property and personal property as evidenced by the loan documents. The confirmation hearing has not been held as of the date of this Order.

5. A Consent Order between Middle Plantation and Condor One was entered January 19, 1996 authorizing the debtor limited use of cash collateral pursuant to §363 of the Code and providing partial adequate protection to Condor One. In that Consent Order, the debtor "acknowledged and agreed" that Condor One holds a properly perfected lien on the property and the rents, issues and profits arising therefrom.

6. The Consent Order expressly limits the debtor's use of cash collateral to only that as authorized in the Consent Order, including, in pertinent part and summarized, that: (1) the debtor may only use the cash collateral as allowed under the Consent Order; (2) the debtor must account for all cash collateral to Condor One; (3) the debtor must set up an escrow account

for all cash collateral received; and (4) the debtor may disburse funds from the escrow account only as authorized in the Consent Order.

7. In Paragraph 8(c) of the Ordering section, the Consent Order limits disbursements from the escrow account to

> (i) the payment of the actual expenses necessary for the operation and maintenance of the Property pursuant to the provisions hereof, (ii) fees for the management of the Property pursuant to the provisions hereof, and (iii) payments to Condor One pursuant to the terms hereof.

The Paragraph continues:

> Nothing contained herein is to be construed as consent by Condor One to allow payment of professional or consultant fees from the Rents or other cash collateral without full notice and a hearing and opportunity to object to the payment of such fees.

8. In Paragraph 8(d) of the Ordering section, the Consent Order further restricts the disbursements allowed under Paragraph 8(c) by limiting "actual expenses necessary" to those in a predetermined, attached budget, limiting fees for management services to 4% payable to B.T. Properties Corporation, and requiring all other funds to be disbursed to Condor One as "partial adequate protection".

9. In Paragraph 14 of the Ordering section, the Consent Order states:

> Nothing herein shall be construed to limit or abridge the debtor's right to petition the court for approval of professional fees and expenses, nor abridge Condor One's rights to object to any administrative expenses, professional fees, costs or expenses, to be paid from Condor One's cash collateral or otherwise. Condor One does not consent to the use of its rents or cash collateral except as provided herein, and nothing in this

> Consent Order shall be deemed or construed as an express or implied consent to the use of the Rents or cash collateral for the payment of the debtor's attorney's fees, except as may be approved by the court after notice as provided in the Bankruptcy Code and Federal Rules of Bankruptcy Procedure.

10. Because the first Consent Order governing cash collateral expired by its own terms, a Second Consent Order was agreed to by the parties and entered by the court on March 20, 1996. The Second Consent Order adopts the findings of fact and conclusions of law of the first Consent Order and incorporates and acknowledges the representations and covenants of the first Consent Order.

11. On March 8, 1996, R. Keith Johnson, P.A. filed an Application for Payment of Interim Attorney Fees and Expenses requesting compensation in the amount of $7,682.50 for legal services and $643.44 for costs. The application requested fees for services rendered for the benefit of the debtor from October, 1995 through February, 1996.

12. On March 26, 1996, Condor One, Inc., filed a Limited Objection To Application for Payment of Interim Attorney Fees and Expenses. Condor One did not object to the propriety or amount of the fees, but instead objected to the allowance of the fees to the extent that payment of the fees would use Condor One's absolute property or cash collateral.

13. Section 330 of the Bankruptcy Code provides that officers of the estate, including the debtor's attorney, are entitled to reasonable compensation for their services and

reimbursement of their expenses. Under 11 U.S.C. §331, counsel for the debtor-in-possession under in Chapter 11 may request interim compensation. The bankruptcy court may then approve the compensation and direct that the fees be paid out of the estate. The compensation and reimbursement of expenses is generally determined under the standards as set forth in 11 U.S.C. §330. 2 Collier on Bankruptcy §330.04 (15th ed. 1996).

14. Traditionally, the payment of administrative fees, such as attorney's fees and expenses, has been the responsibility of the debtor's estate, not the secured creditors. In Re Flagstaff Food Service Corporation, 739 F.2d 73, (2d Cir. 1984); Matter of Trim-X, Inc., 695 F.2d 296 (7th Cir. 1982); In Re Bob Grissett Golf Shoppes, Inc., 50 B.R. 598 (Bankr. E.D. Va. 1985).

15. However, section 506 of the Bankruptcy Code sometimes allows for a sharing of costs of the estate with secured creditors. Section 506 states:

> The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

This section permits costs to be charged against the secured creditor's collateral for services performed by the trustee, or the debtor in possession acting under §1107 in certain specified cases. In Re Bob Grissett Golf Shoppes, Inc., 50 B.R. 598, 603 (Bankr. E.D. Va. 1985).

Section 506 was a codification of prior case law which held that even though as a general rule secured creditors would not be

liable for the estate's administrative expenses, they would be liable for expenses of maintaining the collateral's value or liquidating it. See, e.g. In Re Trim-X, Inc., 695 F.2d 296 (7th Cir. 1982); Textile Banking Co. v. Widener, 265 F.2d 446 (4th Cir. 1959). In Textile Banking, a pre-Code case, the Fourth Circuit found that it would not allow the trustee to "encroach upon the amount of the secured debt for the payment of any of the expenses of administration" where the trustee elected to sell encumbered property.

In *In Re Flagstaff Foodservice Corporation*, 739 F.2d 73, 76-77 (Flagstaff I), the leading case at the time it was rendered, the Second Circuit interpreted §506(c), holding that professional fees of the debtor should not be paid out of encumbered assets unless (1) the expenses were for the direct and primary benefit of the creditor holding the security interest in that particular collateral, or (2) the creditor consented to the application or motion. The Second Circuit further limited its holding by stating that the "debtor in possession . . . must show that its funds were expended primarily for the benefit of the creditor and the creditor directly benefitted from the expenditure." In Re Flagstaff Foodservice Corporation, 762 F.2d 10 (1985) (Flagstaff II).

The Third Circuit subsequently interpreted §506(c) less restrictively, allowing for fees to be paid out of a secured creditor's collateral if the creditor benefitted directly, but did not require that the funds be "expended primarily for the

benefit of the creditor. In Re McKeesport Steel Castings, Co., 799 F.2d 91 (3rd. Cir 1986).

16. Following the Second Circuit's Flagstaff opinion and the Third Circuit's McKeesport Opinion, several district and bankruptcy courts have helped illustrate the limits of §506(c). See, e.g., In Re Ranch Partners, Ltd., 146 B.R. 833 (D. Colo. 1992) (holding that cash collateral may not be used to pay attorney's fees unless the value of the collateral is greater than the secured creditor's claim); C.I.T Corporation v. A&A Printing, Inc., 70 B.R. 878 (M.D.N.C. 1987) ("expenses which benefit the entire estate . . . cannot be shifted from the debtor's estate to the secured creditors under the rubric of 'cost of preservation' "); In Re 680 Fifth Avenue Associates, 154 B.R. 38 (Bankr. S.D.N.Y. 1993) ("Where a lender is undersecured, the debtor's use of that lender's cash collateral, absent adequate protection would clearly cause a decrease in the value of that creditor's property . . . and would constitute an improper taking."); In Re S & S Industries, Inc., 30 B.R. 395 (Bankr. E.D. Mich. 1983) (a secured creditor "cannot be compelled to finance a Chapter 11 proceeding except to the limited extent provided for in section 506(c)").

17. Most courts have used a three prong test to determine whether a secured creditor's collateral may be taxed to cover the expenses of administering the estate. The charges must be (1) necessary to preserve or dispose of the property, (2) of benefit to the secured creditor, and (3) reasonable. In Re Bob Grissett

Golf Shoppes, Inc., 50 B.R. 598 (Bankr. E.D. Va. 1985). Charges may also be allowed if the creditor consents. In Re Flagstaff Foodservice Corporation, 739 F.2d 73, 77 (2d. Cir 1984); In Re Bob Grissett, 50 B.R. at 604-05. Consent may be express, or as more often found by the courts, implied. See generally, 2 Collier on Bankruptcy §506.66 (15th ed. 1996). However, consent by the secured party is "not to be lightly inferred." In Re S & S Industries, Inc., 30 B.R. 395 (Bankr. E.D. Mich. 1983). In many cases, express consent is obtained through a negotiated "carve out" for the professional fees in the cash collateral order. In this event, the attorney's priority is within the secured creditor's control and payment exists only to the extent of the creditor's consent. The attorney may bring a motion to authorize the use of cash collateral under §363(c)(2)(B) and the creditor, in turn, may seek to have its interests adequately protected under §363(c).

18. In *C.I.T. Corporation v. A & A Printing*, the Middle District of North Carolina was faced with the issue of whether §506(c) permits recovery of storage and security expenses from the secured creditor when there were no unencumbered assets, the creditor had been seeking abandonment since the beginning of the bankruptcy case, and the expenses protected not only the secured creditor, but also other assets of the estate. 70 B.R. 878, 880 (1987). In reviewing several similar cases, the court concluded that "nearly all have found that Section 506(c) is a narrow exception to the general rule that unsecured creditors bear the

cost of bankruptcy administration, and that it does not permit recoupment of expenses which benefit the estate at large, but help secured creditors only indirectly." Id.

The trustee in that case also argued unsuccessfully that the "equities" should hold the secured creditor responsible for at least some part of the costs of administration, or else the reorganization process would fail from the start. Id. at 881. The Court disagreed with the trustee, and stated that the trustee's reliance on an Eastern District of Virginia decision was misplaced. The trustee had argued that under In Re Bob Grissett Golf Shoppes, Inc., 50 B.R. 598, 604 (1985), where there were no unencumbered assets available to fund administrative expenses, the court "should balance the misfortune of having some allowances go unpaid against the possible inequity of charging them all against mortgaged property." Id. at 881 (quoting First Western Savings and Loan Assoc. v. Anderson, 252 F.2d 544, 548 (9th Cir. 1958). The Court found that the enactment of the Bankruptcy Code "dramatically circumscribed" the courts ability to balance vague hardships, and instead set forth objective criteria which must be met before secured parties are made to pay for administrative expenses in cases where there are no unencumbered funds. The court thus refused to apply an equity balancing test. See also, Norwest Bank V. Ahlers, 485 U.S. 197, 206 (1988) (finding that "whatever equitable powers [are retained by] bankruptcy courts . . . can only be exercised within the confines of the Bankruptcy Code.").

19. In finding that §506(c) administrative expenses should not be charged to the undersecured, sole, secured creditor, this court is mindful of a basic underlying policy of Chapter 11 proceedings. Chapter 11 is a reorganization proceeding, a proceeding which has as its goal the successful completion of a plan which will lead the debtor to viability. This change is inherently an expensive process. If the estate cannot afford the costs of this process, it is basically an un-administrable estate. To elucidate, a debtor's estate

> should not be administered and run unless it can generate funds with which to pay the costs of administration, and then some. . . . If the assets are completely encumbered, and if they cannot create extra funds, administering the estate is pointless, and creates expenses that leach the wealth currently in the estate.

C.I.T Corporation v. A&A Printing, Inc., 70 B.R. 878 (M.D.N.C. 1987).

20. The burden of proving the necessity, reasonableness, and benefit to the estate is on the professional requesting the fees. Matter of Trim-X, 695 F.2d at 299; In Re Bob Grissett, 50 B.R. at 602.

21. In the present circumstance, the request for interim compensation will be paid from the secured creditor's collateral. Condor One is the sole secured creditor. The amount due on the note is in the amount of approximately $3.7 million. The Plan as proposed allows Condor One a secured claim of only $2.5 million. Thus, Condor One is undersecured. Further, because Condor One has a broad security interest in the assets of the debtor, there

are no unencumbered assets at this time that can be used to pay the debtor's professional fees except those assets secured by Condor One. Thus, the payment of professional fees will be from the secured creditor's collateral.

22. Further, Condor One has not consented to the use of its cash collateral to pay professional expenses of the estate. Both the First Consent Order on Cash Collateral and the Second Consent Order on Cash Collateral contain broad prohibitive language concerning the use of the cash collateral. Both Orders speak directly to the issue at bar, expressly stating that Condor One does not consent to the payment of professional fees out of cash collateral. There are no professional fee "carve outs" contained in the orders.

23. As presented to the court, the evidence is not sufficient to support a finding that the actions taken by the debtor-in-possession's attorney meet the three prong test above. Though the fees and expenses are found to be both proper and reasonable, there has been no showing that the services were necessary for the preservation of the property or of benefit to the secured party. Nor has there been a showing of consent by Condor One. In fact, the case records indicates an express denial of consent by Condor One.

The award of compensation may not trump other priorities appearing in the Code. Nor may the award of fees trump creditor's state law or Article 9 security interests that have been given priority protected by the Code. Thus, absent a showing

that the fees meet the 3 prong test above, or consent by the secured creditor, the court must deny the application for compensation.

24. Since the present request is brought to the court by way of a request for interim compensation, it is not necessary for the court to summarily deny all fees at this time. Section 331 of the Code allows for interim compensation, but does not mandate it. Interim compensation "assure[s] the continued efficient rendition of professional services to the estate," 2 Collier on Bankruptcy 331.02 (15th ed. 1996), during protracted litigation, but the award of compensation is within the discretion of the court. In a case such as this, where there are no unencumbered assets from which to pay the professional fees, any compensation should await the confirmation of a plan of reorganization or the acquisition of unencumbered assets allowing for the payment of such fees.

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that:

1. The Application for Payment of Interim Attorney Fees and Expenses filed by the attorney for the Debtor in Possession on March 8, 1996 is hereby DENIED; and

2. The movant is not prejudiced from bringing a further interim or final request in accordance with this Order.

This the 22nd day of April, 1996.

George R Hodges

George R. Hodges
United States Bankruptcy Court