UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

ALP FREDDY'S LIMITED PARTNERSHIP, d/b/a FREDDY'S, **NO. 93-20542**
Chapter 11

Debtor.

BACKGROUND

The Court has before it applications for interim compensation pursuant to Section 331 filed by: (1) Nixon, Hargrave, Devans & Doyle ("Nixon, Hargrave"), the attorneys for the Debtor; (2) Pepper, Hamilton & Scheetz ("Pepper, Hamilton"), the attorneys for the Unsecured Creditor's Committee (the "Committee"); (3) Lacy, Katzen, Ryen & Mittleman ("Lacy, Katzen"), local counsel for Pepper, Hamilton and the Committee; (4) Shefferly & Silverman, local Michigan counsel for the Debtor; (5) Ernst & Young, the accountants for the Debtor; and (6) Arnold Zahn, Zahn Associates, Inc. ("Zahn"), Secretary to the Committee. The application of Nixon, Hargrave, dated September 2, 1993 and noticed[1] by the Debtor for the filing of any objections on September 22, 1993, requests fees of $214,523.20 and disbursements of $18,648.15 for the period from March 12, 1993, the date of the filing of the petition, through July 31, 1993, and states that it holds a retainer of $60,000.00. The application of Pepper, Hamilton, dated July 9, 1993 and noticed by the Debtor for objections on August 6, 1993, requests fees of $91,021.00 and disbursements of $5,106.05 for the period from March 31, 1993 through June 30, 1993. The application of Lacy, Katzen, dated July 14, 1993 and

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[1] Since there are more than 100 creditors in the case, the Debtor is required to do all noticing. Notice of the pending applications giving recipients 20 days to file any objections to the payment of administrative expenses was not sent to all creditors, but was sent by the attorneys for the Debtor only to: (a) the Applicant; (b) the Debtor; (c) the attorney for the Committee; (d) the Office of the U.S. Trustee; and (e) entities which had filed notices of appearance and demands for copies of all notices.

noticed by the Debtor for objections on August 6, 1993, requests fees of $14,788.50 and disbursements of $626.71 for the period from March 31, 1993 through July 12, 1993. The application of Shefferly & Silverman, dated August 16, 1993 and noticed by the Debtor for objections on September 15, 1993, requests fees of $5,339.00 and disbursements of $839.15 for the period from May 6, 1993 through July 31, 1993. The application of Ernst & Young, dated August 5, 1993 and noticed by the Debtor on September 14, 1993, requests fees of $116,329.50 and disbursements of $9,649.00 for the period March 31, 1993 through June 30, 1993. The application of Zahn, dated July 8, 1993 and noticed by the Debtor for objections on August 20, 1993, requests fees of $3637.50 and disbursements of $4,052.67.

On November 17, 1993 a hearing was held on various objections to the pending applications. Some of the objections were addressed to the reasonableness and necessity of some of the services performed and disbursements incurred in connection with several of the applications. Other objections were addressed to whether the Court should provide for the payment at this time of any of the amounts allowed.

Whether to authorize the payment of any amounts allowed as interim compensation is within the sound discretion of the Bankruptcy Court and depends on the particular facts and circumstances presented in each case. "Placing the time of payment within the parameters of the court's sound discretion establishes a flexible system which allows consideration of such factors as the particular needs of each administrative claimant, the length and expense of the case's administration, and the amount of available assets, in determining fair and equitable interim distributions pending final resolution of the case." *In re Barron,* 73 B.R. 812, 814 (Bankr. S.D.Cal. 1987). Therefore, it is important to review the facts and circumstances of this case in determining whether to authorize the payment of any amounts which may be allowed as interim compensation based on the pending applications.

At the time of the filing of its petition on March 12, 1993, the Debtor, a partnership, operated twenty-six (26) health and beauty aid discount stores in New York and Florida. The Debtor had purchased the operation in a leveraged buy-out from FNS Sales, Inc. ("FNS"), which holds a second security interest in its assets.

On March 23, 1993 the Court entered an Interim Order (the "Interim Financing Order") approving a financing arrangement between the Debtor, Michigan National Bank ("Michigan National"), its primary secured creditor, and FNS, which allowed the Debtor, on certain terms and conditions, to use cash collateral in which Michigan National and FNS had an interest pending a final hearing pursuant to Section 363 and Rule 4001. One of the principal issues in the negotiations surrounding the Interim Financing Order was a "carve out" provision.[2] When the Debtor, Michigan National and FNS were unable to agree to the terms of a long-term financing agreement or agreement for the use of cash collateral, the Court held a final hearing on April 8, 1993 on the Debtor's motion

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[2] A provision which provided a priority for the payment of the quarterly fees due to the U.S. Trustee and some portion of the fees and expenses of the professionals of the Debtor and the Committee over any administrative claim which Michigan National and FNS might have as a result of the Interim Financing Order.

The provision reads:

> The Borrowings of the Debtor from MNB and the post-petition Obligations incurred to FNS, (including all interest, charges, costs, expenses and professional fees in connection therewith) shall have priority in payment pursuant to Section 364(c)(1) of the Bankruptcy Code over all other costs and expenses of administration in the Chapter 11 Proceedings or any subsequent Chapter 7 Proceeding, including those described in Sections 503(b) and 507(b) of the Bankruptcy Code, but excluding the sum of Eighty-Five Thousand ($85,000.00) Dollars (of which Sixty Thousand {$60,000.00} Dollars was paid pre-petition) for professional fees to the professionals for the Debtor including the U.S. Trustee's fees and Twenty-Five Thousand ($25,000.00) Dollars for professional fees for the professionals for the Official Creditors' Committee, which fees shall, in any event, be subject to approval and allowance by the Court.

for the use of cash collateral.[3] At the final hearing the Court authorized the Debtor to use cash collateral as long as the same overall levels of inventory, accounts receivable and cash proceeds that existed on April 8, 1993 were maintained, monthly interest was paid to Michigan National, weekly financial reporting was maintained and the Debtor paid "all post-petition obligations as they became due in the ordinary course of Debtor's business." An order (the "Cash Collateral Order") with these provisions was subsequently entered by the Court.

Prior to May 11, 1993, the Court was presented *ex parte* with a proposed administrative order (the "Administrative Order") for the payment of interim compensation to Nixon, Hargrave, Pepper, Hamilton and Lacy, Katzen on a monthly basis which included "holdback" and quarterly review procedures and provisions. Although signed off on by the Debtor, the Committee and the Office of the U.S. Trustee, it was not noticed to the Debtor's other creditors, specifically its secured creditors. On May 11, 1993, the Court advised Lacy, Katzen, the other applicants and the Office of the U.S. Trustee by letter that if the Administrative Order was to be pursued further, the Court required a motion on notice to the Debtor's secured creditors, a hearing and submissions on the question of whether this case warranted the Court exercising its discretion to alter the normal scheme of allowing and providing for the payment of interim compensation under Section 331 every 120 days. Michigan National objected to the Administrative Order. On July 7, 1993, the Court denied the relief requested on the basis that this case did not present the extraordinary circumstances which would warrant the relief requested. The Court also did not grant the request for retainers to be paid out of cash collateral when objected to by a secured creditor with an interest in such cash collateral.

As a result of the unsuccessful "carve out" negotiations and the objection to and denial of the

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[3] One of the principal reasons for the failure of the parties to enter into a long-term financing agreement or agreement for the use of cash collateral was unsuccessful negotiations concerning an increased dollar amount "carve out" provision.

Administrative Order, it was clear at the very early stages of this case both to the Court and all professionals representing the Debtor or the Committee that there were serious concerns about the ability of the Debtor to reorganize. It was also clear that given the amount of the secured debt and the nature and extent of the Debtor's assets and prospective operations if the Debtor was not able to successfully reorganize and was liquidated, there was a real possibility that there would not be a source of funds available to insure the payment of professionals in whole or in part, except for any retainer held by Nixon, Hargrave and any rights the beneficiaries might have under the "carve out" provision contained in the Interim Financing Order. It was also clear from the Court's ruling on the use of cash collateral that the Debtor could continue to use cash collateral only if all of its ordinary course of business operational obligations were paid. With such notice and knowledge, the professionals for the Debtor and the Committee proceeded in their representation at their own risk but with the ability, because of their unique access to the Debtor and extensive knowledge of the Debtor's operations, to constantly visit and revisit with the Debtor the issues of its prospects for reorganization and the advisability of it continuing operations.

On July 7, 1993, at the request of the Debtor and after notice and a hearing, the Court entered an order, pursuant to Section 365(d)(1), extending for 90 days the time period for the Debtor to determine whether to assume or reject the majority of its store leases. In its Order, the Court reserved the right to further extend this period. By a series of orders (the "Extension Orders"), the Debtor's time to determine whether to assume or reject its remaining store leases has been extended to December 6, 1993. Each of the Extension Orders specifically requires that the Debtor comply with the provisions of Section 363(d)(3) by timely performing all of its obligations under the leases in question. Therefore, prior to both the mailing of the initial notices and the hearing regarding each of the pending applications for interim compensation, each of the applicants was or should have been aware that there were Extension Orders under which the Court had specifically required that the

Debtor comply with the provisions of Section 365(d)(3) and timely perform all of its obligations under the leases in question.[4]

On May 24, 1993, Pepsi-Cola Buffalo Bottling Corporation filed an adversary proceeding in connection with its alleged reclamation rights under Section 546 for approximately $12,000 in goods which it had shipped to the Debtor. During a July 20, 1993 pretrial conference, held almost four months after the required reclamation notices would have had to have been given under Section 546 and the applicable Uniform Commercial Codes, the Court was advised by the attorneys for the Debtor that substantial reclamation claims had been filed against the Debtor which the Debtor believed could and would ultimately be resolved by an order of the Court granting all allowed reclamation claimants an administrative claim pursuant to the provisions of Section 546(c). On September 10, 1993, the Court entered a Stipulation and Order (the "Reclamation Claims Order"), after a previously submitted proposed Order had been revised in accordance with its requirements, which allowed $2,002,194.38 in reclamation claims as administrative claims pursuant to Section 546(c). The Order provided that these reclamation claims would not be paid unless and until each secured creditor holding a valid, properly perfected security interest in the Debtor's inventory and proceeds was paid in full or upon the earlier entry, after notice and a hearing, of an Order of the Court. Therefore, at the very early stages of the case and well before both the mailing of the initial notices and the hearing regarding each of the pending applications for interim compensation, the Court and each of the applicants was or should have been aware that there were in excess of two

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[4] Although many courts have held that the Debtor's obligations under Section 365(d)(3), if not paid, are only administrative expenses under Section 503(b) not entitled to any special priority, this Court believes that such obligations when specifically required to be paid by a court order during an extension period provided for under Section 365(d)(1) may be entitled to a special priority in payment. *See In re Telesphere Communications, Inc.,* 148 B.R. 525 (Bankr. N.D.Ill. 1992).

million dollars ($2,000,000) of unpaid reclamation claims which were ultimately allowed as administrative expenses.

On July 21, 1993, the Debtor filed a motion for the approval of its proposed store and office employee severance plans (the "Severance Plans"). The Severance Plans provide for the payment of severance to employees at the time of a store closing in varying amounts depending upon the years of service and position held by the employee. Although initial opposition was filed by the Debtor's secured creditors, on the August 4, 1993 return date of the Debtor's motion the Court was advised that the matter had been settled and that an order would be submitted. On August 20, 1993, an Order and Stipulation approving the Severance Plans was entered (the "Severance Plans Order"). Therefore, prior to the time set to file objections to all of the pending applications for interim compensation, the Court and each of the applicants was or should have been aware that the Debtor had potential future obligations to employees under its post-petition Court approved Severance Plans which, if unpaid, could be Section 503(b) administrative expenses. Whether timely or untimely, the Court received a number of objections regarding the pending applications for interim compensation. Irrespective of its receipt of any objections, the Court has an obligation in connection with determining whether to exercise its discretion and provide for the payment of any interim compensation allowances under Section 331 to evaluate the facts and circumstances of the case which are otherwise known to it and which may affect its decision on payment.[5] The Unsecured Creditor's Committee in the A.L. Price Chapter 11 case pending in the Bankruptcy Court for the Eastern District of Michigan (the "Price Committee") objected to the payment of more than 50% of

[5] This Court has consistently ruled that especially in matters where it must exercise its discretion, it will look to and consider all relevant facts and circumstances, not just those raised by the parties before it, and will, if necessary, initiate relevant inquiries and, when warranted, will exercise or fail to exercise its discretion even in the absence of opposition.

any interim compensation allowances. The Price Committee alleged that it believed that all administrative claims might not ultimately be paid in full and a 50% holdback appeared warranted. FNS objected to the payment of any interim compensation allowances in amounts in excess of the aggregate amounts provided for in the "carve out" provision contained in the Interim Financing Order. With respect to the applications of Nixon, Hargrave, Ernst & Young and Zahn, the Office of the United States Trustee had objections to the reasonableness and necessity of some of the services rendered and disbursements incurred but did not otherwise take a position regarding the payment of any allowances.

On Wednesday, November 17, 1993, the Court held a hearing on the pending applications. At the same time a hearing was held on a motion by Michigan National to lift the stay. At the hearings on these motions, the Court was advised that: (1) the Debtor had now determined that it could not successfully reorganize by its continued operations; (2) the Debtor was pursuing purchasers for some or all of its remaining stores and had several interested prospective purchasers; (3) if the Debtor could not sell its remaining stores within the next several weeks, it likely would have to liquidate or be liquidated by the secured creditors; (4) the Debtor was negotiating with its secured creditors in connection with the possible sales of some or all of its remaining stores; (5) the Debtor was concerned that although it believed that it had availability under the Cash Collateral Order, it was not reasonably certain that it could continue to operate and pay or provide for its ongoing operational expenses, and, therefore, it was consenting to the motion of Michigan National to lift the stay. At the same hearing, with the consent of Michigan National, the Court adjourned the motion to lift the stay to December 8, 1993 advising the Debtor and its attorneys that the Debtor was, as always, responsible for making the determination as to whether it could continue to meet its ongoing obligations and should continue to operate. At the hearing on the pending applications, FNS urged the Court to deny the payment of any interim compensation allowances in view of the present

status of the case. FNS asserted that this case would be concluded within 60 days, and at that time the Court would know the extent of all unpaid administrative expenses and could provide for their payment to the extent of available assets. The applicants, while conceding that all administrative expenses might not be paid in full in this case, nevertheless urged that the Debtor should be authorized to immediately pay any interim compensation allowances awarded to them to the extent of its ability to do so. In order for the applicants to know where they stood going forward in this case, the Court indicated that it would attempt to issue a decision Friday, November 19, 1993, after returning from hearing cases that day out of town in Watkins Glen. Since this became impossible to accomplish, the Court has attempted to issue a decision as promptly as possible.[6]

DISCUSSION

The issue before the Court for immediate decision is not the allowance of all or part of the fees and disbursements requested in the pending applications for interim compensation, but whether given the present facts and circumstances of the case, including that it now appears almost certain that all administrative creditors will not be paid in full, any allowances granted can be paid by the Debtor, either at this time, or at any time before the conclusion of the case.

When in the ordinary course of a Chapter 11 proceeding allowances of interim compensation are granted pursuant to Section 331 and payment is provided for in whole or in part,[7] allowing

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[6] Because of the short time frame the Court has allowed itself to issue a decision on these issues, issues which it has not previously had occasion to deal with, the Court has not had the opportunity to do extensive research or spend as much time as otherwise would be warranted in making its decision. As an aside, the Court is currently working with the Monroe County Bar Association Bankruptcy Committee on establishing guidelines for the compensation of professionals, which the Court anticipates will address many of the issues currently presented.

[7] Many courts have a standard "holdback" requirement pending the determination of a final allowance under Section 330 at the conclusion of the case.

payment is generally the result of the Court's belief and understanding that the Debtor is otherwise current on all of its post-petition operational obligations and, except for the services of the professionals in the case whose fees and expenses are under the control of the Court, the Debtor is not incurring unpaid administrative expenses. If the Court is aware that the Debtor has or is incurring unpaid administrative expenses and there is a serious concern as to whether all administrative expenses will be paid if the Debtor does not successfully reorganize, the payment of allowances of interim compensation should not be made to the prejudice of other existing or potential administrative expense claimants.

This is often accomplished by providing that any payment be on a pro rata basis with any other then known unpaid administrative expenses and subject to later return, in whole or in part, (some courts use the term surcharge or disgorgement) to insure that the administrative expenses of any superseding Chapter 7 case are paid and that all unpaid administrative expenses in the Chapter 11 case, as finally determined at the end of the case, are treated equitably.[8]

However, some courts have held that depending on the facts and circumstances of the particular case, the court in its sound discretion can defer payment of interim compensation until funds become available for the payment of all administrative claims or until confirmation of a plan. *In re First Hartford Corporation*, 23 B.R. 729, 732 (Bankr. S.D.N.Y. 1982).

Other courts have held that allowing the payment of an administrative expense knowing that it is likely that a return, surcharge or disgorgement of all or a portion of the payment will be required,

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[8] The provisions of Sections 503(b) and 507(a)(1) do not establish any priority among administrative expenses. However, at least one court has held that there is a priority over other administrative expenses for any unpaid lease obligations of the Debtor required to be paid by Section 365(d)(3) and that payments made in the ordinary course of business to providers of post-petition goods and services are final and not subject to disgorgement if the Debtor does not have sufficient assets to pay all administrative expenses in full at the end of the case. *In re Telesphere Communications, Inc.*, 148 B.R. 525, 531 (Bankr. N.D.Ill. 1992).

because there are or most likely will be insufficient funds to pay all administrative expenses is not favored. *In re IML Freight, Inc.*, 52 B.R. 124, 139 (Bankr. D.Utah 1985). In such circumstances, courts have authorized the payment of only such amounts as would be allowed the applicant under all possible circumstances with the burden on the applicant to demonstrate this. *Id.* at 139.

In the present case the Court is presented with unusual facts and circumstances at the time that it must rule on the requests for the payment of interim compensation. These include the existence of: (1) the Cash Collateral Order which specifically provides that as a condition to the use of cash collateral the Debtor pay all of its post-petition obligations in the ordinary course of business; (2) the Extension Orders which specifically require that the Debtor comply with the provisions of Section 365(d)(3) during the extension periods which at this time run through December 6, 1993; (3) the Reclamation Claim Order allowing over $2,000,000 in reclamation claims as administrative expenses with their payment deferred; and (4) the Severance Plans Order approving post-petition plans proposed and implemented in part because of a serious concern about the viability of the Debtor's operations. In addition to the existence of these Orders and the Court's knowledge of the Debtor's obligations under them, at the time of the hearing on the pending applications the Court has been advised that even though there may be availability under the Cash Collateral Order, the Debtor has serious concerns about its ability to continue to operate and even pay or provide for its operational expenses in the ordinary course of business let alone any allowances of interim compensation.

Given all of these facts and circumstances, the Court in the exercise of its discretion under Section 331 will not allow the payment of any allowances of interim compensation on the pending applications at this time. This is without prejudice to any interim compensation allowances being paid when there are funds available to pay all administrative expenses in full, including all allowed

reclamation claims, or pursuant to a confirmed plan.[9]

The Court is concerned in any case where professionals are rendering substantial services to a Debtor and are not receiving payment. Clearly the professionals whose applications are pending before the Court have provided valuable services in this case that have benefitted all parties, including the Court. The provisions of Section 331 are designed in part to insure that professionals rendering services to a debtor are not being asked to finance the reorganization by not being paid until the end of the case when interim payments are possible and on the facts and circumstances of the case warranted. However, Section 331 does not insure that the Court in the sound exercise of its discretion will always allow the immediate payment of allowances of interim compensation, that professionals have a priority in payment or will be paid to the exclusion of other administrative creditors, or that professionals will ultimately even be paid. Professionals do have a unique position

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[9] The Court is aware that as an alternative, it might issue a very complicated order in the following form: The Debtor is authorized to pay the interim compensation allowances herein provided that the awards are paid on a pro rata basis among the firms receiving the allowances and the unpaid reclamation claimants, based on the total amount of the interim compensation allowances and all allowed reclamation claims; and further provided that through the date of any payment: (1) pursuant to the requirements of the Cash Collateral Order the Debtor has paid or provided for the payment of all of its post-petition trade and tax obligations incurred in the ordinary course of its business (not paid when they became due); (2) the Debtor has made all payments due to any parties provided for by the Severance Plans Order on all closed stores; (3) the Debtor has paid all of its obligations under all leases covered by the Extension Orders and has provided for the payment of such obligations for periods through December 6, 1993 for locations at which the Debtor intends to operate after November 30, 1993; and further provided that all firms and reclamation claimants receiving payment under this Order specifically understand that they may be surcharged by subsequent order of this Court for all or a portion of such amounts as may be necessary to pay the administrative expenses of any superseding Chapter 7 case or to insure that all creditors with unpaid administrative claims at the end of the case receive a pro rata or otherwise equitable distribution in the event that all such administrative creditors are not paid in full. However, such an order would: (a) be difficult for the Debtor to implement; (b) take the attention of the Debtor away from the more important matters it should be attending to at this time in the case; and (c) otherwise serve little purpose given the present posture of the case and the almost certain need to surcharge the recipients at a later time, at substantial additional time cost and expense, to insure that all unpaid administrative expenses are treated equitably.

in a reorganization to evaluate whether to become or remain involved in the case and have some of the same abilities as other creditors to insure payment, in whole or in part, from third party sources. In addition, professionals for the Debtor may have the ability to obtain substantial pre-petition retainers under some circumstances.

Pursuant to Section 331, the Court will allow interim compensation on the pending applications as follows:

(a) to Pepper, Hamilton & Scheetz, fees of $91,021.00 and disbursements of $5,106.05;

(b) to Lacy, Katzen, Ryen & Mittleman, fees of $14,788.50 and disbursements of $626.71;

(c) to Shefferly & Silverman, fees of $5,339.00 and disbursements of $839.15;

(d) to Ernst & Young, fees of $116,329.50 and disbursements of $9,649.00; and

(e) to Zahn Associates, fees of $3,637.50 and disbursements of $4,052.67.

These awards are subject to reconsideration at the end of the case and in connection with a final application when the Court is in a position, pursuant to Section 330, to determine the overall reasonableness and necessity of the services rendered and expenses incurred.[10] *See In re Four Star Terminals*, 42 B.R. 419, 439 (Bankr.. D.Alaska 1984).

At the November 17, 1993 hearing Nixon, Hargrave was given additional time to respond to the objections of the Office of the U.S. Trustee, which it has done, but which the Court requires additional time to fully review and consider. When it has, the Court will award appropriate interim compensation to Nixon, Hargrave, with payment deferred in accordance with this decision and order.

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[10] The Court specifically reserves the right to reconsider those services of Ernst & Young designated as "Engagement Administration".

Further, the Court will not allow the payment of any interim compensation allowance to Nixon, Hargrave from the retainer which it is holding until the Court reviews its Retainer Agreement. Should at any time any payment to Nixon, Hargrave be allowed from the retainer, it is without prejudice to any recovery of all or a portion of the retainer as a result of the adversary proceeding commenced by the Price Committee and pending in the Bankruptcy Court in the Eastern District of Michigan.

This decision is without prejudice to the rights of any of the applicants under the "carve out" provision of the Interim Financing Order or any argument that any of them may have that any services rendered and disbursements incurred by them in this case, including those covered by the pending applications, may be recovered pursuant to Section 506(c).

IT IS SO ORDERED.

/s/
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY COURT JUDGE

DATED: November 23, 1993