



Entered on Docket
March 10, 2006

Hon. Gregg W. Zive
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

In re:

UNIQUE DRYWALL & STUCCO, INC.

BK-04-50046

Debtor.

MEMORANDUM DECISION RE:
IMMEDIATE PAYMENT OF
ALLOWED ATTORNEY FEES

Debtor's counsel Alan R. Smith's ("Applicant") First & Final Application for Compensation covering the period December 9, 2003, through April 30, 2004 (the "Application") was approved following a hearing thereon; however, the court refused to approve payment until the parties provided additional briefing regarding whether actual payment was appropriate because of the conversion of the case from a Chapter 11 to a Chapter 7 at the same hearing. The order entered as a result of the hearing provided Applicant shall have an allowed Chapter 11 administrative claim for professional services rendered in the amount of \$7,935.00 and expenses in the amount of \$1,485.98 for a total of \$9,420.98. A retainer paid to Applicant pre-petition in the amount of \$5,839.00 was held in trust by Applicant. Postpetition, an additional \$2,522.14 was paid which he also held in trust. The difference between the amount held in trust, \$8,361.14, and the allowed compensation is \$1,059.84.

After lengthy argument at a subsequent hearing, the court allowed the parties to file

1 additional briefs and took the matter under submission.

2 Two issues are before the court. First, although the case was converted from a Chapter 11
3 to a Chapter 7, should Applicant be paid the prepetition retainer of \$5,839.00 prior to paying the U.S.
4 Trustee or any Chapter 7 administrative claimants, notwithstanding the priority distribution scheme
5 set forth in 11 U.S.C. § 726(b)? Second, if the court finds Applicant's prepetition retainer cannot be
6 paid outside the priority distribution scheme set forth in § 726(b), can Applicant be paid, along with
7 the remainder of Applicant's approved fees and expenses, for a total of \$9,420.98, prior to any
8 payment made subject to § 726(b), so long as the Chapter 7 case is administratively solvent and other
9 Chapter 11 administrative claimants of equal priority will not be affected?
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11 A. Should the pre-petition retainer in the amount of \$5,839.00 be applied immediately
12 towards Applicant's approved fees and costs, or is it subject to the priority
13 distribution scheme set forth in 11 U.S.C. § 726(b)?

14 In a Chapter 7 case, the trustee is required to distribute the estate property or proceeds
15 pursuant to the priorities set by the Bankruptcy Code. See 11 U.S.C. §§ 726, 507. The distribution
16 scheme set forth in § 726(b) mandates pro rata distribution of assets among creditors in the same
17 statutory class. Section 726 provides, in pertinent part, as follows:
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19 Payment of claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6),
20 (7), or (8) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of
21 subsection (a) of this section, shall be made pro rata among claims of the kind
22 specified in each such particular paragraph

23 11 U.S.C. § 726 (b).

24 Section 507(a) establishes a hierarchy of creditors and describes the order in which they may
25 lay claim to the assets of the bankruptcy estate. At the top of this hierarchy are Chapter 7
26 administrative claims which are given priority over Chapter 11 administrative claims. 11 U.S.C. §
27 726(b). However, according to the majority view, U.S. Trustee's fees, which come due during the
28 Chapter 11 case, receive the same priority as the Chapter 7 administrative expenses upon conversion

1 and are not junior to the Chapter 7 administrative expenses. See *In re Lochmiller Industries, Inc.*,
2 178 B.R. 241, 250 (Bankr. S.D. Cal. 1995) (citing *In re Juhl Enterprises, Inc.*, 921 F. 2d. 800 (8th
3 Cir. 1990)); *In re Darmstadt Corp.*, 164 B.R. 465 (Bankr. D. Del. 1994); *In re Bancroft Laundry*
4 *Center, Inc.*, 164 B.R. 586 (Bankr. N.D. Ohio 1994); *In re K & M Printing & Lithographing, Inc.*,
5 135 B.R. 404 (Bankr. D. Or. 1992); *In re AM-PM Photo Camera Fashions, Inc.*, 116 B.R. 222
6 (Bankr. D. Id. 1990).

8 In addition, “numerous courts have recognized their authority to order disgorgement of
9 professional fees to effectuate full payment to higher priority claimants or for pro rata distribution
10 to claimants with the same priority.” *Lochmiller Industries*, 178 B.R. at 250. The Ninth Circuit
11 recently held in *In re Strand*, 374 F. 3d 854 (9th Cir. 2004), that “[b]ecause interim awards are
12 interlocutory and often require future adjustments, they are ‘always subject to the court’s
13 reexamination and adjustment during the course of the case.’” *Id.* at 858 (citing *In re Evangeline Ref.*
14 *Co.*, 890 F.2d 1312, 1321 (5th Cir. 1989) (quoting 2 *Collier on Bankruptcy* ¶ 331.03 (15th ed.)).

16 Under the Code, a retainer for future services is property of the bankruptcy estate. See 11
17 U.S.C. § 541; *In re C & P Auto Transport, Inc.*, 94 B.R. 682, 690 (Bankr. E.D. Cal. 1988). Although
18 estate property is typically distributed pursuant to § 726(b) in a Chapter 7 case, courts are split as to
19 whether a prepetition retainer remains within the scope of mandatory pro rata distribution set forth
20 in § 726(b) when a case is converted from a Chapter 11 to a Chapter 7.

22 *In re Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6th Cir. 2004), is a case with facts
23 similar to those presented here: Chapter 11 bankruptcy counsel was appointed, counsel was paid a
24 retainer, the case was converted to a Chapter 7, counsel’s fees were paid, and then the case became
25 administratively insolvent. The *Specker* court held that disgorgement of interim compensation in an
26 administratively insolvent case in order to achieve pro rata distribution to all similarly situated
27 claimants is mandatory under § 726(b). *Id.* at 662-63. The court reasoned that
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1 [i]nterim compensation is subject to re-examination and adjustment (citations
2 omitted). This includes retainers, which are held in trust for the estate, and remain
3 the property of the estate (citations omitted). As discussed above . . . administrative
4 claims on the estate, at all times remained subject to the statutory *pro rata* distribution
5 scheme in § 726(b).

6 *Id.* Therefore, according to *Specker*, a retainer provided to counsel prior to the filing of a Chapter
7 11 is subject to pro rata distribution upon conversion to the Chapter 7.

8 *In re North Bay Tractor, Inc.*, 191 B.R. 186 (Bankr. N.D. Cal. 1996), stands for the same
9 proposition. The facts are as follows: after the Chapter 11 case was converted to a Chapter 7, the
10 Chapter 11 trustee requested that debtor’s counsel, who had received 45% of his total fees on account
11 of his prepetition retainer, not be paid any additional fees unless and until all of the other Chapter 11
12 administrative claimants received 45% of their fees. The bankruptcy court held that while the
13 attorney “will not be required to disgorge any of his retainer into the estate, he may not receive any
14 further payment unless and until the other claimants of equal priority have been paid a percentage
15 equal to the percentage of his total fee covered by the retainer.” *Id.* at 188. Therefore like *Specker*,
16 the court found that pursuant to § 726(b), an attorney is not entitled to be paid a higher dividend than
17 any other similarly situated claimants.

18 Contrary to the holdings in *Specker* and *North Bay Tractor*, other courts have held that
19 counsel is *not* required to share a prepetition retainer pro rata with other equal priority claimants
20 where either the retainer is treated as security or the retainer is held in trust. See *In re Printing*
21 *Dimensions, Inc.*, 153 B.R. 715, 719 (Bankr. D. Md. 1993)(citing *In re Kinderhaus Corp.*, 58 B.R.
22 94 (Bankr. D. Minn. 1986)); *In re Burnside Steel Foundary Co.*, 90 B.R. 942, 944 (Bankr. N.D. Ill.
23 1988); *In the Matter of K & R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989).

24 For example, in *In the Matter of K & R Mining, Inc.*, 105 B.R. 394 (Bankr. N.D. Ohio 1989),
25 the court held just the opposite of *Specker*. The facts of *K & R Mining* are also similar to the facts
26 of this case: a retainer was received by the debtor’s attorney prior to the filing of the Chapter 11, and
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1 thereafter, the case was converted to a Chapter 7. Quoting *In re Burnside Steel Foundary Co.*, 90
2 B.R. 942, 944 (Bankr. N.D. Ill. 1988), the court in *K & R Mining* reasoned as follows:

3 [T]he typical retainer paid to a debtor's attorney in a Chapter 11 case is
4 intended to secure future payment of attorney's fees awarded by the Court.
5 In the event the Court orders such an award, and the debtor does not have
6 the cash to pay the award, the retainer insures payment. If the case fails
7 and is converted to Chapter 7, the retainer enables the debtor's attorney to
8 avoid the subordination of the Chapter 11 expenses of administration to
9 those incurred in administering the Chapter 7 estate mandated by section
10 726(b) of the Bankruptcy Code.

11 The reason why this result obtains is simple. The debtor's attorney who
12 receives a prepetition retainer to insure payment of fees to be earned in the
13 Chapter 11 case (or post petition retainer authorized by court order)
14 becomes a secured creditor, secured by a possessory security interest in
15 cash There is nothing theoretically different between the attorney
16 who receives a retainer against future fees and a landlord who takes a cash
17 security deposit to secure the payment of future rent. The reason that the
18 retainer succeeds in avoiding the subordination requirements of section
19 726(b) is that section 726 only affects distribution priorities among holders
20 of unsecured claims, and an attorney with the retainer is, to the extent of the
21 retainer, the holder of a secured claim.

22 *K & R Mining*, 105 B.R. at 397. The *K & R Mining* court held that the debtor's attorney possessed
23 a security interest in the retainer to secure payment of fees and expenses and upon court approval of
24 those fees and expenses, the retainer could be applied to reduce the fees and expenses awarded. *Id.*
25 at 398. The Ninth Circuit, however, in *In re LPM Corp.*, 300 F.3d 1134 (9th Cir. 2002), disagrees,
26 in part, with the reasoning set forth in *In re Burnside Steel Foundary Company* (quoted by *K & R*
27 *Mining, Inc.*, 105 B.R. at 397). The Ninth Circuit held that "post-Chapter 11 rent claims have
28 administrative priority and are entitled to payment under § 365(d)(3), unless the case is converted to
a Chapter 7. In that event, the claims are paid as specified in 11 U.S.C. § 726." *In re LPM Corp.*,
300 F.3d at 1138. Therefore, unlike *Burnside Steel Foundary Co.* and *K & R Mining*, the Ninth
Circuit would subject post-Chapter 11 rent claims to the priority distribution scheme set forth in §
726(b).

1 Therefore, this court is presented with two different lines of reasoning. *Specker*, a recent
2 decision out of the Sixth Circuit and *North Bay Tractor*, a bankruptcy decision from the Northern
3 District of California, hold that attorneys who receive prepetition retainers prior to the filing of a
4 Chapter 11 case will be paid with equal priority claimants if that case is converted to a Chapter 7.
5 Additionally, *LPM Corp.*, a Ninth Circuit case, has held that once a case is converted to Chapter 7
6 and is administratively insolvent, payment of post-petition rent is controlled by § 726(b). On the
7 other hand, *K & R Mining*, a Sixth Circuit bankruptcy case out of Ohio; *In re Burnside*, a bankruptcy
8 case out of the Northern District of Illinois; and *Kinderhaus*, a bankruptcy case out of Minnesota, find
9 that prepetition retainers can be paid to attorneys prior to other similarly situated administrative
10 claimants if a case is converted from a Chapter 11 to a Chapter 7. This court is persuaded by the
11 reasoning set forth in *Specker*, *North Bay Tractor* and *LPM Corp.*, and finds that prepetition retainers
12 should be paid in accordance with the distribution scheme set forth in § 726(b).
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15 “Equality of distribution among creditors is a central policy of the Bankruptcy Code.
16 According to that policy, creditors of equal priority should receive *pro rata* shares of the debtor’s
17 property.” *Specker*, 393 F.3d at 664 (quoting *Begier v. Internal Revenue Serv.*, 496 U.S. 53, 58
18 (1990)). “[I]f one claimant is to be preferred over others, the purpose should be clear from the
19 statute.” *Nathanson v. N.L.R.B.*, 344 U.S. 25, 29 (1952). To find that Applicant is not required to
20 share a prepetition retainer pro rata with other like claimants upon conversion of a case from Chapter
21 11 to a Chapter 7 would be to ignore the plain language of § 726(b) and to unjustly award him a
22 “superpriority” status that is not provided by the Code. Indeed, equality of distribution would be
23 vitiated if equally situated administrative claimants did not receive their pro rata share.
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25 Applicant contends he is entitled to be paid ahead of other similarly situated claimants and
26 the U.S. Trustee because his fees are secured by a retaining lien against the prepetition retainer.
27 Based on the recent decision in *Specker*, this court finds Applicant’s retainer should be paid
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1 according to the distribution scheme set forth in § 726(b). The plain language of the Code simply
2 does not provide Applicant with a “superpriority” status over similarly situated administrative
3 claimants. Applicant’s contention validly points out that he has a right to payment, but the method
4 by which payment is effected is still governed by the Code.

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6 Applicant also argues that the retainer is held in an express trust for the benefit of counsel and
7 is beyond the reach of this court. The trust, however, is limited by the language of the Attorney Fee
8 Agreement which states the following: “[t]he retainer and funds in the trust account may be applied
9 as set forth above prior to an order of the Bankruptcy Court approving the fees, however such fees
10 may be repaid by Attorney to the extent that they may not be approved by the Bankruptcy Court.”
11 Attorney Fee Agreement at 4 (*Application to Employ Attorney, Dkt. No. 7*). This language makes it
12 clear that Applicant’s “express trust” is subject to the orders of this court, and this court finds that
13 the retainer, even though it is held in trust, is subject to the priority distribution scheme of § 726(b).
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15 Applicant claims for the first time in his Additional Brief that he has a security interest in the
16 retainer. This theory was not argued at the hearing and was not within the supplemental briefing
17 parameters provided by the court. As such, this argument will not be considered.

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19 B. If the Chapter 7 case is administratively solvent and other Chapter 11
20 administrative claimants of equal priority will not be affected, can Applicant’s
21 entire amount of approved fees, be paid immediately, notwithstanding § 726(b)?

22 Where a case is administratively solvent, an administrative claimant may be paid in advance
23 of other administrative claimants, subject to disgorgement if the case ultimately is determined to be
24 insolvent. *In re Energy Cooperative, Inc.*, 55 B.R 957, 967 (Bankr. N.D. Ill. 1985).

25 Applicant contends there are sufficient assets to pay all administrative claimants in full
26 without requiring counsel to disgorge his postpetition retainer. Applicant submitted the Declaration
27 of James T. Morris, President of Debtor, which Applicant contends demonstrates there are sufficient
28 assets to pay all administrative claimants in full without requiring Applicant to disgorge his

1 postpetition retainer. This declaration, however, only provides Debtor's account balance up to July
2 26, 2004. There is no evidence suggesting the current state of Debtor's financial responsibilities.
3 Further, there has been no evidence submitted by either the Office of the U.S. Trustee or the Chapter
4 7 trustee demonstrating that there will be insufficient assets upon administration of the Chapter 7
5 case. The U.S. Trustee simply indicates in his Additional Brief that the Chapter 7 Trustee has
6 reported some of the estate property stolen and that the value of the remaining property and the extent
7 of the administrative claims are not known. As insufficient evidence has been submitted, this court
8 will defer its ruling on this issue pending a further evidentiary hearing if necessary.
9

10 CONCLUSION

11 Applicant's prepetition retainer should be paid in accordance with the provisions of § 726(b)
12 and disbursed on a pro rata basis with other similarly situated administrative claims. However, if this
13 case is administratively solvent, Applicant can be paid immediately. This court will conduct an
14 evidentiary hearing, if necessary, in order to determine whether there are sufficient assets to
15 pay Applicant's approved fees and costs immediately rather than at the end of the case.
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