

UNITED STATES BANKRUPTCY COURT  
DISTRICT OF MINNESOTA  
THIRD DIVISION

In re:  
  
Kinderhaus Corporation,  
84-1010  
  
Debtor.

Chapter 7 Case  
  
BKY Case No. 3-

MEMORANDUM ORDER

This matter came before the Court on March 18, 1992, on the objection by Debtor's counsel to the Chapter 7 trustee's proposed Second Amended Final Account Before Distribution, and the Chapter 7 trustee's continued motion for turnover of attorney's fees. Sheridan J. Buckley, the Chapter 7 trustee, (Buckley) represents the bankruptcy estate. Richard G. Nadler represents Richard G. Nadler & Associates (Nadler). The Court, having considered the briefs of the parties, and being fully advised in the matter, now makes this ORDER pursuant to the Federal and Local Rules of Bankruptcy Procedure.

I.

This dispute concerns Chapter 11 attorney's fees previously paid in full to Debtor's counsel before the Chapter 7 trustee completed his administration of the estate in the converted case. The problem arises because, according to Buckley's calculations, there are insufficient funds in the bankruptcy estate to pay all Chapter 11 administrative claims in full.

Events which took place during the pendency of the bankruptcy case, originally filed as a Chapter 11 on May 31, 1984, give rise to the present dispute. The Debtor was a child care provider. At the hearing on adequacy of the disclosure statement held November 4, 1985, the Debtor requested conversion to Chapter 7; but requested staying the effect of conversion until close of business November 8, 1985, pending an attempt to sell the business in Chapter 11. On November 7, 1985, the Debtor filed an expedited motion for approval of a sale of the Debtor's assets free and clear of liens for \$100,000 to a competitor. At that time, the Internal Revenue Service (IRS) was a tax lien claimant with two tax liens on the property filed on May 6, 1983 and June 30, 1983, in the aggregate amount of \$44,023.19.

The sale was approved on November 13, 1985. On December 31, 1985, Nadler applied for interim allowance of compensation and reimbursement of expenses. The matter was heard on January 8, 1986, and the fees were conditionally approved. The parties were permitted to brief the issues of immediate payment of the fees and their treatment as administrative expenses. On February 26, 1986, this Court awarded the firm \$16,285.58 in attorney's fees and

expenses as reasonably necessary in connection with the Chapter 11 case through that date.(FN1) The Order permitted Nadler to offset his retainer of \$7,200 against the approved amount, leaving a balance due of \$9,085.58. Pursuant to the Order, an additional \$2,182.70 was authorized for immediate payment as an administrative expense. Payment of the balance was stayed pending either confirmation of a

(FN1) See: In re Kinderhaus, Ch. 7 Case No. 3-84-1010, slip op. at 1 (D.Minn. February 26, 1986).

liquidation plan, or appropriate distribution, should the case be converted to a Chapter 7 case.(FN2)

ordered The case converted to a Chapter 7 case on March 26, 1986. On December 5, 1986, Nadler was awarded additional attorney's fees and costs in the Chapter 11 case of \$2,159.79, and attorney's fees and costs of \$1,264.74 in the Chapter 7 case.(FN3) The trustee was to pay Nadler forthwith the sum of \$10,327.41, representing the balance due of \$6,902.88, but unpaid, from the January 10, 1986 award, plus the additional compensation of \$3,424.53 awarded in the case.(FN4)

full In his Second Amended Final Account Before Distribution, Buckley shows gross receipts of \$132,717.17. From these funds, he primes the IRS lien to pay claims allowed under 11 U.S.C. Section 507(a)(1) through (a)(6)(FN5) up to the amount of the IRS secured claim, then proposes to pay the IRS lien of \$44,023.19 in

11 The Application proposes pro rata payment of the remaining claims allowed under Section 507(a)(1) through (a)(6), reaching only Chapter administrative expense claims at 66.257% of the allowable amounts. According to Buckley, 11 U.S.C. Section 724(b)(FN6) requires this distribution

(FN2) In its February 26, 1986 order, the Court calculated the amount of administrative expenses of equal priority with Nadler's to be \$68,685.58. The Court also concluded that \$33,580.06 of the \$100,000 sale proceeds appeared to be unencumbered, and therefore available to pay administrative expenses on a pro rata basis. Nadler's pro rata share was \$4,365.40. Since a successful outcome in the case was doubtful, the Court ordered that \$2,182.70, or one-half of Nadler's pro rata share, would be allowed, but it could not be paid until the case was concluded with a liquidation plan or conversion to Chapter 7. Id. at page 8.

(FN3) See: In re Kinderhaus, Ch. 7 Case No. 3-84-1010, slip op. at 1-2 (D.Minn. December 5, 1986).

(FN4) The trustee later sought delayed payment of Nadler's fees pending complete administration of the estate. Ultimately, with leave of Court, he paid Nadler at Nadler's insistence.

(FN5) 11 U.S.C. Section 507(a)(1) through (a)(6) reads in pertinent part:

(a) The following expenses and claims have priority in the following order:

(1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

(2) Second, unsecured claims allowed under section 502(f) of this title.

(3) Third, allowed unsecured claims for wages, salaries, or commissions, including vacation, severance, and sick leave pay--...

(4) Fourth, allowed unsecured claims for contributions to an employee benefit plan--...

(5) Fifth, allowed unsecured claims of persons--

(A) engaged in the production or raising of grain,...

(B) engaged as a United States fisherman...

(6) Sixth, allowed unsecured claims of individuals, ...arising from the deposit...of money in connection with the purchase, lease, or rental of property, or the purchase of services...that were not delivered or provided....

(FN6) 11 U.S.C. 724 reads in pertinent part:

(b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed--

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;

(2) second, to any holder of a claim of a kind specified in Sections 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), or 507(a)(6) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

(3) third, to the holder of such tax lien, to any extent that such holder's allowed tax claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;

(4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and this is junior to such tax lien;

(5) fifth, to the holder of such tax lien, to the extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and

(6) sixth, to the estate. (Emphasis added.)

scheme. Under that distribution, Nadler's pro rata share is less than what he received. Buckley argues that since Nadler was paid in full prior to complete administration of the bankruptcy estate, the only means by which other Chapter 11 claimants can receive a proper pro rata distribution is for Nadler to return the overpayment. Failure to order repayment, he claims, will give Nadler a windfall to the detriment of other similarly-situated creditors.

Nadler objects to the proposed distribution scheme disputing Buckley's interpretation of Section 724(b). Further, he claims that the IRS earlier agreed that all Chapter 7 and Chapter 11 administrative expenses could prime the lien. Therefore, according to Nadler, under the circumstances of this case, the Court should not require turnover of attorney's fees.

## II.

1. Is Nadler entitled to an order sustaining his objection to Buckley's Second Amended Final Account Before Distribution?  
2. Does 11 U.S.C. Section 724(b) entitle Buckley to a turnover order for attorney's fees previously paid to Nadler for redistribution on a pro rata basis with other administrative claimants?

## III.

Section 724(b) and its legislative history clearly indicate that Buckley's proposed distribution scheme is correct. Under Section 724(b), as the legislative history unambiguously demonstrates, Section 507(a)(1) through (a)(6)(FN5) claimants in a converted case step into the shoes of the tax collector only to the extent of the amount of the claim secured by the lien. See: In re Atlas Commercial

Floors, 125 B.R. 185, 187 (Bankr. E.D.Mich. 1991). And see: In re Dowco Petroleum, 137 B.R. 207, 213 (Bankr. E.D. Tex. 1992). Once these claimants have been paid in full, according to their priorities, or up to the aggregate amount of the claim secured by the lien, the tax lien must be satisfied through payment of the tax claim before payment of any other claims. Atlas, at 187. In this case, after payment of Section 507(a)(1) through (a)(6) priorities is made in the amount of \$44,023.19, the tax lien must then be paid, and the balance of funds to be distributed is insufficient to result in full payment of allowed Chapter 11 administrative expense claims. Accordingly, distribution of to these claimants must be pro rata. This application will allow for total payment of only 66.257% of all Chapter 11 administrative expenses.

Based upon the foregoing analysis, Nadler's objection to the proposed Second Amended Final Account Before Distribution must be overruled, and Buckley is entitled to an order for turnover.(FN7)

(FN7) Nadler appealed an earlier fee order to the District Court on May 7, 1986. The District Court ultimately denied Nadler leave to appeal from the February 26, 1986, interlocutory order. In his argument in this proceeding, Nadler asserts that the IRS agreed before the District Court that all Chapter 11 and Chapter 7 administrative expenses could prime its lien. This misstates the IRS' position. As the pleadings show, the IRS argued that the administrative expense issue on appeal was moot, because the case was now a case under Chapter 7, and administrative claimants had the benefit of 11 U.S.C. 724(b). There is no suggestion in the pleadings that the IRS intended to allow its lien to be primed beyond the amount authorized by the statute.

NOW, THEREFORE, IT IS ORDERED:

1. Nadler's objection to the Chapter 7 trustee's Second Amended Final Account Before Distribution is overruled.

2. Buckley's motion for turnover is hereby granted, and Nadler is ordered to turn over the attorney fee overpayment, in the amount of \$3,058.01, forthwith to enable the trustee to complete distribution to creditors.

Dated:

Dennis D. O'Brien  
U.S. Bankruptcy Judge