

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

HORIZON AIR, INC.

CASE NO. 91-02301

Debtor

APPEARANCES:

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STEPHEN D. GERLING, U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

The Court considers herein the Fee Applications of Menter, Rudin & Trivelpiece, P.C. ("Menter"), appointed as Debtor's counsel by an Order dated August 13, 1991, and Dow, Lohnes & Albertson, Esqs., ("Dow"), appointed as Special Counsel to the Debtor by an Order dated December 16, 1991.

The Menter Fee Application, its first, was filed July 21, 1993, and seeks a fee of \$192,657.00 together with a reimbursement of expenses in the sum of \$16,814.00, while Dow's Fee Application, its second, was filed July 6, 1993 and seeks a fee of \$36,477.00 together with reimbursement of expenses in the sum of \$2223.33. Both Fee Applications appeared on the Court's motion calendar held at Syracuse, New York on August 10, 1993.

Appearing at the motion term and filing opposing papers to both Fee Applications was the Internal Revenue Service ("IRS"), which contends that the

fees sought by Menter and Dow cannot be paid from the Debtor's accounts receivable since the IRS holds both pre and post-petition liens on those accounts, the latter lien having been granted to the IRS by virtue of a cash collateral Order signed by this Court on January 14, 1992 ("Cash Collateral Order"). The IRS asserts that the decision of the United States Court of Appeals for the Second Circuit in In re Flagstaff Foodservices Corp., 739 F.2d 73 (2d Cir. 1984) prohibits payment of post-petition attorneys' fees from the collateral of a secured creditor absent certain conditions not present here.

In addition, the IRS contends that Menter's Fee Application substantively contains "much puffing" with regard to services rendered to the Debtor in connection with its dispute with the Federal Aviation Administration ("FAA").

Menter and Dow, while not appearing to dispute the IRS's reliance on the rationale of In re Flagstaff Foodservices Corp., supra, assert that by virtue of the Cash Collateral Order, Debtor was authorized to use cash collateral in the ordinary course of business and that payments of their post-petition attorneys' fees using the so-called "horizontal and vertical dimension tests" is an "ordinary course of business" expense. Both applicants also cite the payment of the Debtor's post-petition tax obligations out of cash collateral, which they contend will be preferential in nature if the Debtor is prohibited from paying its attorneys' fees in the same manner as "ordinary course of business" expenses.¹

Following the motion term, the Court reserved decision on both Fee Applications and directed the parties to submit memoranda of law not later than August 31, 1993.

On September 14, 1993, on motion of the Internal Revenue Service, the case was converted from Chapter 11 to Chapter 7.

JURISDICTIONAL STATEMENT

¹ Menter's Fee Application indicates that it received a retainer of \$50,893.00 while the Court has previously approved a fee to Dow of \$12,199.00.

The Court has core jurisdiction of this contested matter by virtue of 28 U.S.C. §§1334(b) and 157(a), (b)(1) and (2)(A).

DISCUSSION

Menter and Dow's reliance upon the January 14, 1992 Cash Collateral Order as a basis for payment of their attorneys' fees is misplaced. Attorneys' fees earned and payable within the context of a Chapter 11 case do not fall within the category of expenses incurred in the ordinary course of business and if they are to be "carved out" of the collateral of a secured creditor there must be clear and unequivocal language to that effect. No such language is found in the Cash Collateral Order upon which Menter and Dow rely.

Code §503(b) clearly differentiates between the costs and expenses of preserving the estate or in other words those incurred in the ordinary course of business (Code §503(b)(1)(A) and professional compensation and reimbursement awarded pursuant to Code §330 (Code §503(b)(2)).

As observed by the bankruptcy court in In re Channel 2 Associates, 88 B.R. 351, 352 (Bankr. D.N.M. 1988), relying upon the decision of the Third Circuit in In re F/S Airlease II, Inc., 844 F.2d 99 (3d Cir. 1988), "compensation of a non-§327 approved professional through §503(b)(1) would render §327 nugatory and contravene Congress' intent."

There is no dispute here that both Menter and Dow are professionals within the meaning of Code §327 and were in fact appointed as such pursuant to that section by prior Orders of this Court. Thus, their professional fees cannot be categorized as a Code §503(b)(1)(A) administrative expense incurred in the ordinary course of the Debtor's post-petition business, but may only be allowed as a Code §503(b)(2) administrative expense - "compensation and reimbursement awarded pursuant to Section 330(a) of this title." See In re Pacific Forest Industries, Inc., 95 B.R. 740, 743 (Bankr. C.D.Cal. 1989), In re Vernon Sand and Gravel, Inc., 109 B.R. 255, 258 (Bankr. N.D.Ohio 1989).

The alternative argument of Menter and Dow that because the Debtor paid, with the knowledge and consent of the IRS, such post-petition expenses as taxes, payments on aircraft and leases and airport and slot rental obligations,

the IRS has waived its right to object to payment of post-petition attorneys' fees is equally unpersuasive.

Courts have consistently concluded that post-petition payments such as taxes and lease obligations are ordinary course of business expenses, which fall under Code §503(b)(1)A) and which may be paid by the Debtor in the absence of prior court approval. See In re Vernon Sand & Gravel, Inc. supra 109 B.R. at 257.258.

Congress in enacting Code §§327, 328, 330 and 331 clearly intended that professional fees, while admittedly entitled to an administrative priority, were to be treated in a manner clearly distinguishable from expenses incurred in the ordinary course of debtor's business. Thus, voluntary payment of those latter expenses by a debtor in no way effects a waiver of the application of the aforementioned Code sections to the approval and payment of professional fees. Thus, this Court must agree with the IRS that neither Menter's nor Dow's fees may be paid out of the Debtor's accounts receivable to the extent those accounts are encumbered by the IRS's rollover security interest. The Court, however, does not pass upon other arguments of the IRS asserted in opposition to the Fee Applications.

Finally, the Court notes that even if the Fee Applications of Menter and Dow were otherwise subject to approval within the Chapter 11, the conversion of this case from Chapter 11 to Chapter 7 prior to the award and payment of any such fees relegates any such award to a second level priority pursuant to Code §726(b) and effectively postpones the Court's determination on the merits of the pending Fee Applications to the date of a hearing on the Chapter 7 Trustee's final report and accounting. In the interim, Menter shall continue in possession of the retainer in the sum of \$50,893.50 subject to a further order of this Court.

IT IS SO ORDERED.

Dated at Utica, New York

this day of December, 1993

STEPHEN D. GERLING
U.S. Bankruptcy Judge