

In the United States Bankruptcy Court

for the Northern District of Iowa

ALVIN E. HOLST and L. MARIBELLE HOLST
Debtors.

Bankruptcy No. X91-02043F
Chapter 12

ORDER RE: DEBTORS' OBJECTION TO TRUSTEE'S DISTRIBUTION

The matter before the court is the debtors' objection to the trustee's distribution of money to debtors' former attorney in satisfaction of his administrative claim. Hearing on the matter was held on March 21, 1994, in Fort Dodge. Debtors Alvin and Maribelle Holst (HOLSTS or DEBTORS) appeared pro se. Also appearing were Carol Dunbar, the case trustee; David A. Sergeant; and Neven Mulholland, attorney for First American State Bank.

I.

Debtors' amended chapter 12 plan of reorganization (docket nos. 110, 116, 121) was confirmed in October, 1992 (docket nos. 122, 123). The plan defined an "administrative claim" to include costs and expenses arising under 11 U.S.C. § 507(a)(1) including all allowed attorney's fees (docket no. 110, Plan 2.2, page 3). Such fees were also "classified" as administrative expenses (docket no. 110, Plan 3.1, page 5).

The plan provided that administrative claims which were due and payable on or before the "date of distribution" were to be paid in full on the date of distribution. Those not due and payable on the date of distribution were to be paid when due in the ordinary course of the debtors' business (docket no. 110, Plan 4.1, pages 6-7). The distribution date was defined as the date which would be the later of (a) 60 days after confirmation or (b) the date on which the order of confirmation was no longer subject to appeal (docket no. 110, Plan 2.13, page 4). The confirmation order was not appealed.

Although section 4.1 of the plan does not say it, the court construes the plan as a whole as providing that debtors would pay administrative claims directly and not through the trustee. The plan provided that the trustee would make payments to the creditors in classes II, III and IX (docket no. 110, Plan 8.2(d), page 14).

Debtors had retained David A. Sergeant to represent them in this case. Sergeant applied for interim fees in April, 1992. On June 24, 1992, the court issued an order allowing interim fees and reimbursement of expenses in the sum of \$5,008.05. Sergeant was permitted to apply his pre-petition retainer to the allowance (docket no. 85); the retainer was insufficient to pay the allowed interim fees in full.

Sergeant filed his final fee application on February 16, 1993 (docket no. 130). Debtors objected to the application (docket no. 136). Because of the deteriorating relationship with his clients, Sergeant moved to withdraw as their counsel (docket no. 144). His application was granted (docket no. 147). Debtors have not hired new counsel.

By order dated July 26, 1993 (docket no. 150), Sergeant was allowed professional fees as an administrative expense. After consideration of post-decision motions, the court issued an order on October 1, 1993, adjusting Sergeant's final allowance. He was allowed \$16,727.66 (docket nos. 160, 161) as an administrative expense under 11 U.S.C. § 503(b)(2). Some of this amount was paid.

On February 24, 1994, Holsts wrote to case trustee Carol Dunbar and enclosed a cashier's check for \$35,796.60. They asked Dunbar in turn to remit to First American State Bank the sum of \$18,079.09 as a plan payment on the Bank's Class III claim and \$14,463.27 as a plan payment on Bank's other claim. The balance of \$3,254.24 was for trustee's fees on those distributions.

The trustee's attorney notified Holsts that the trustee had paid \$11,003.46 to David Sergeant in satisfaction of the court's allowance of Sergeant's administrative claim. The trustee took a 10 per cent fee on that payment. The balance was distributed to First American State Bank on its secured claims and to the trustee for her fee on those payments. The trustee told Holsts that in order for the trustee to make the correct payments to the Bank under the plan and to pay the trustee's fees in full, \$12,103.80 was still due.

Holsts wrote to the court complaining of the trustee's distribution. The court treated their letter as an objection to the trustee's distribution and set the matter for hearing.

II.

Although the plan provides for debtors to pay administrative claims directly, they failed to pay Sergeant's claim after it was allowed. Section 1226(b)(1) of the Bankruptcy Code (Title 11 United States Code) provides that "[b]efore or at the time of each payment to creditors under the plan, there shall be paid-- (1) any unpaid claim of the kind specified in section 507(a)(1) of this title. . . ." As Sergeant had an allowed, but unpaid, claim under § 507(a)(1), the trustee asserts that the foregoing Code section required that she pay Sergeant his allowed fees.

The trustee determined that funds would go first to the attorney in full payment of his claim and second to the secured creditor in partial payment of its claim. This determination was based on construing § 1226(b)(1) to mean that regardless of the sufficiency of the funds available, administrative claims must be paid in full; then the trustee may make payments, even if partial payments, to other classes of creditors.

But § 1226(b)(1) may mean only that when required plan payments are made, unpaid administrative claims must always be paid in full. It may not speak at all to the priority of plan payments if insufficient funds are available to make all required payments. The court concludes that it does not. In this case, two claimants were entitled to payments--Sergeant was entitled to payment in full of his allowed administrative expense claim, and Bank was entitled to full payment of the annual installment on its secured claim.

Because the debtors paid the trustee insufficient monies, they defaulted in the performance of their plan. Because of the default, the trustee was unable to make the payments required by the plan. On what legal basis does she then decide how to distribute the funds in her possession? By the plan? She cannot satisfy its provisions, for if she pays Sergeant, she has deprived Bank of its plan entitlement; she cannot pay Bank without paying Sergeant. The plan does not instruct the trustee in what manner to distribute insufficient payments, and the court considers that it may not be done according to a chapter 7 liquidation scheme because neither chapter 12 nor the plan so provide.

The most appropriate course is for the trustee to hold the funds and to bring the debtors' default before the court. In re Winter, 151 B.R. 278, 283 n.8 (Bankr. W.D. Okla. 1993). There are options. A debtor, the trustee or an unsecured creditor may seek modification of the plan. 11 U.S.C. § 1229(a). A debtor may voluntarily dismiss the case. 11 U.S.C. § 1208(b). A party-in-interest may seek dismissal on account of a material default in performance of the plan. 11 U.S.C. § 1208(c)(6). A party-in-interest may obtain conversion of the case to chapter 7 if it can show the debtor committed fraud in connection with the case. 11 U.S.C. § 1208(d).

If the case were dismissed, the court has the authority to retain jurisdiction over the funds in the trustee's possession pursuant to 11 U.S.C. § 349(b). The court could determine whether unpaid administrative claims might be paid from these funds. Moreover, the continued jurisdiction would give any creditor claiming a security interest in the funds an opportunity to assert its claim, as it may not be appropriate to permit payment of administrative claims from another's collateral. When the trustee distributes first to administrative claimants out of funds which are insufficient to make all required payments, she risks paying the wrong parties.

Holsts are in material default with regard to their plan. It was their obligation to pay sufficient funds to the trustee to make possible payment to both Sergeant and the Bank. This remains their responsibility. It may be that Holsts will cure their default. If so, this dispute dies away. Or it may be that motions to dismiss the case or modify the plan are in the offing. The Bank claims a security interest in the funds paid to Sergeant, but Bank has not had an opportunity to assert its claim. There was insufficient evidence at the hearing to prove such interest. If the case is dismissed, and if Bank has no security interest in the funds Holsts paid to trustee, it may be that Sergeant will be permitted to retain his payment.

The court will not order Sergeant's payment returned to the trustee. The debtors' objection to the distribution will be overruled. Bank may bring whatever adversary or contested matter it believes appropriate seeking a determination of its interest in the funds paid by trustee to Sergeant. The overruling of the debtors' objection is without prejudice to the Bank's claims in the funds. If Bank fails to bring a proceeding in this court before any dismissal of the case, then its recourse, if any, will be in any other court of appropriate jurisdiction. If the Bank brings a proceeding in this court, the court will, upon dismissal, retain jurisdiction of the funds and the claims of Sergeant and the Bank.

Holsts are advised that if they desire to appeal this decision, they must do so by filing a Notice of Appeal with the Clerk of Bankruptcy Court within 10 days of the entry of this decision. Fed.R.Bankr.P. 8002(a).

A further comment is in order. This court has, as it has in this case, approved plans which provide for debtors to pay their attorney's administrative claims directly and not through the trustee. This has been so where debtors propose to pay the administrative claim in full on confirmation or allowance. The permissive use of such treatment helps to hold down legal costs because the trustee does not take a percentage fee on such payments. Other courts do not permit such treatment. They require administrative expense payments to be made through the trustee. See In re Beard, 134 B.R. 239, 245-46 (Bankr. S.D. Ohio 1991). It is considered that because administrative expense claims have received special treatment by Congress, it is important that they be monitored by the trustee. Id.

This case is an example of what happens when plan proponents are permitted to depart from the conventional wisdom. In the future, this court will not confirm plans unless they provide for payment of administrative claims through the trustee or the proponents provide and prove they are ready, willing and able to pay their attorney's fees in full upon allowance.

IT IS ORDERED that the objection of Alvin and L. Maribelle Holst to the trustee's distribution of funds to David A. Sergeant is overruled. Judgment shall enter accordingly.

SO ORDERED ON THIS 25th DAY OF MARCH, 1994.

William L. Edmonds
Chief Bankruptcy Judge

I certify that on _____ I mailed a copy of this order and a judgment by U. S. mail to: Debtors, David Sergeant, Neven Mulholland, Carol Dunbar and U. S. Trustee.