UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:	)	
	)	
RITE INDUSTRIES, INC.,	)	**Case No. B-99-12653C-11G**
	)	
Debtor.	)	
IN RE:	)	
	)	
POLYCHEM OF GEORGIA, INC.,	)	**Case No. B-99-12654C-11G**
	)	
Debtor.	)	

MEMORANDUM OPINION AND ORDER

THIS MATTER came on for hearing before the undersigned bankruptcy judge on June 15, 2000, in Greensboro, North Carolina upon the Official Committee of General Unsecured Creditors of Rite Industries, Inc.'s Motion to Amend Order, or in the Alternative, For Relief from Order entered January 7, 2000. Charles Ivey and James Talcott appeared on behalf of Rite Industries, Inc., and Polychem of Georgia, Inc., (the "Debtors"), Christine Myatt appeared on behalf of the unsecured creditors' committee of Rite Industries, Inc., John Northern appeared on behalf of the unsecured creditors' committee for Polychem of Georgia, Inc., Christopher Strickland and John H. Small appeared on behalf of GE Capital Corporation ("GECC") and Robyn Palenske appeared on behalf of the Bankruptcy Administrator. After hearing the arguments of counsel and reviewing the briefs submitted, the Court makes the following:

FINDINGS OF FACT

The above captioned Debtors filed Voluntary Petitions for Reorganization under Title 11, Chapter 11 of the United States Bankruptcy Code on November 12, 1999. Upon the filing of the Petitions, the Debtors continued the operation of their businesses until substantially all assets of

the Debtors' businesses were sold at a closing taking place on December 30, 1999. The cases were administratively consolidated by Order dated November 19, 1999.

On or about November 12, 1999, the court preliminarily approved a post-petition financing agreement between Debtors and GECC. On December 17, 1999, the court conducted a final hearing on the motion filed on November 12, 1999, pursuant to 11 U.S.C. §§ 361, 363 and 364, for Debtors to incur post-petition secured indebtedness and to grant a security interest and priority, and to authorize limited use of cash collateral and to provide adequate protection (the "DIP Motion"). On January 7, 2000, the court entered a Final Order allowing the DIP Motion. The Final Order provided for a carve-out for the payment of qualified fees and expenses of the professionals employed by the Debtors, up to a maximum aggregate amount not to exceed $300,000.00, and a separate, limited allowance for the payment of qualified fees and expenses of the professionals employed by the committees up to an aggregate amount not to exceed $25,000.00. Pursuant to a consent order entered on February 23, 2000, GECC agreed to pay all of the fees and expenses which were allowed by the court for compensation of professionals employed by the Debtors and the committees and by virtue of that order, the professionals for the committees were paid in excess of $25,000.00. It was further agreed that the Motion to Amend the January 7, 2000 Order would be heard at a later date.

For the reasons stated herein, the Motion to Amend, or in the Alternative, for Relief from the Order of January 7, 2000, will be denied.

ISSUE

The issue before the court is whether the funds advanced pursuant to the post-petition loan documents and earmarked for professionals under the carve-out should be distributed pro-rata to all outstanding and unpaid administrative claimants.

DISCUSSION

At the time that the Debtors filed for Chapter 11, the Debtors were not intending to seek to reorganize, rather the Debtors wanted to sell the assets of the businesses. The Debtors did not have sufficient monies to continue to operate the businesses and the major secured creditor in the case, GECC, was undersecured. The creditor agreed to advance the sum of $3,000,000.00 to the Debtors as the creditor believed that it could recoup more of its loan if the Debtors were sold as ongoing concerns rather than liquidated. Therefore, GECC and the Debtors petitioned the court to approve DIP financing in the amount of $3,000,000.00. The court, after appropriate notice, approved the post-petition loan under 11 U.S.C. § 364(c). Section 364 provides that a court may authorize a debtor to obtain credit or incur debt with priority over any or all administrative expenses specified in §§ 503(b) or 507(b). See 11 U.S.C. § 364(c)(1). The Debtors were allowed to borrow monies post-petition and, in exchange, gave the creditor a first priority lien on certain post-petition assets. GECC essentially agreed to fund the payment of attorney fees from its collateral and also to pay certain budgeted items, but the carve-out for professional fees will not be diluted by other unpaid administrative claims.

The purpose of the requested financing pursuant to the DIP Credit Agreement was to provide ongoing working capital to the Debtors and to pay, pursuant to court orders, fees, costs, expenses and disbursements to professionals retained by the Debtors and any official committees appointed by the court. The Final Order specifically states that, pursuant to §§ 363(e), 364(c)(1) and 364(d) of the Bankruptcy Code the post-petition loan had priority over any and all administrative expenses including, without limitation, those specified in §§ 105, 326, 328, 330, 331, 503(b), 506(c), 507(a), (b), 553 and 726 of the Bankruptcy Code. As security for such post-petition obligations, the creditor was awarded a first priority senior security interest in the

collateral and a lien upon all existing and after-acquired property of the Debtors of whatever kind or nature (exclusive of any avoidance actions available to the bankruptcy estate of the Debtors pursuant to §§ 544, 545, 547, 548, 549, 550, 553(b) or 724(a) of the Bankruptcy Code). Funds could only be released pursuant to an agreed upon budget with carve-outs for legal fees and expenses for the Debtors' counsel in an aggregate amount not to exceed $300,000.00 and for the unsecured creditors' committees in the aggregate amount not to exceed $25,000.00. The fees for legal expenses were segregated and held in an escrow account pending approval by the court.[1]

The committees now contend that the total amount allocated to legal fees, $325,000.00, should be used to pay all cost of administration claims and that the court "may not permit GE Capital to usurp the Court's authority to determine which administrative claims should be allowed and how the property of the estate should be disbursed." (Supplemental Mem. By Polychem Committee in Supp. of Mot. to Amend at 9.) The statement overlooks the fact that the post-petition financing agreement which was approved by the court, after notice and hearing, altered the normal priority scheme set forth in the Bankruptcy Code and granted the post-petition lender super-priority and that the court approved the terms and conditions of the loan including the carve-out provisions for professionals.

A carve-out is an agreement by a creditor holding a secured or super-priority claim to earmark funds for payment of estate professionals whose claims would ordinarily have a lower priority. See BII, Inc. v. Chapter 7 Trustee for IBI Sec. Serv., Inc. (In re IBI Sec. Serv., Inc.), 133 F.3d 205, 208 n.4 (2d Cir. 1998)(citing 3 COLLIER ON BANKRUPTCY ¶ 364.04[2][d]

[1] A retainer of $100,000.00 was paid, which is included in the total $300,000.00 carve-out for the Debtors' professionals.

(Lawrence P. King ed., 15th ed. rev.1997)).

In In re American Resources Management Group, 51 B.R. 713 (Bankr. D. Utah 1985), a lender agreed to post-petition financing under § 364. The terms of the financing included permission to use cash collateral for certain administrative expenses, including professional fees. The agreement provided for the payment of reasonable, necessary fees and expenses of the trustee and debtor's counsel and the reasonable and necessary costs of legal and accounting fees for the creditors' committee. See id. at 716 n.5. A dispute arose when counsel for the creditors' committee requested to be paid more than the $15,000.00 allocated under the agreement. See id. at 718. The court ruled that the committee was limited to the $15,000.00 provided for in the agreement since the creditor could selectively waive its lien in this manner and the committee had not objected to the terms of the agreement. The court found that the unequal treatment of similarly situated creditors was warranted given that, otherwise, the estate, the creditors' committee and the trustee would be without the assistance of counsel. See id. at 721-22. The court reasoned that the post-petition loan was not freed from the creditor's lien to become part of the estate but rather that the creditor had agreed "that the trustee could make use of its cash collateral, so long as one such use was to pay the professional fees up to the stipulated maximums." James S. Cole, The "Carve Out" from Liens and Priorities of Guarantee Payment of Professional Fees in Chapter 11, 1993 Det. C.L. Rev. 1499, 1529 (1993)(discussing In re Am. Resources Management Group, 51 B.R. 713 (Bankr. D. Utah 1985)); see also Official Unsecured Creditors' Comm. V. Stern, (In re SPM Manufacturing Corp.), 984 F.2d 1305 (1st Cir. 1993) (court held that where the secured creditor agreed to make payments to professionals out of the proceeds of its collateral, the creditor may provide for the payment of certain administrative claims and not others). Similarly, GECC and the Debtors entered a post-petition financing

agreement under which the Debtors could make use of GECC's cash collateral, so long as it was used in part to fund the carve-outs for professional fees up to $325,000.00.

It is the contention of the committees that the funds are property of the estate and are available for distribution to all administrative claimants. The creditors' committees are asking that they be permitted to share in the $325,000.00 carve-outs as if they were § 506(c) expense awards. The creditors' committee argues that whether the professional fees are to be funded by post-petition financing, or by recovery of § 506(c) expenses, the result should be the same and that if there are insufficient funds in the estate to pay all of the allowed administrative expenses, the parties are required to share the funds of the estate on a pro-rata basis with the other administrative claimants. The creditors' committees further contend that while a creditor may limit the amount of monies that it chooses to loan the debtor on a post-petition basis, the creditor may not control the allocation of the monies in a manner that conflicts with the statutory priority and distribution section of the Bankruptcy Code. In support of this contention, the committees submitted case law supporting the proposition that monies that come into the estate under § 506(c) should be distributed on a pro-rata basis to all cost of administration claimants if there are insufficient funds available for payment in full. See Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.), 26 F.3d 481 (4th Cir. 1994); In re Debbie Reynolds Hotel & Casino, Inc., 238 B.R. 831 (9th Cir. 1999); In re Ben Franklin Retail Stores, Inc., 210 B.R. 315 (Bankr. N.D. Ill. 1997).

"'Generally, administrative expenses are paid from the unencumbered assets of a bankruptcy estate rather than from secured collateral.' Section 506(c) codifies a common law exception to this general rule." Loudoun Leasing Dev. Co. v. Ford Motor Credit Co. (In re K & L Lakeland, Inc.), 128 F.3d 203, 207 (4th Cir. 1997)(citing JKJ Chevrolet, 26 F.3d at 483).

Section 506(c) provides, "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 U.S.C. § 506(c). However, § 506(c) is not applicable in the instant case.

First, while it is true that § 506(c) expenses that come into the estate are distributed on a pro-rata basis among administrative claimants, the court does not have before it an application for § 506(c) expenses. Moreover, rulings by the United States Supreme Court and the Fourth Circuit Court of Appeals make it clear that only the trustee and the debtor-in-possession have standing to ask a court for § 506(c) expenses for any party involved in a bankruptcy proceeding. See Hartford Underwriters Ins. Co. v. Union Planter Bank, N.A., 120 S.Ct. 1942 (May 30, 2000); Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.), 26 F.3d 481 (4th Cir. 1994)(only the trustee and/or the debtor-in-possession have standing to ask a court for § 506(c) expenses for any party involved in a bankruptcy proceeding).

Second, the post-petition financing agreement between the Debtors and GECC was executed pursuant to § 361, 363 and 364 and granted GECC a super-priority lien pursuant to § 364. GECC consented to the carve-out of $300,000.00 for the Debtors' professionals and $25,000.00 for the professionals of the creditors' committees from the proceeds of the its §364 super-priority post-petition financing. The DIP Financing Agreement specifically states that GECC will have priority over any § 506(c) expenses. The court finds that the carve-out funds at issue are completely separate from any § 506(c) expenses and the court disagrees with the contention of the committees that distribution scheme of the carve-out funds is analogous to the distribution of § 506(c) expenses such that the monies designated for the payment of professional fees, an amount not to exceed $325,000.00, is available for distribution to all

administrative claimants.

Counsel "carve-out" fees are "a normal and enforceable provision in cash collateral stipulation." Harvis Trien & Beck, P.C. v. Fed. Home Loan Mortgage Corp. (In re Blackwood), 153 F.3d 61, 67 (2d Cir. 1998); see also BII, Inc., 133 F.3d at 208 n.4 and In re Augie/Restivo Baking Co., Ltd., 64 B.R. 236, 239 (Bankr. E.D.N.Y. 1986). The terms of the carve-out were approved by the court and the court is unwilling to alter those terms. It would be unfair to now permit funds that were carved out for professionals to be obtained by other competing cost of administration creditors. While it may seem unfair to other cost of administration creditors, as the Supreme Court stated in Hartford, "[T]hey may insist on cash payment, or contract directly with the secured creditor or may be able to obtain a super-priority under § 364(c)(1), (2) or (3) or § 364(d)." Hartford Underwriters, 120 S.Ct. at 1950. An administrative claimant may protect his interest before incurring the risk of non-payment, and may be able to seek super-priority status under §§ 364(c)(2),(3) or 364(d). See id.

"Negotiated 'carve-outs' have been the subject of various decisions and are viewed as being necessary in order to preserve the balance of the adversary system in reorganization. 'Carve-outs' for fees from super-priority post-petition liens are designated to provide for payment of fees of the debtors and unsecured committee's counsel, trustee's counsel and other professional persons. 'Carve-outs' are used in order to avoid skewing the necessary balance of debtor and creditor protection needed to foster the reorganization process." In re Evanston Beauty Supply, Inc., 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992); see also In re Ames Dept. Stores, Inc., 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990). Counsel for the unsecured creditors was unable to reach a "negotiated" carve-out agreement with GECC and opposed the Motion for Confirmation of the Sale and Approval of the Financing Order Pursuant to § 361 and § 364. The

court, after a full hearing as to all the issues approved the Debtors' motion. The court will not now modify its order and find that the post-petition carve-out for professionals in the amount $300,000.00 and $25,000.00 for counsel for the Debtors and counsel for the unsecured creditors' committees, respectively, should now be shared on a pro-rata basis with all administrative creditors.

Typically attorneys fees are afforded priority under § 507(a)(1), but in some instances they have an even higher priority. In this case GECC agreed to carve-out a portion of the loan proceeds to be used exclusively to pay professionals. This allows the professionals to have the same super-priority as the post-petition lender. It does not mean that the $325,000.00 that was expressly carved-out of the post-petition loan is to be shared by all administrative creditors. A specific dollar amount of the loan proceeds was expressly reserved for each group of professionals and, therefore, the attorneys for the Debtors and the attorneys for the unsecured creditors' committees have priority over all other administrative creditors up to the respective amounts reserved.

CONCLUSION

The post-petition financing agreement was negotiated and bargained for, and only after a hearing was held where arguments of counsel were heard did the court enter a final order approving the financing agreement. The order granted professionals super-priority carve-outs for specific dollar amounts. The priority afforded the professionals exceeds any priority under §§ 506(c) or 507. And the terms of the distribution were specific and not on a pro-rata basis as is required under §§ 506 and 507. The limitation on the super-priority carve-out to counsel for the unsecured creditors' committees does not impair the committees' ability to discharge their statutory functions.

It is therefore ORDERED, ADJUDGED AND DECREED that the Motion to Amend Order, or in the Alternative, for Relief from Order is DENIED.

This the 16 day of August, 2000.

CATHARINE R. CARRUTHERS

Catharine R. Carruthers
United States Bankruptcy Judge