UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MINNESOTA

In re: Chapter 11 case

HEI, Inc.

BKY 15-40009

Debtor.

UNITED STATES TRUSTEE'S REPLY TO DEBTOR'S RESPONSE
TO RECOMMENDATION AGAINST EMPLOYMENT OF PROFESSIONALS

The United States Trustee, through his undersigned attorney, files this reply to the above named debtor's memorandum in support of applications to employ professionals. The debtor seeks to hire Alliance Management (Docket #4), Fredrikson & Byron, P.A. (Docket #5), and Winthrop & Weinstine, P.A. (Docket #6). (Applicants). The debtor's response was made in opposition to the U.S. Trustee's recommendation that the employment of each firm not be approved. For his reply, and in furtherance of his position, the U.S. Trustee states the following:

80/20 INSTRUCTION

1. With respect to each of the three applications before the court, the U.S. did not recommend the proposed employment because each application provides for the payment fees under "Instruction 9(c)" of the court's chapter 11 filing instructions, as set forth on the court's web site. The U.S. Trustee maintains that the proposed employment should not be approved subject to that "instruction".

2. First, it is important to note that in their response, the three professionals to be employed do not state they will refuse to go forward with continued representation of the debtor's bankruptcy estate if payment under the 80/20 Instruction is not allowed. Moreover, with or

without the availability of the accelerated payment, nobody is forcing the professionals to continue their representations of the estate.

3. Second, in its response, the Applicants cite a number courts which have implemented local rules that have similar provisions allowing expedited payment to professionals, and allege that the U.S Trustee should "work through the appropriate channels to initiate change, rather than attacking the instructions indirectly by recommending against employment of professionals who seek to use the process set up and approved by the court". (Docket #62, p.3). However, the burden of change does not lie with the U.S. Trustee, it lies with the Applicants. Congress clearly required in §330 and §331 that notice to parties in interest and a hearing is a prerequisite to payment of professional fees. Applicants' assertion that the U.S. Trustee should "work through appropriate channels" seems to be a reference to the local practice committee. Although the U.S. Trustee wholeheartedly agrees that the local practice committee provides meaningful and effective guidance to the bar and debtors seeking bankruptcy relief, it is not entitled to re-write legislation. To the contrary, if the Applicants want to get paid under terms different than now established in the bankruptcy code, it is their burden to write members of Congress and have the statute changed. Moreover, the fact that other courts in other parts of the country likewise ignore the explicit requirements of the bankruptcy code simply does not make it proper or acceptable in this district or in this particular case.

4. The Applicants also allege that the possibility of an administratively insolvent case is a "hypothetical scenario". Docket #62, p.5, However, it is not unlikely given that the debtor, by its own admission, is liquidating, and to date, there have been no bankruptcy schedules or statements filed. In fact, the likelihood of administrative insolvency is completely unknown. Also, it cannot be claim as a "hypothetical scenario" when there have been numerous other cases in

Minnesota in which professionals employed under the 80/20 Instruction have taken more than that to which they are entitled, necessitating attempts by the chapter 7 trustee to later seek recovery, and requiring the trustee to incur additional unnecessary costs to do so. See: *Roman Anthony Restaurant Group*, #12-32916; *J&J Powersports, Inc.*, #12-30599; *Lundallum, Inc.*, #06-40611[1]; *Arc Venture Holdings*, 08-46367; *Next Generation Media, Inc.*, #10-40097; and *Twin Cities Avanti Stores, Inc., et al.*, #09-34469[2]. Simply put, the existence of the 80/20 Instruction has made the jobs of both the chapter 7 trustees and the U.S. Trustee excessively and unnecessarily difficult, and sometimes impossible when a proper distribution as required by §726 cannot be made.

5. In addition, in the *Next Generation Media, Inc.*, Case #10-40097, now under advisement, the issues goes beyond whether interim payment is appropriate without notice and a hearing. The issue there is whether the professional that received interim payment under the 80/20 Instruction is entitled to keep the funds received, notwithstanding the fact that they never provided notice and a hearing and were never allowed the fees, when the effect is to give the professional a disproportionately large payment relative to other equal priority chapter 11 administrative expense claimants.

6. The Applicants also assert that the 80/20 Instruction "were adopted so that Minnesota would be recognized as a jurisdiction that was up-to-date with the procedures that had evolved in the courts that were handling the largest and most sophisticated cases". Docket #62, p.4.

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[1] In Lundallum, when requested to return the retainer to the chapter 7 trustee, the attorney for the chapter 11 debtor was unable to immediately do so, and is now making payments to the trustee under a repayment plan.

[2] Fredrikson & Byron itself was counsel to the chapter 11 debtor and was required to return a $47,500 retainer to the chapter 7 trustee in this administratively insolvent case. Patti Sullivan, the trustee in the case, was required to hire separate counsel to pursue recovery of the retainer from Fredrikson, and incurred additional fees to do so, thereby depleting the aggregate chapter 7 estate.

However well-intentioned, the fact remains that Instruction 9(c) simply does not work to bring large or sophisticated cases to Minnesota. To the contrary, over the last decade during which the 80/20 Instruction was in place, the very large Minnesota based companies seeking bankruptcy relief file *exclusively* in the courts on the east coast. See *In re Minneapolis Star Tribune Holdings Corp., et al.*, Bky #09-10244, filed 1/15/09, Southern District, New York; *In re Northwest Airlines, Inc., et al.*, Bky #05-17930, Filed 9/14/15, Southern District, New York; *Residential Funding Company, LLC, et al.*, Bky #12-12019, Filed 5/14/12, Southern District, New York; *In re Dolan Companies, Inc.*, Bky 14-10614, filed 3/23/14, District of Delaware[3]. The reality is that large, publicly traded companies based in Minnesota simply will not file in Minnesota, and the existence of the 80/20 Instruction does not change that fact.

8. Applicants also state that it is unlikely that the estate is administratively insolvent, based on the pending sale of the Tempe AZ location, but it is impossible for any party in interest to know that. There has been no §341 meeting, there has been no schedules or statement filed, and it is impossible to know whether the Tempe plan is ten times the size of the Boulder, CO plant, or *vice versa.* At this time, parties have no knowledge whatsoever of the extent of debtor's assets, the extent or nature of liens, or the extent and nature of other claims against the estate.

9. The Applicants allege that the court is entitled to shorten the time between fee applications, as provided for under 11 U.S.C. §331. The U.S. Trustee agrees that this is in the court's discretion.

[3]Dolan and its 24 related cases was a publicly held company which, *inter alia*, publishes the local legal newspaper Finance and Commerce. Residential Funding and its related cases were engaged, *inter alia*, in originating, pooling and selling residential mortgages on the secondary financial markets.

WINTHROP APPLICATION

10. In addition to opposing the 80/20 payment provision, the U.S. Trustee also took issue with the proposed employment of Winthrop and Weinstine, P.A. based on ambiguity in the application as to whether the employment is under subsection 327(a) or subsection 327(e).

11. The U.S. Trustee does not oppose Winthrop's employment under §327(a), provided it establishes disinterestedness and provides for a segregation of duties from Fredrikson & Byron. In fact, it appears Winthrop could do so by clearing the conflicts with Wells Fargo and Cresa, but until this issue is resolved, Winthrop cannot be employed under §327(a).

12. Winthrop still cannot be employed under §327(e) because the proposed scope of representation goes far beyond the special specified purpose unrelated to the reorganization process, as allowed for in §327(e). Here, Winthrop's work has and will include, *inter alia*, transactional work arising from the sale of the Tempe facility and the related stalking horse and bid procedures. These appear to include establishing the bid procedures, analyzing competing bids, handling inventory price adjustments, and closing any sale transaction. This is an integral, intrinsic part of the debtor's overall reorganization efforts. As such, the employment must be under §327(a) and Winthrop must establish its disinterestedness. If it undertakes these duties, establishes its disinterestedness, and does not duplicate efforts with Fredrikson & Byron, the employment of Winthrop under §327(a) would be appropriate.

ALLIANCE APPLICATION

13. Along with opposing the 80/20 payment terms, the U.S. Trustee had additional issues with the employment of Alliance, principally the fact that the proposed payment terms are excessive. In its response to the U.S. Trustee's adverse recommendation, the debtor misstates the

U.S. Trustee's objection to the employment of Alliance. The response states that the U.S. Trustee opposes both the "asset sale success" fee and the "new financing" fee as duplicative. In fact, the U.S. Trustee opposes either of those fees when taken in conjunction with the hourly fees also being charged. As the debtor points out, §328(a) permits employment "on any reasonably terms . . . including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis". 11 U.S.C. §328(a). However, the debtor and Applicants fail to note that the different employment alternatives are stated in the disjunctive. Here, Alliance seeks to be hired on both an hourly basis and a contingent fee basis for the same work, and such terms are simply not reasonable.

14. Alliance has apparently worked on liquidation of the debtor's business since October 2014, and according to the affidavit of Michael Knight, took a total of $295,000.00 in fees for work between October 22, 2014 and December 31, 2014, charging from $295 to $495 per hour. In addition, since July 2014, it took a total of $355,000, and has now taken an additional retainer of $117,275.16. (Application, p.2, ¶¶ 5-6). Now, the debtor wants the court to approve payment of an additional 3% of the entire value of the company (since the expectation expressed to the court is that the company will in the end be fully liquidated). And again, the aggregate cost is unknown since there have been no schedules filed which list assets or asset values. It simply can't be established that this is reasonable under the present circumstances.

15. Alliance is no different than any other entity that provided the debtor with goods or services pre-petition. If there is a real need to keep Alliance involved during the liquidation process, new, reasonable employment terms should be negotiated and the U.S. Trustee would not oppose the debtor's employment of Alliance going forward. Further, the work should go beyond simply monitoring the liquidation process and should not duplicate the "M & A" work to be done

by Winthrop. If the need for Alliance going forward cannot be shown, the debtor's prepetition contract with Alliance should be rejected and Alliance should be allowed to file its claim.

CONCLUSION

16. Under 11 U.S.C. §327(a), the estate may employ a professional to represent the debtor in possession. Given the nature of the 80/20 Instruction, the proposed employment of each of the professionals is under terms that explicitly contravene the requirements of the bankruptcy code. The proposed employment cannot be approved on that basis. In addition, the debtor and Winthrop need to determine whether the employment of Winthrop will under §327(a). Finally, the employment of Alliance cannot be approved because the "incentive" compensation would result in excessive and unnecessary charges against the estate which are disproportionate to any value derived by creditors.

WHEREFORE, the United States Trustee files this reply to the debtor's response in support of the applications to hire Fredrikson & Byron, P.A., Winthrop & Weinstine, P.A. and Alliance Management. The United States Trustee recommends that the proposed employment of each professional not be approved until the foregoing issues are resolved.

Dated: January 20, 2015

DANIEL M. McDERMOTT
United States Trustee
Region 12

By: _e/Michael R. Fadlovich_____
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VERIFICATION

I, Michael R. Fadlovich, an attorney for the United States Trustee, do hereby certify that the foregoing is true and correct to the best of my knowledge, information and belief.

Dated: January 20, 2015

_____s/Michael R. Fadlovich_____
Michael R. Fadlovich

CERTIFICATE OF SERVICE

In re: Chapter 11 case

HEI, Inc.

BKY 15-40009

Debtor.

The undersigned hereby certifies under penalty of perjury that he is an employee in the Office of the United States Trustee for the District of Minnesota and is a person of such age and discretion as to be competent to serve papers. That on January 20, 2015, he caused to be served a copy of the attached: United States Trustee's Reply to Debtor's Memorandum in Support of Applications to Employ professionals, by placing said copy in a postpaid envelope addressed to the person(s) hereinafter named, at the place and address stated below, which is the last known address, and by depositing said envelope and contents in the United States Mail at Minneapolis, Minnesota.

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Debtor.

O R D E R

The above-entitled matter came on before the undersigned on the application by the debtor for an order approving the employment of Fredrikson & Byron, P.A., Winthrop & Weinstine, P.A., and Alliance Management, as attorneys and consultants to the debtor in the above captioned chapter 11 case. Appearances, if any, were as noted in the record.

Based upon the arguments of counsel, the findings of the court on the record, and all of the files, records and proceedings herein, it is hereby ORDERED:

That the three applications to employ are not approved.

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KATHLEEN H. SANBERG
United States Bankruptcy Judge