

## **Disgorgement Revisited**

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The subject of professional compensation and disgorgement, particularly in light of the Sixth Circuit Court of Appeals' decision in *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6<sup>th</sup> Cir. 2004), has caused many courts to pause, assess and consider the impact and extent of the court's ruling. On a simple and basis level, there is little debate over the holding of the court. Section 726(b) of the Bankruptcy Code mandates disgorgement of amounts paid to professionals during a chapter 11 proceeding when the case is subsequently rendered administratively insolvent in order to achieve a *pro rata* distribution among other administrative claimants in a case converted from chapter 11 to chapter 7. What is less clear, however, is whether and to what extent the manner in which the Sixth Circuit characterized the retainer received by debtor's counsel (a post-petition retainer according to the court) impacted its ruling or its failure to consider that the attorney was a secured creditor by virtue of holding a retainer, and thus was not subject to disgorgement under Section 726(b).

The first case to raise questions regarding the Sixth Circuit's ruling in *Specker* was *In re U.S. Flow*, 332 B.R. 92 (Bankr. W.D. Mich. 2005), in which Judge Gregg denied a trustee's motion seeking disgorgement in a converted chapter 7 proceeding in which there were insufficient funds to pay administrative creditors. The trustee argued that Section 726(b) and the ruling in *Specker* mandated disgorgement of amounts paid to debtor's counsel and creditors' committee counsel during the chapter 11 proceeding. Unlike *Specker*, in *U.S. Flow*, the amounts paid to the professionals did not involve a retainer, but rather were based on a consensual carve-out negotiated with the secured lender of the debtor. Not only had the carve-out been noticed

out, disclosed and approved by the court, but furthermore it had not been objected to or subject to any appeal by any party in interest. Moreover, there was never any challenge to the validity, priority or amount of the secured lender's claim – their liens were not avoidable, and thus the proceeds transferred by the secured creditors to the professionals could not be recovered for the benefit of the estate.

Since *U.S. Flow* was decided, there have been a flurry of decisions issued by courts around the country over whether (i) Section 726(b) merely provides a distribution scheme, as opposed to a remedy; and (ii) the granting and approval of a retainer makes the professional a secured creditor and thus exempt from the scope of Section 726(b). In addition, courts have considered whether a professional is “disinterested” for retention purposes if the professional is deemed to be a secured creditor by virtue of holding a retainer. Set forth below is a summary of the relevant cases decided during the last year. As the summaries indicate, the issues relating to professional compensation when a chapter 11 is converted to a chapter 7 liquidation and there are insufficient funds to pay administrative creditors is fraught with uncertainty and extensive and costly litigation.

**1. *In re Appalachian Star Ventures, Inc.*, 341 B.R. 222 (Bankr. E.D. Tenn., March 9, 2006).**

The debtor filed a voluntary chapter 11 petition in December 1993. Debtor's counsel filed, and in January 1994 the court approved, an application approving counsel's retention. The disclosure of compensation statement filed by debtor's counsel pursuant to Federal Rule of Bankruptcy Procedure 2016(b) indicated that the debtor had paid counsel a \$15,000 retainer. In April 1994 counsel filed an application seeking an award of interim compensation in the amount of \$33,952.73. In June 1994 counsel was awarded fees in the amount of \$15,000 to be paid from his retainer (that had been held in escrow) and expenses of \$697.73 to be paid from the debtor's

operating funds. The remaining amounts sought in the interim application were reserved for future determination. In September 1994, the chapter 11 was converted to a chapter 7. Thereafter, counsel filed a final fee application seeking approval of the balance reserved under the prior interim fee application, plus additional compensation of \$16,365 and expenses in the amount of \$538.18. In October 1994, counsel's application was approved, however, no further amounts were actually paid to counsel. On January 19, 2006 (almost 8 years later), the chapter 7 trustee filed a motion seeking disgorgement of a portion of the fees previously paid to counsel from the retainer (\$5,630.65). The trustee contended that Section 726(b) and *Specker* mandated disgorgement in order to provide a *pro rata* distribution among all chapter 11 administrative creditors.

In defending the motion, counsel argued that (i) the ruling of *Specker* did not apply because it involved disgorgement of interim compensation, as opposed to final compensation that had been properly noticed, with no objections, and approved by the court without any subsequent appeals; and (ii) counsel was a secured creditor under state law by virtue of holding an approved retainer, and thus Section 726(b) was not applicable.

Judge Marcia Phillips Parsons dismissed counsel's first argument on two bases. First, in the final fee application, counsel did not seek, nor did the order grant, final approval of the interim fees previously awarded by the court, but rather only sought approval of those additional fees and expenses incurred since the interim application. Second, because awards of interim compensation under Section 331 are always subject to subsequent review and adjustment, disgorgement was still available. Compensation awards only become "final," according to the court, if paid pursuant to a confirmed plan or as part of a distribution made pursuant to Section 726(b). Because neither of these events had occurred in this case, counsel's award was only

“final” insofar as indicating that counsel did not intend to file any further applications. Finally, the court stated that even final orders for compensation under Section 330 are “interlocutory and subject to review and modification while the case is pending.”

The Court next addressed the second issue raised by counsel, finding that “whether disgorgement is required if the attorney has a lien under state law was not raised or addressed in *Specker Motors*.” Moreover, the Court was unable to find any other rulings in the Sixth Circuit addressing this issue. The Court reviewed decisions from other jurisdictions, and in reliance thereof, concluded that counsel held a lien in the retainer that was not subject to disgorgement. According to the Court: “. . . § 726(b)’s distribution scheme from which the disgorgement issue arose applies only to “creditors of equal priority” or “equally situated administrative claimant[s].” An attorney with a lien on a retainer paid to him is not “equally situated” with other administrative claimants that advance services or credit to the debtor on an unsecured basis. As such § 726(b) is inapplicable to the case at hand.”

**2. *Rus, Miliband & Smith, APC v. Yoo (In re Dick Cepek, Inc.)*, 339 B.R. 730 (BAP, 9<sup>th</sup> Cir., March 21, 2006).**

Debtor retained Rus, Miliband & Smith as its chapter 11 counsel. Prior to the bankruptcy, counsel received a retainer in the amount of \$84,955.85. The chapter 11 petition was filed on March 12, 1999. Counsel disclosed its receipt of the retainer to the court, the creditors and the U.S. Trustee when it filed its application for employment. None of the retention pleadings filed with the Court stated that counsel held a security interest in the retainer or considered itself a secured creditor as a result of the retainer. There was no written agreement executed between the debtor and counsel setting forth the terms and conditions of the representation. No objections were filed to the proposed representation. An order was entered by the bankruptcy court approving the engagement of counsel and further provided that counsel

(i) was a “disinterested person,” and (ii) could draw upon the retainer in accordance with the Office of the United States Trustee Guidelines (that allow professionals in the Central District of California to draw down on retainers before submitting a fee application if they follow the procedures set forth therein).

From March 1999 to July 1999, counsel filed its “Professional Fee Statements” for services rendered during that time. No objections were filed, and thus counsel drew down on its retainer. On November 24, 1000, counsel filed its first interim fee application requesting compensation in the amount of \$100,904.50 and costs in the amount of \$31,914.86. In the application, counsel requested the Court “to authorize the deduction of its allowed fees and costs from the retainer funds on hand, to the extent such retainer funds are available or become available.” In February 2000, before the first fee application was heard by the Court, the case was converted and a chapter 7 trustee was appointed. In January 2003, counsel filed its second and final fee application incorporating and requesting the same amounts sought in the first application. Other than the retainer, counsel did not receive any other funds on account of services rendered in the case.

In December 2004, the trustee filed a final report indicating that the estate was administratively insolvent. In response to this report, (even though the chapter 7 trustee, no other chapter 11 professional or other party raised disgorgement), the Court *sua sponte* asked whether disgorgement was required under Section 726(b). After briefing the issues, counsel argued that by virtue of holding a retainer, counsel was a secured creditor. The trustee argued that if counsel was a secured creditor, counsel was no longer a “disinterested person” as required under Section 327(a), and thus would potentially be required to disgorge all fees (not just those fees necessary to equalize all administrative claimants). In response, counsel argued that because it had

disclosed the retainer and the Court had approved its employment on such terms (including a finding that it was “disinterested”), disgorgement was not available. While the Court indicated that it was not convinced that counsel would be “disinterested” under such circumstances, it indicated that it was also not persuaded that counsel had a security interest in the retainer because there was nothing in the retention pleadings to evidence same.

The Court held a series of hearings. First, it approved final compensation for counsel. Thereafter, the Bankruptcy Court ordered debtor’s chapter 11 counsel to disgorge a portion of its pre-petition retainer in order to equalize payments among all chapter 11 administrative creditors pursuant to Section 327(b) on in reliance of *Specker*. In so ruling, according to the Appellate Court, while it was unclear whether the Bankruptcy Court held that counsel had a security interest in the retainer. Nevertheless the bankruptcy court did indicate that whether the fees were paid from a security retainer was irrelevant -- in either case, disgorgement was supported by *Specter*. The order of disgorgement was stayed pending its appeal.

On appeal, the two questions the Court raised were: (i) did the Bankruptcy Court err in holding that retainers in which a professional holds a security interest are subject to disgorgement under Section 726(b), and (ii) if so, did counsel hold a security interest in the retainer. Bankruptcy Judge Montali issued the ruling of the Court holding that a professional with a valid prepetition retainer, properly documented, disclosed and approved by the Bankruptcy Court, is not required to surrender it under Section 726(b) in the interest of equal treatment. The Court vacated and remanded the matter to the Bankruptcy Court to determine whether counsel held a valid security retainer, and if so, held it was not subject to disgorgement under Section 726(b).

In ruling on the issues, the Court distinguished between the various types of retainers. Classic retainers, according to the Court, “refer to the payment of a sum of money to secure availability over a period of time,” and the attorney is entitled to the retainer whether or not services are needed. An advance retainer occurs when a client prepays for expected services with ownership of the funds in the retainer being intended to pass to the attorney at the time of payment. A security retainer is held as security for payment of future services to be rendered by the attorney and remains property of the estate until the attorney applies the funds to charges for services actually rendered, with any unearned portion returned to the client.

In this case, the Court recognized that counsel held a security retainer. In contrast to the Bankruptcy Court, Judge Montali first held that *Specker* did not apply because the Sixth Circuit Court of Appeals never considered the nature of the security interest, if any, held by the attorney in the retainer. Rather, the court’s analysis and holding in *Specker* was limited solely to whether disgorgement was mandatory or discretionary under Section 726(b). The 9<sup>th</sup> Circuit BAP, thereafter, declined to follow *Specker* and held that security retainers were not subject to disgorgement under Section 726(b).

The Court next addressed the issue of whether a professional’s retention of a security retainer impacts the professional’s status as a “disinterested person.” In analyzing this issue, the Court relied on Collier’s that provides that a professional’s status as a secured creditor by virtue of holding a security retainer does not disqualify the professional from being retained by the estate under Section 327. See Collier on Bankruptcy, ¶ 328.02[4]. Moreover, Section 328 of the Bankruptcy Code specifically allows an estate professional to be employed on a retainer. Third, the bankruptcy court had already found counsel to be disinterested after having made proper,

adequate and full disclosure. To read the Code sections otherwise, in reliance of *In re Martin*, 817 F.2d 175, 180 (1<sup>st</sup> Cir. 1987), is:

a literalistic reading [that] defies common sense and must be discarded as grossly overbroad. After all, any attorney who may be retained or appointed to render professional services to a debtor in possession becomes a creditor of the estate just as soon as any compensable time is spent on account. Thus to interpret the law in such an inelastic way would virtually eliminate any possibility of legal assistance for a debtor in possession, except under a cash-and-carry arrangement or on a pro bono basis.

It stands to reason that the statutory mosaic must, at the least, be read to exclude as a “creditor” a lawyer, not previously owed back fees or other indebtedness, who is authorized by the court to represent a debtor in connection with reorganization proceedings – notwithstanding that the lawyer will almost instantaneously become a creditor of the estate with regard to the charges endemic to current and future representation.

*Id.* at 740, n. 10 (citing *In re Martin*, 817 F.2d 175, 180 (1<sup>st</sup> Cir. 1987)).

Ultimately, the Court concluded that the determination of whether a professional is “disinterested” is case and fact specific, including an assessment of whether the security interest sought by the professional is reasonable, negotiated in good faith, whether it is commensurate with the predictable magnitude of foreseeable services, whether it is needed as a means of ensuring the engagement of competent counsel, whether there are any telltale signs of overreaching, whether the retainer will have any putative influence of subsequent decision-making, and whether the retainer will impact the reorganization or otherwise unduly jeopardize the proceedings (either actually or through public perception). None of these factors had been, but should be, evaluated by the Bankruptcy Court as part of the remand.

A concurring opinion was filed by Judge Pappas to echo concerns expressed by Judge Marlar in a dissenting opinion suggesting that a professional’s holding of a retainer may lead to difficult ethical considerations and potentially develop into an interest that is materially adverse to the estate. Nevertheless, because Section 328(a) permits counsel to be retained on any

reasonable terms and conditions, including a retainer, assuming the proposed retainer cleared all the hurdles articulated by Judge Montali, Judge Pappas was not prepared to conclude that the holding of a retainer disqualified the professional not being disinterested *per se*.

Judge Marlar, in contrast, indicated that the ruling was contrary to Congress' and the Code's fundamental concept of "equitable distribution." By allowing an attorney to become a secured creditor by virtue of holding a security retainer favors the attorney over others and places them in a superpriority position over other administrative creditors. To the extent that State law allows such security retainers, federal bankruptcy law would preempt such treatment. Finally, Judge Marlar disagreed with the majority's characterization of *Specker* and believed that the import of Sixth Circuit's ruling was that Section 726(b) trumps an attorney's interest in a retainer that is property of the estate.

**3. *In re Lockwood Corporation*, 2006 Bankr. LEXIS 882, 2006 WL 2038660 (Bankr. D. Neb., April 26, 2006).**

Lockwood Corporation filed a chapter 11 petition, and three years after its commencement, the case was converted to a chapter 7. Insufficient funds existed to pay administrative claims and thus, the chapter 7 trustee sought disgorgement from the professionals that received interim compensation during the chapter 11 on the basis of Section 726(b) and *Specker*. KMPG was one of the professionals that was required to make disgorgement. After the chapter 7 administrative claims were paid in full, the trustee held insufficient funds to make full payment to the chapter 11 administrative claimants. KMPG argued that the remaining funds should first be distributed *pro rata* to those claimants that had been forced to disgorge amounts to the trustee. The Court denied KPMG's motion based on the plain language of Section 726(b) that requires "equitable and consistent treatment of similarly situated creditors." To rule otherwise, according to the Court, would have been inconsistent with this mandate.

**4. *In re Hyman Freightways, Inc.*, 342 B.R. 575 (Bankr. D.Minn., May 18, 2006), *aff'd.*, 2006 U.S. Dist. LEXIS 92206 (D.Minn. December 19, 2006).**

After a chapter 11 case was converted, the chapter 7 trustee sought a refund from three firms that had served as professionals for the debtor during its chapter 11 case because there were insufficient funds to pay chapter 11 administrative claims. The trustee estimated that it could pay, at best, absent disgorgement, 10% of their claims. Each of the firms was appointed pursuant to applications approved by the Bankruptcy Court.

Debtor's counsel, Fredrikson & Byron, P.A., received two retainers payments totaling \$80,312.05 prior to the filing of the chapter 11 petition. It filed an application seeking authorization to pay from its retainer \$5,515.19 in pre-petition fees and expenses and allowance of its pre-conversion chapter 11 fees of \$282,729.60 and expenses of \$25,634.26 (totaling \$308,363.86). The U.S. Trustee objected, and the Court issued an interim order allowing counsel's post-conversion expenses to be paid along with chapter 7 administrative expenses after approval of the trustee's report and authorized counsel to apply its retainer, less any amounts due to experts pre-conversion.

Special labor counsel for the debtor was also retained during the chapter 11 and received a retainer in the amount of \$20,000. Three months after the case was converted, counsel applied for compensation in the amount of \$48,291 and expenses in the amount of \$814.15. The Court allowed the application in full, authorized the firm to draw on its retainer and order the balance of the fees to be paid in the normal course of the chapter 7 administration by the chapter 7 trustee.

Merical Associates, Inc. was employed as a financial consultant for the debtor. Merical filed an application seeking compensation in the amount of \$42,700 and expenses in the amount

of \$987.51. Prior to conversion, the Court approved the application in full, and the debtor paid the allowed compensation to Merical.

In seeking disgorgement, the trustee relied primarily on Section 726(b) of the Bankruptcy Code. Unlike the court in *Specker*, Judge Kressel stated that Section 726(b) is “all about how a trustee is to *distribute* property of the estate, it says nothing about *collecting* property.” The Court further stated:

Section 726 thus requires that chapter 11 administrative expenses be paid pro rata from the remaining funds on hand. This should be the end of the analysis.

The trustee, however, is not satisfied with the requirements of the statute. He wants to turn a statute dealing with distribution into a recovery vehicle by going back in time and collecting a few of the chapter 11 administrative expenses to add to the distribution pot. Nothing in § 726 provides for such a recovery. Property becomes property of the estate in a number of ways, for example: it can be property of the debtor and thus becomes property of the estate under 11 U.S.C. § 541(a)(1), or the trustee may recover it under any of the provisions that allow for recovery of property. 11 U.S.C. § 541(a)(3). *However, there is no provision in § 541 that allows or requires the trustee to recover and add to property of the estate for distribution, administrative expenses that have already been paid.*

*Id.* at 578-79 (Emphasis added).

Judge Kressel further relied on various other sections of the Code in negating the right of the trustee to recover the amounts previously paid to the professionals through orders of the Court. First, Section 549(a)(1) sets forth the basis upon which a trustee may recover post-petition payments – the trustee must demonstrate that the payments were not authorized or not in the ordinary course of business. Here, the payments to the professionals were authorized and thus not recoverable. According to Judge Kressel, “Congress knew how to explicitly provide for trustees to cover postpetition transfers,” and thus, by failing to provide a mechanism for recovery of the professional fees outside these parameters, the negative implication was that such amounts were not subject to disgorgement.

Second, the Court dismissed Sections 329 and 330 as providing a basis to support disgorgement. Judge Kressel pointed out that both of those sections were quite specific in so far as providing recovery of fees. Section 329(b) only allows recovery to the extent that the compensation exceeds the reasonable value of the services. Section 330(a)(5) only allows recovery of compensation awarded on an interim basis to the extent it exceeds the reasonable value of services rendered. In this case, no one, including the trustee, contended that the professionals had been paid more than the reasonable value of their total services, and thus neither of these sections supported disgorgement.

Third and finally, the Court dismissed the trustee's contention that equitable principles justified the relief sought. Rather, instead, the Court stated: by "cynically singl[ing] out these three professionals for the modest amounts of money they received, [i]t is difficult to imagine what equity is being accomplished through this attempt, especially, in light of the fact that it has been over eight years since these payments were made. The Court expressed concern that in each of these cases the recipients of the funds were entities with different partners and equity holders than at the time the funds were paid, and thus "the cost of refunding these fees would fall on a group of individuals that is different from the group that benefited from the payments when they were made." Moreover, in light of the proposed benefit to be derived from granting disgorgement – a minor 3% increase in the *pro rata* distribution to claimants – did not justify the expense and time expended by the trustee.

The U.S. Trustee appealed the ruling of the Bankruptcy Court that had denied a refund of the professional fees. On appeal, the District Court affirmed the ruling of the Bankruptcy Court. In making this ruling, the District Court observed that Section 726(b) only concerns the distribution of the estate and does not contain any provision for the collection, addition, or return

of property to the estate. According to the Court: “The statute’s plain language simply does not speak to the remedy of disgorgement. Thus, the Bankruptcy Court did not err in finding that the plain language of § 726(b) does not require disgorgement.” *Id.* at \* 7.

Like the lower court, the District Court held that disgorgement of interim professional compensation is a matter of discretion and the Bankruptcy Code does not expressly mandate disgorgement when there are insufficient assets to reimburse all administrative claimants. Moreover, disgorgement, according to the Court, is a harsh remedy that should be applied and mandated by the equities of the case. In this case, the Court held that the Bankruptcy Court had considered the circumstances of the case (*i.e.*, the 8 year period between the payment of the fees and the request for disgorgement, the fact that the trustee was not seeking a refund of compensation paid to claimants with a lower priority or to chapter 11 claimants, and the minor increase that would result if the fees were returned to the estate) and reached an equitable result, while at the same time recognized that the facts in another case might dictate a refund.

The District Court also found support for its ruling in Section 105(a) of the Code. Because the language of that section permits, but does not require, a court “to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title,” the District Court reasoned that the Bankruptcy Court had discretion not to order disgorgement or otherwise act in this case. The District Court also rejected the trustee’s argument that the fees sought are property to be recovered for the benefit of the estate under Section 541 of the Bankruptcy Code, noting that Section 726(b) was not contained in the various sections delineated in Section 541(a)(3) as comprising “property of the estate.”

Likewise, the District Court, consistent with the Bankruptcy Court, rejected the application of Sections 329, 330 and 549 as providing support for disgorgement in this case.

First, while Section 329 permits disgorgement of postpetition professional fees, the determination to grant such relief, according to the Court, is subject to the court's discretion. Second, Section 330(a) only permits disgorgement to the extent that the interim fees exceed the final amount awarded or such fees are unreasonable, neither of which circumstance applied in this case. Finally, the District Court held that Section 549 was irrelevant because the fees in this case had been granted with the requisite approval. Moreover, the District Court noted that Congress knew how to provide for recovery of postpetition payments, but had not provided for recovery of such amounts under Section 726(b). Thus, there was no basis to imply that such relief was implicit therein.

**5. *In re St. Joseph Cleaners, Inc.*, 346 B.R. 430, 2006 Bankr. LEXIS 1348 (Bankr. W.D. Mich., July 12, 2006).**

St. Joseph filed for chapter 11 relief on November 10, 1997, and hired Kreis Enderle to represent it. Counsel received a \$10,000 retainer (the source of which was unclear, but assumed by the Court for purposes of the decisions to have come from the debtor). The debtor confirmed its plan of reorganization, but thereafter defaulted on the plan. The case was converted to a chapter 7 on September 14, 2000 and a chapter 7 trustee was appointed. On May 10, 2005, the trustee filed his final report and accounting that indicated that there were sufficient amounts to pay all chapter 7 administrative claims but insufficient amounts to pay in full chapter 11 administrative claims. The report also listed Kreis Enderle as having a "negative" distribution of \$5,302.87. Kreis Enderle interpreted this statement in the report to reflect an intention by the trustee to recover such amount previously paid to them as approved compensation during the chapter 11, and thus filed an objection to the final report. This objection prompted the trustee to file a motion seeking disgorgement from counsel, in reliance of *Specker*.

Ultimately, the Court held that the fees previously approved and paid pursuant to a confirmed plan (earned so many years ago) were not subject to disgorgement and consistent with the Sixth Circuit's ruling in *In re Chattanooga Wholesale Antiques, Inc.*, 930 F.2d 458 (6<sup>th</sup> Cir. 1991) (court refused to allow a trustee to recover amounts paid to lender under confirmed plan that erroneously provided for secured claim of bank when its lien was unperfected; the court concluded that the binding effect of the confirmation order precluded the chapter 7 trustee from later recovering plan distributions that had been made in reliance thereof). See also, *In re Reef Petroleum Corp.*, 99 B.R. 355, 359 (Bankr. W.D. Mich. 1989) (after a plan was aborted, the court precluded recovery of payments made pursuant to a confirmed plan that a party could rely on as being final).

In issuing his opinion, while Judge Hughes initially recognized that he was bound by the Sixth Circuit's ruling in *Specker*, nevertheless, in reflecting on decisions of other courts (including Judge Kressel's decision in *Hyman Freightways*), he questioned the Sixth Circuit's conclusion that disgorgement was mandatory because there was little explanation and it appeared to rely on the fact that interim awards for professionals are subject to re-examination and adjustment" to justify equalization under Section 726(b). Judge Hughes, like Judge Kressel, did not believe that Section 726(b) mandated such a remedy, but rather, to obtain such a result, the court was forced to exercise its powers under Section 105(a) of the Code. According to Judge Hughes, the Bankruptcy Code is well drafted, and "judicial intervention should be the exception, not the rule" and "[c]ourts should not invent a remedy without first considering carefully the Bankruptcy Code as a whole."

Judge Hughes also recognized, as part of his ruling, that the Bankruptcy Code distinguishes professionals from other administrative claimants. See e.g., Sections 327,

330(a)(1)(A), 331 versus Sections 363(b) and (c). One way a court *could* provide for disgorgement, according to Judge Hughes, is to defer the award of final compensation under Section 330 until the Section 726 distribution or condition the final award on disgorgement in the event the estate is subsequently administratively insolvent, as was done by the court in *In re Lochmiller Industries, Inc.*, 178 B.R. 241, 247 (Bankr. S.D.Cal. 1995).

Like Judge Kressel, Judge Hughes did not find a basis to order disgorgement in light of Section 549, 330 and 331 of the Bankruptcy Code. “Administrative insolvency” is not a specific factor that the court is required to consider under Section 330 in evaluating whether compensation sought or previously awarded is reasonable. Nevertheless, according to the Court, it might be relevant in determining the overall compensation sought by a professional because the factors set forth therein are not exclusive. See Section 102(3) of the Code. However, the court in *Specker* and similar cases, did not look to Section 330 as providing any justification for their rulings – they merely assumed that administrative insolvency *per se* “mandate[d] an irrebuttable presumption of unreasonableness and a corresponding right by the Chapter 7 Trustee to pursue recovery from the professional in the name of Section 726(b).” Judge Hughes further indicated that if that was what Congress had intended, it could have codified disgorgement for purposes of Section 330 when it amended that section in 1994 – its failure to do negated the right of the court to imply such a remedy under the guise of Section 105(a).

Finally, Judge Hughes expressed agreement with the court’s ruling in *In re U.S. Flow Corporation*, 332 B.R. 792 (Bankr. W.D. Mich 2005) “as far as it goes,” but felt that it “raise[d] a host of other questions.” See fn. 16. The Court focused on who demanded the carve-out and contended, while in certain cases it may be in the secured creditor’s interest to have competent counsel representing the debtor and the committee and therefore is willing to pay for such

representation, that is not always the case. In *U.S. Flow*, it was the professionals, as opposed to the lender, that were seeking the carve-out as an addition to the budget, suggesting that this fact provided a basis for the trustee to argue that such funds were property of the estate rather than collateral beyond the reach of the estate. Judge Hughes stated that such carve-out arrangements create “statutory and ethical problems,” for example, if the agreement to pay fees is tied to an agreement not to investigate the validity, priority or appropriateness of the lender’s liens and claims or impact a finding of “disinterestedness” under Section 327 of the Bankruptcy Code.

**6. *In re World Waste Services, Inc.*, 345 B.R. 810, 2006 WL 2079109 (Bankr. E.D. Mich., July 24, 2006).**

On June 27, 2003, the debtors filed a voluntary chapter 11 which were jointly administered. Schafer & Weiner, PLLC were employed as debtor’s primary counsel, and Sullivan & Leavitt, P.C. was retained as special counsel for the debtors on September 18, 2003. Comerica Bank, the secured lender with a blanket lien in the debtors’ assets, agreed to permit the debtors to use its cash collateral to fund expenses of the estate in accordance with a formula and budgets submitted by the debtors. On November 13, 2003, the debtor sought to sell all of its assets pursuant to a Section 363 sale. The sale was approved to Richfield Equities, LLC in February 2004. The funds from the sale were used to pay most, but not all, of the administrative expenses incurred prior to the sale. While approximately 325 administrative claims totaling approximately \$5.55 million had been paid, there remained approximately 173 unpaid administrative claims, including Schafer & Weiner, Sullivan & Leavitt, GE Capital and Sullivan Ward. The debtors remain in chapter 11, have not yet confirmed a plan, do not expect any additional or material funds to come into the estate, which is administratively insolvent, and there is no motion to convert pending.

Sullivan & Leavitt filed a motion seeking disgorgement and a *pro rata* share and distribution among the administrative claimants. GE Capital, an administrative creditor filed a joinder in the motion. In response to the motion, Sullivan Ward argued that (i) it had only received a portion of its administrative claim, (ii) its compensation was based on a carve-out from the secured lender's collateral, (iii) the motion is moot because even if disgorgement were ordered, all of the disgorged amounts would go to the secured lender, and (iv) ordering disgorgement, from a public policy perspective, would chill and discourage entities from dealing with chapter 11 debtors.

The debtors also argued against disgorgement because: (i) seeking such relief required an adversary proceeding under Bankruptcy Rule 7001(1), not simply a motion, because the movant was seeking to recover money or property, (ii) disgorgement would provide no benefit to the movant because the secured lender was still owed in excess of \$6.0 million on its secured debt, (iii) disgorgement is not proper as a matter of law because in this case, unlike *Specker*, the professionals had received "final" awards of compensation and the ruling of the Sixth Circuit should be narrowly construed and interpreted to apply only to interim awards of compensation, (iv) Section 726(b) and *Specker* do not apply because this case remains in chapter 11 and has not been converted, (v) *Specker* is not applicable because the funds paid as compensation were out of the secured lender's cash collateral subject to the secured lender's consent, (vi) the movants had waived their right to seek disgorgement by failing to have objected to the final fee applications, and (vii) it would be inequitable and impracticable to require disgorgement; hardship would be suffered from requiring disgorgement; and such claimants were entitled to rely on the "finality" of such payments.

The Court, for the most part, dismissed each of the arguments proffered in response to the motion. First, because the Court viewed the motion as merely one to determine whether disgorgement would be permissible, as opposed to ordering disgorgement, an adversary proceeding was not a prerequisite for the Court to rule. Second, the Court held that *Specker* was not limited to interim awards of compensation – the reasoning and broad language of the ruling, according to Judge Shapiro, went well beyond to “anyone who provides services or credit to a bankrupt firm.” Third, *Specker* rejected the “parade of horrible arguments, the inequitable arguments and the practical difficulties arguments.” Fourth, while Judge Shapiro does not explicitly indicate why the result of *Specker*, based on Section 726(b) (not applicable in a chapter 11 context) should nevertheless be applied to an administratively insolvent chapter 11 case, in dismissing this argument, he seems to rely on the bankruptcy policy of equality of distributions.

According to the Court:

To decide otherwise would to in effect reward the quick and the persistent at the expense of others whose claims are similarly situated and whose efforts were just as important to the debtors attempts to reorganize as theirs. That is antithetical to the very concept of bankruptcy as expressed through the equality of distribution provisions as well as the very idea of preferences, as pertains to prepetition payments to certain prepetition creditors payments to whom are at risk under certain circumstances.

*Id.* at \*5. The Court further stated, in addressing the difficulties of pursuing recovery of such amounts:

[T]rustees or responsible persons in liquidation situations face those kinds of problems all the time, particularly in situations involving preferences, to which disgorgement is akin, or to collection of accounts receivable. Business judgments will have to be made. The difficulty of pursuit, and collection however, does not eliminate the obligation to pursue, but rather will limit how long and how far to prudentially continue it.

*Id.* Fifth, Judge Shapiro relied on Sections 330 and 331 that always subject professional fees to re-examination and adjustment. Finally, in making this ruling, Judge Shapiro appears to cast doubt on whether he would follow Judge Gregg’s ruling in *U.S. Flow*.

Ultimately, Judge Shapiro concluded that “the remedy of disgorgement [was] theoretically permitted” but he was not in a position to indicate at this juncture how equality of treatment was to be achieved. Some of the questions that the Court indicated would need to be answered in order to determine how to proceed were: (i) From whom is disgorgement sought – all administrative creditors that were paid or just the professionals? (ii) By what criteria do you decide what group of individuals should disgorge? and (iii) Who will pursue disgorgement and how will the cost of doing so be paid? Neither the pleading before the Court or *Specker*, according to Judge Shapiro, “clearly or sufficiently fully delineate[d] or decide[d] to enable this Court to now say anything more than disgorgement is theoretically permitted, and likely required, way to deal with the problem of administrative insolvency in this case.

**7. *Callaway v. Blank Rome, LLP (In re Midway Airlines Corporation), Case No 01-02319-5-ATS, Adversary Proceeding No. S-05-00098-5-AP (Bankr. E.D.N.C., August 24, 2006).***

The chapter 7 trustee brought an adversary proceeding to require Blank Rome to disgorge attorneys fees of \$612,371.55 (including a \$100,000 retainer that Blank Rome was holding in trust) received by them as counsel for the unsecured creditors committee during the chapter 11. Because the case was administratively insolvent, the trustee contended that Section 726(b), which requires *pro rata* payment of similar claims, mandated disgorgement of the fees paid. In response, Blank Rome contended that Section 726(b) did not mandate disgorgement, and asserted various defenses including statute of limitations under Section 549(d)(1), laches, estoppel, waiver, *res judicata* and Section 330(a)(5). This case, like others, was converted to a chapter 7 after efforts to reorganize were unsuccessful.

The Court denied the trustee's request for disgorgement. The Court's ruling was based on Judge Kressel's ruling in *In re Hyman Freightways, Inc.* as being the "most persuasive opinion that has addressed the issue." Judge Small stated:

This court agrees with Judge Kressel that the plain language of § 726(b) itself pertains only to distribution, and does not mandate disgorgement of fees from professionals. See *In re St. Joseph Cleaners, Inc.*, \_\_\_ B.R. \_\_\_, 2006 WL 2023553 at \*6 (Bankr. W.D. Mich. 2006) (the "authority to 'reel back' such [professional] fees does not stem either directly from Section 726(b) or indirectly through the imposition of Section 105(a)") see also 3 *Collier on Bankruptcy* ¶ 331.04[2][b] (Alan N. Resnick & Henry J Sommer, eds., 15<sup>th</sup> ed. Rev. 2005) ("[t]here is nothing in sections 331 or 726(b) that requires disgorgement due to administrative insolvency").

The Court did not rule out that, nevertheless, it may require disgorgement in an administratively insolvent estate. Ultimately, however, disgorgement "will depend on the circumstances of each case and the facts specific to each professional." In this case, the administrative procedures order entered by the Court required a 20% holdback to ensure that there would be funds available if the estate was determined to be administratively insolvent. Therefore, according to the Court, disgorgement was contemplated, at least to the extent of 20% of the amount of allowed interim compensation. Because of the existence of numerous outstanding factual issues, ultimately, the Court could not rule on whether and to what extent disgorgement should be granted on this basis.

Finally, the Court agreed with Blank Rome that the retainer they had received was a security retainer under North Carolina law, and thus was not subject to disgorgement under Section 726(b). The Court relied upon the ruling of Judge Montali in *In re Dick Cepek, Inc.*, 339 B.R. 730, 739 (B.A.P. 9<sup>th</sup> Cir. 2006) in making with this ruling. However, because Blank Rome had failed to hold back the 20% of the interim fee awarded to it during the case, the Court ordered it to continue to hold the retainer in trust and precluded it from applying it to outstanding

fees pending the Court's receipt and evaluation of the trustee's estimate of administrative fees and funds available to pay them.

**8. *Ungaretti & Harris, LLP v. Steinberg (In re Resource Technology Corporation)*, 356 B.R. 435, 2006 Bankr. LEXIS 3250, 47 Bankr. Ct. Dec. 132 (Bankr. N.D.Ill. December 4, 2006).**

This case arose in the context of a case that had been converted from a Chapter 11 to a Chapter 7 case. The Chapter 7 Trustee was seeking approval of a proposed compromise to resolve various claims subject to an adversary proceeding, including, among other things, (i) payment of professional fees earned by the debtor's counsel, and (ii) waiver of disgorgement of fees already received by debtor's counsel. In denying the requested application to compromise, Judge Wedoff stated, in *dicta*, that even if the payments for the professional fees at issue had been authorized, they would be subject to disgorgement, based on Section 726(b) and the Sixth Circuit's ruling in *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659, 664-65 (6<sup>th</sup> Cir. 2004), in light of the present inability of the estate to pay all of its chapter 11 administrative expenses. While disgorgement was not before the Court at that time, nevertheless, Judge Wedoff seemed to suggest that if the issue were brought before the Court, he would order disgorgement under Section 726(b), like the Sixth Circuit did in the *Specker Motor Sales* case – "A Chapter 11 administrative creditor who has been paid interim compensation under § 331 . . . is required to disgorge the payments if there are insufficient estate assets to pay all the other Chapter 11 administrative creditors in full." *Ungaretti & Harris, LLP v. Steinberg (In re Resource Technology Corporation)*, 356 B.R. 440-441.

**9. *In re High Voltage Engineering Corp, et al.*, 2007 Bankr. LEXIS 434 (Substantively Consolidated) (D. Mass. January 19, 2007).**

Generally, once the final order granting allowance and payment of professional fees is entered and funds are distributed in payment of such fees under a confirmed chapter 11 plan that

has become effective and substantially consummated, most professionals believe that the fees they received are inviolate and beyond attack. However, a motion recently filed in a Massachusetts bankruptcy case may now give rise to second thoughts before professionals breathe a sigh of relief.

In *In re High Voltage Engineering Corp., et al.*, the chapter 11 trustee appointed in a subsequent case filed by the debtors filed a motion asking the court to reconsider the administrative expense claims of professionals that had been paid in the debtor's prior chapter 11 bankruptcy case as part of a confirmed plan. A short time after the plan was confirmed and professionals had been paid, the debtors found that they were in need of additional bankruptcy relief. In lieu of seeking to reopen the prior chapter 11 or to modify the plan post-confirmation,<sup>1</sup> the debtors filed a new chapter 11 case and a trustee was appointed.

Rather than seeking to reopen the prior chapter 11 case in order to set aside and challenge the fee awards, the trustee filed a motion in the debtors' second chapter 11 case. The trustee alleged that the professionals may have been aware that the debtors' plan was not feasible at the time of confirmation and, therefore, they may not be entitled to their fees. The trustee thus sought reconsideration of the order(s) allowing the professionals' claim(s) for payment in the prior bankruptcy pursuant to 11 U.S.C. § 502(j) and Federal Rule of Civil Procedure 60(b), made applicable in bankruptcy proceedings by Rule 3008 of the Federal Rules of Bankruptcy Procedure.

Judge Feeney recently refused to allow the trustee to vacate previously entered, final, non-appealable orders that allowed compensation to certain professionals employed in the

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<sup>1</sup> It is unclear whether the plan had been substantially consummated by the time the new case was filed or whether the debtor would have had the right to seek to modify the plan post-confirmation under Section 1127 of the Bankruptcy Code.

debtor's prior chapter 11 cases. In making this ruling, the Court relied on the defenses asserted by the professionals, who contended that the trustee in this case was precluded from obtaining the requested relief because: (i) the trustee, as a successor of the debtors, was barred from attacking the alleged fraud that was committed with participation of the debtors (*i.e.*, faulty projections and inadequate exit financing, giving rise to the procurement of a confirmation order that ultimately proved false) based on the doctrine of *in pari delicto*; (ii) the binding language of the release and exculpation provisions of the confirmation order acted as a bar to the claims asserted by the trustee under the doctrines of *res judicata*, collateral estoppel and judicial estoppel; and (iii) the doctrine of the law of the case, as pertains to the order of confirmation in the first case, prohibited the trustee from using Rule 60(b) as an "end run" around Section 1144 that circumscribes the period in which and circumstances when a bankruptcy court may revoke an order of confirmation. (NOTE: In this case, the order of confirmation had become final and no attempt was made by the trustee to vacate this order within the one year period prescribed in Rule 60(b) of the Federal Rules of Civil Procedure.)

**10. *Seek Wilderness, Ltd., a/k/a Iverson Snow Shoe Company v. Olson (In re Seek Wilderness Ltd.)*, Case No. 01-90650, Bankr. W.D.Mich. (Marquette) (Judge Hughes), (Transcript from Telephonic Bench Opinion on August 31, 2006).**

This case, which coincidentally involved the same counsel that represented the debtor in *Specker Motor Sales*, is notable for various rulings and observations by the Bankruptcy Court. Among others, the Court, in denying a motion for summary judgment in an adversary proceeding brought by the chapter 7 trustee against debtor's chapter 11 counsel after conversion of the chapter 11 case to a chapter 7 case, suggested the following: (i) counsel retained by a pre-petition debtor with a retainer is employed by a different entity than the post-petition estate (*i.e.*, debtor-in-possession) that is created on the date of filing; (ii) counsel retained pre-petition may

have a security interest in the retainer, to the extent authorized under State law, to cover fees and expenses incurred only up to the petition date; (iii) the balance of any pre-petition retainer remaining on the filing date may not serve as security for the post-petition services and expenses of debtor's counsel absent approval under Section 364 of the Bankruptcy Code; (iv) although debtor's counsel may have obtained an engagement letter pre-petition, it is required to obtain a new engagement letter post-petition because it then represents a new entity – the DIP, as opposed to the debtor; (v) even if debtor's counsel is able “to establish that he has a valid retainer for his postpetition services to the bankruptcy estate, *Specker Motors* appears to hold that the validity of that retainer can be disregarded and that . . . [debtor's counsel's] postpetition claim for fees should still be reduced to that of an unsecured Chapter 11 priority claim to be tossed among the other unpaid Chapter 11 administrative expenses entitled to a Section 726 distribution. . . .;” (vi) there remains an unresolved issue regarding whether disgorgement should be calculated based upon all administrative claims paid and accrued, or merely on the basis of those remaining unpaid; and (vii) Section 549 precludes the recovery of amounts paid to administrative expense creditors, other than retained professionals, where those payments have been made in the ordinary course.

### **Conclusion**

In reviewing these recent cases, it is difficult to glean many bright lines that will necessarily protect a professional that has received court-approved compensation during a chapter 11 case which subsequently converts and is found to be administratively insolvent. While professionals may be able to argue that pre-petition retainers received by them are security retainers under applicable State law, and thus are not subject to disgorgement, asserting that position may place the professional at greater risk. The professional may have to disgorge all

amounts previously received, if then being classified as a secured creditor, makes the professional no longer a “disinterested person,” and thus ineligible for appointment under Section 327(a). Moreover, some courts have suggested that the taking of a post-petition retainer may subject the professional to disgorgement if the retainer is not approved under Section 364, absent which, it would be deemed to be a violation of the automatic stay provisions under Section 362(a)(4).

Ultimately, whether Section 726(b) (i) is mandatory or discretionary, (ii) is merely a distribution scheme or, alternatively, (iii) provides a remedy – the absence of which would mean the creation of a right without a remedy – is yet to be definitively determined. That assessment will probably need to await the existence of a conflict among the circuits and, hopefully, a willingness by the Supreme Court to resolve the issue. Alternatively, Congress could attempt to address this issue. However, in light of the current political climate, it is unlikely that there will be any legislative fixes for bankruptcy-related issues.

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