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WHOSE MONEY IS IT:
DISGORGEMENT UNDER 11 U.S.C. § 726(b)

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"Money is the sovereign queen of all delights - for her, the lawyer pleads, the soldier fights."
- Richard Barnfield, English poet (1574 – 1620)

The potential for disgorgement of fees is real and always looms large over a chapter 11 debtor's professionals and its actions in the bankruptcy case. For example, Fed. R. Bankr. P. 2014 requires significant upfront disclosure by professionals, which disclosures must be supplemented throughout the case; 11 U.S.C. § 327 requires professionals to be both disinterested and not hold an interest adverse to the debtor's estate; and recent decisions have held that debtor's counsel may even hold an independent fiduciary duty to creditors and the estate.[1] These are just some of the many examples of types of obligations debtor's professionals must be mindful of when navigating the pitfalls of the Bankruptcy Code to avoid the dreaded potential of disgorgement of their fees. Importantly, these examples are all within the control of the debtor's professionals, and, generally speaking, absent bad faith conduct or misrepresentations being made to the Bankruptcy Court, disgorgement of fees for any of these reasons will not be warranted.

However, after a chapter 11 case has been converted to chapter 7, the debtor's professionals might face the potential for disgorgement of their fees notwithstanding their good faith and their compliance with all applicable rules and statutes. This eventuality could arise when a chapter 7 trustee moves to disgorge the chapter 11 professional's fees in order to ensure *pro rata* distribution to chapter 11 administrative creditors as is required under 11 U.S.C. § 726(b).

A Section 726(b) disgorgement motion can raise two separate, but related, questions: (i) can a trustee disgorge fees awarded to the chapter 11 professionals by court order prior to conversion to chapter 7 and (ii) can a trustee disgorge a pre-petition retainer being held by the debtor's professionals?

11 U.S.C. § 726(b).

Before delving into these questions, it is important to have a basic understanding of § 726(b), which provides:

> (b) Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), or (8) of section 507 (a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1112, 1208, or 1307 of this title, a claim allowed under section 503 (b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503 (b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

The rule provided by § 726(b) is a simple one: (i) when a chapter 11 case is converted to a chapter 7 case, the chapter 7 administrative expenses have priority over the chapter 11 administrative expenses and (ii) chapter 11 administrative expenses are paid on a pro rata basis if the estate does not have sufficient assets to pay chapter 11 administrative expenses in full. While simple in theory,

as discussed below, the application of this rule to chapter 11 professionals has led to significant disagreement among courts.

DISGORGEMENT OF PROFESSIONAL FEES UNDER 11 U.S.C. § 726(b).

To the extent a chapter 7 estate does not have sufficient assets to pay all chapter 11 administrative expenses in full, there is an apparent split in authority regarding the requirement that a professional disgorge fees awarded to it in the chapter 11 case. There do not appear to be any recent reported decisions in New Jersey dealing with this issue. As discussed below, the majority of courts that have considered this issue, including the only Circuit Court of Appeals that has addressed the issue, hold that disgorgement is mandatory to comply with the provisions of § 726(b). Other courts, however, recognize that disgorgement of chapter 11 professional fees is always possibility and is within the bankruptcy court's discretion, but is not mandatory under § 726(b).

Cases holding that disgorgement under 11 U.S.C. § 726(b) is mandatory:

In *In re Metropolitan Electric Supply Corp.*, 185 B.R. 505 (Bankr. E.D. Va. 1995), after conversion, the chapter 7 trustee sought to disgorge professional fees paid to chapter 11 professionals. The court determined that although chapter 11 professionals may receive compensation before the end of the bankruptcy case, they are "placed upon notice of the § 726(b) distribution scheme by holding themselves out as having working knowledge of the Bankruptcy Code," and thus knows that "§ 726(b) may require disgorgement" of interim payments of professional fees. The bankruptcy court held that § 726(b) "mandates" *pro rata* distribution, where the estate is administratively insolvent, the court must disgorge professional fees.

In *In re Lochmiller Industries, Inc.*, 178 B.R. 241 (Bankr. S.D. Ca. 1995), the bankruptcy court reached a similar conclusion. As in *Metropolitan Electric*, following conversion from chapter 11, the chapter 7 trustee sought disgorgement of professional fees paid in chapter 11 case under § 726(b). The chapter 11 professionals argued that (i) disgorgement was not appropriate or, alternatively, (ii) that all chapter 11 administrative claimants previously paid should equally share the burden and be subject to disgorgement. Addressing the second objection first, the court determined that the Bankruptcy Code treats ordinary course administrative claimants differently from professionals, and does not permit recovery of administrative expenses paid by a chapter 11 debtor in the ordinary course of its business, primarily because these payments are expressly permitted by the Bankruptcy Code without the need for prior court approval. The court stated that to rule otherwise would "virtually eliminate the ability of any Chapter 11 debtor to operate." The court then concluded that the disgorgement of the professional fees was appropriate and required by the bankruptcy court, and that chapter 11 professionals are the only party the Bankruptcy Code permits to bear the risk of administrative insolvency. The court was not moved by the argument that such treatment was inequitable, concluding that the Bankruptcy Code demands that chapter 11 professionals, alone, bear the risk of post-conversion administrative insolvency, and further finding that a *pro rata* sharing of the disgorgement among the chapter 11 professionals was not necessary: "the amount the Trustee shall be allowed to collect from any of the Chapter 11 Professionals shall not be divided *pro rata* among them. The risk that one or more of them may not be able to return the amounts paid is most properly borne by the Chapter 11 Professionals."

In *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6th Cir. 2004), this issue was finally brought to the Circuit Court of Appeals level when the United States Court of Appeals for the Sixth Circuit was faced with the question of disgorgement of pre-conversion chapter 11 professional fees under § 726(b).[2] The bankruptcy court and the district court both ruled that debtor's former chapter 11 counsel had to disgorge fees under § 726(b) because chapter 7 estate was administratively insolvent. Upon appeal, the Sixth Circuit affirmed, holding that compensation paid to professionals under the bankruptcy code is "always subject to disgorgement," and at all times remains "subject to the statutory *pro rata* distribution scheme in § 726(b)." The Court based its decision upon its reading of the statute and held that "mandatory disgorgement is the only reasonable and logical result if 11 U.S.C. § 726(b) is to be given any effect." Because the facts of the case as to administrative insolvency were uncontested, the court held that "interim compensation must be disgorged when necessary to achieve *pro rata* distribution of a Chapter 7 bankruptcy case."[3] In so holding, the Court rejected the earlier holding of the Sixth Circuit Bankruptcy Appellate Panel in *In re Unitcast, Inc.*, 219 B.R. 741 (B.A.P. 6th Cir. 1998) (discussed below), which provided for a discretionary approach. Further the Court was not persuaded by the appellant's arguments that disgorgement of professional fees -- but not of other administrative expenses -- was inequitable: "It is true that only professionals can be asked to disgorge

interim compensation, but that is because only professionals can receive interim compensation under § 331(a). Indeed, failure to order disgorgement gives interim compensation superpriority."

Despite the Sixth Circuit's strong language, one must questions whether the failure of to disgorge chapter 11 professional fees truly gives professionals a "superpriority" claim, or whether it merely puts them on an even footing with other administrative creditors paid in the ordinary course during the pendency of the chapter 11 case, such as suppliers, employees, etc? Do the provisions of the Bankruptcy Code giving special treatment to the payment of professional fees, warrant such disparate treatment, even after a final fee application has been approved by the bankruptcy court? Apparently, the Sixth Circuit believes these questions should be answered in the affirmative. The cases discussed below, however, came to different conclusions.

Cases holding that disgorgement under 11 U.S.C. § 726(b) is not mandatory:

The first major case finding that disgorgement under § 726(b) is not mandatory was *In re Unitcast, Inc.*, 219 B.R. 741 (B.A.P. 6th Cir. 1998).[4] The United States government asserted an administrative claim against the estate, and asked the bankruptcy court to disgorge chapter 11 professional fees to effectuate a *pro rata* distribution to all administrative creditors. The bankruptcy court declined to order disgorgement of interim fees awarded, but instead reduced debtor's counsel's final fee application by 25%. On appeal, the court affirmed the bankruptcy court's decision and determined that while a bankruptcy judge clearly has authority to order disgorgement of interim fees under § 726, the Bankruptcy Code does not mandate disgorgement. Instead, the court determined that disgorgement should be considered on a case by case basis. The court held "disgorgement is a remedy within the discretion of bankruptcy judges as the final arbiters of professional fee requests . . . . Administrative insolvency is one factor appropriately considered in the exercise of that discretion."

In *In re Hyman Freightways, Inc.*, 342 B.R. 575 (Bankr. D. Minn. 2006), the chapter 7 trustee of an administratively insolvent estate sought disgorgement of professional fees from chapter 11 professionals. Although the *Hyman* court reached the same conclusion as the court in *Unitcast,* it based its holding on a completely different, and unique, approach to § 726(b). In interpreting § 726(b), the *Hyman* court viewed the statute as one relating only to *distribution* of property, and not to *collection* of property. Thus, the court determined that while § 726(b) requires *pro rata* distribution among chapter 11 administrative creditors, it only requires that "chapter 11 administrative expenses be paid *pro rata* from the remaining funds on hand." The court continued by stating that, since the chapter 11 professionals had already been paid on their claims, they did not presently have an administrative expense claim against the estate, and as a result, they were irrelevant to the § 726(b) scheme:[5]

> If the trustee were successful in recovering these payments, that would *create* an administrative expense by these professionals for that amount, but at present, none exists. So what the trustee proposes is not to make a *pro rata* distribution to existing administrative expense holders from existing funds, but to change both the amount of the property for distribution and the amount of the administrative expenses. Carried to its logical conclusion, the trustee's argument would require the trustee to recover every payment made during the chapter 11 case and then redistribute the money in accordance with § 726, thereby unwinding the chapter 11 process. The impracticability and absurdity of this is obvious.

342 B.R. at 579.

In re St. Joseph Cleaners, Inc., 346 B.R. 430 (Bankr. W.D. Mich. 2006), also decided in 2006, is an interesting case because it comes from a court sitting in the Sixth Circuit that was bound to follow the *Specker Motor* holding, yet found that disgorgement was not appropriate. In *St. Joseph Cleaners,* the bankruptcy court began by pointing out that "the bankruptcy Code itself provides a comprehensive scheme for the distribution of estate property during the administration of the bankruptcy case," such that the Code almost guarantees that "absolute equality of distribution will not be realized as soon as the Chapter 11 debtor uses the first dollar of estate property to pay for a post-petition good or service." Therefore, the court strongly questioned and criticized the *Specker Motor* decision because it did not believe that § 726(b) should be used to disrupt the Bankruptcy Code's distribution scheme. However, the court also realized it was bound by the *Specker Motor* decision. While adhering to the *Specker Motor* holding, the court found the case before it to be factually distinguishable from *Specker Motor*, such that it held that disgorgement would not be necessary. The court determined that because the fees at question were awarded to the chapter 11 professionals in conjunction with the confirmation of a

chapter 11 plan -- which was not the case in *Specker Motor* -- *Specker Motor* was distinguishable and disgorgement under § 726(b) was not required. The court concluded that the finality of the chapter 11 plan process and the order confirming that plan removed the fees at question from the requirement of disgorgement discussed in *Specker Motor*.[6]

Although the caselaw regarding the disgorgement of previously awarded professional fees is mixed, the majority of cases, including the only Circuit Court of Appeals case on the issue tend to read § 726(b) literally, thereby requiring professionals to disgorge fees to the extent necessary to ensure a *pro rata* distribution among the chapter 11 administrative creditors. There appears to be some authority for distinguishing between fees awarded pursuant to a confirmed chapter 11 plan and those without the protection of a confirmation order. However, this distinction has yet to be fully tested. Additionally, while an appeal by chapter 11 professionals to equity has been virtually ignored by some courts, other courts seem to deny the disgorgement motion based, in part, upon equitable considerations.

While disgorgement of previously awarded fees seems to be a harsh and inequitable result, chapter 11 professionals should be aware of its possibility, and the arguments for and against disgorgement, at the outset of a chapter 11 case.

DISGORGEMENT OF RETAINERS UNDER 11 U.S.C. § 726(b).

Equally problematic to chapter 11 professionals is the possibility that a retainer received from the chapter 11 debtor prior to the petition date may be subject to disgorgement under the same § 726(b) principles discussed above. Because retainers held by attorneys are generally considered property of the debtor's bankruptcy estate, it could logically follow that they should be treated the same as the fee payments discussed above. However, as discussed below, the majority of courts, including the United States Bankruptcy Court for the District of New Jersey in a recent unpublished decision by Judge Michael B. Kaplan, have determined that retainers are not subject to disgorgement.

Types of Retainers

Before discussing the cases on this issue, it is important to understand the types of retainers professionals can obtain prior to a bankruptcy filing. An understanding of these issues is imperative as the type of retainer may be outcome determinative with respect to a subsequent request for disgorgement.

Classic Retainer: A classic retainer is a retaining fee given to a professional as a preliminary payment to counsel and to insure and secure future services from the professional. "It is intended to remunerate counsel for being deprived, by being retained by one party, of the opportunity of rendering services to another and receiving pay from him."[7]

Security Retainer: A security retainer is an agreement between a party and its counsel with provides that "the retainer will be held by the attorneys to secure payment of fees for future services that the attorney are expected to render."[8] Payment is not earned by the attorney until services are rendered, and any unearned funds are returned to the client at the end of the engagement. This is most often the type of retainer obtained by chapter 11 professionals.[9]

Advance Payment Retainer: An advance payment retainer is generally considered an "earned upon receipt retainer."[10] Under this type of arrangement, the parties agree that the ownership of the funds "is intended to pass to the attorney at the time of payment, in exchange for the commitment to provide legal services."[11]

As was detailed by Judge Tuohey in his *Bressman* decision, in the case of a retainer paid to a debtor's counsel prior to the bankruptcy filing, each of the types of retainers discussed above have been determined to be property of the estate under § 541. However, depending on the type of retainer at issue, disgorgement under § 726(b) may or may not be appropriate.

Disgorgement of Security Retainers Is Generally Not Appropriate.

The majority of courts have held that security retainers are not subject to disgorgement under § 726(b).[12] The bases for these decisions is the conclusion that a security retainer is given to secure future payment of fees, and under applicable non-bankruptcy law, the professionals hold a properly perfected security interest in the security retainer. As such, these courts determine that an attorney holding a security retainer holds a properly perfected security interest in that retainer such that it cannot be recovered by a chapter 7 trustee under § 726(b) to satisfy the claims of other chapter 11 administrative creditors. *See, e.g.*, *In re Dick Cepek, Inc.*, 339 B.R. 730 (B.A.P. 9th Cir. 2006); *In re Mobile Team, Inc.*, 2011 WL 65930 (Bankr. E.D. Va. Jan. 10, 2011); *In re Zukoski*, 237 B.R. 194, 198 (Bankr. M.D. Fla. 1998);

In re Burnside Steel Foundary Co., 90 B.R. 942 (Bankr. N.D. Ill. 1988).[13]

In *In re Santiago*, Docket No. 08-22666(MBK), 2011 WL 666286 (Bankr. D.N.J. Feb. 14, 2011), Judge Kaplan was tasked with deciding the appropriateness of § 726(b) disgorgement to security retainers under New Jersey law. Consistent with the decisions cited above, Judge Kaplan concluded that security retainers held by chapter 11 professionals, although property of the estate, remain subject to a security interest held by the professional. To the extent the professional is in possession or control of that security interest, under New Jersey's version of the Uniform Commercial Code, that professional has properly perfected that security interest, which perfected security interest is not subject to effective challenge under the Bankruptcy Code. Thus, the court concluded:

> To the extent a party has a valid lien on property that was used to produce cash for the estate, that lien is paid first from the proceeds of the liquidation of that property. Therefore, absent equity in the collateral, administrative claimants cannot look to encumbered property to provide a source of payment for their claims. Thus, before § 726(b) is even implicated, all amounts secured by the lien created by the security interest must be paid. Inasmuch as these amounts must be paid before § 726 distributions commence, disgorgement based solely on § 726(b) is impermissible.

2011 WL 666286 at *2. As a result, it appears that practitioners in New Jersey can avoid disgorgement of a pre-petition retainer if the retainer was a security retainer in which the practitioner can claim a properly perfected security interest in under New Jersey law.

However, not all courts are in agreement with the position taken by Judge Kaplan in *Santiago*. For example, in *In re Unique Drywall & Stucco, Inc.*, 2006 WL 4452995 (Bankr. D. Nev. March 10, 2006), the court found that a prepetition retainer remained subject to the provisions of 11 U.S.C. § 726(b). Relying in part upon the language in Sixth Circuit's decision in *Specker Motor* (discussed above), the bankruptcy court determined that retainers should be treated no differently from prepetition fees. While the court recognized that the chapter 11 professional had a right to payment under the bankruptcy code, that right only existed if the estate had sufficient assets, such that "the method by which payment is effected" should be governed by § 726.[14]

See also In re North Bay Tractor, Inc., 191 B.R. 186 (Bankr. N.D. Ca. 1996), where the court refused to order the disgorgement of debtor's counsel's retainer, but disallowed any payments to debtor's counsel over and above retainer until other claimants of equal priority received the same percentage distribution on their claim. In reaching this conclusion, the court stated:

> However, [disgorgement] would undermine the purpose of retainers and chill the willingness of many professionals to undertake representation of Chapter 11 debtors. On the other hand, the result urged by [debtor's counsel] here is equally unfair. It makes no sense for [debtor's counsel] to recover 65% of his total fees while [another administrative claimant] recovers only 20%, just because [debtor's counsel] had access to the debtor just before it filed its petition. The fees of both were earned postpetition and are entitled to equal priority. Neither benefited the estate more than the other. To the maximum extent possible, without compelling disgorgement, they should receive equal dividends.

191 B.R. at 188. Thus, despite Judge Kaplan's decision in *Santiago*, which is consistent with the majority of cases that have addressed this issue, there exists authority for the proposition that pre-petition retainers to chapter 11 professionals remain subject to disgorgement under § 726(b).

However, an interesting issue not raised or addressed by Judge Kaplan in the *Santiago* decision, or in any of the cited decisions, is the effect of the court's conclusion that an attorney has a pre-petition security interest in estate property could have on that attorney's qualification to be retained by the debtor under § 327(a). Stated succinctly, is a potential consequence of this ruling that a court could determine that the attorney is not disinterested or holds interest adverse to the estate by virtue of its holding of the security retainer and, therefore, holding a lien against estate property? *See, e.g., United States Trustee v. Price Waterhouse*, 19 F.3d 138 (3d Cir. 1994) (where the Third Circuit Court of Appeals set forth a per se prohibition against the retention of professionals who hold a pre-petition claim against the estate). If this question is answered in the affirmative, could *Santiago* and related cases place chapter 11 professionals in a no win situation following conversion: either having to disgorge a retainer or potentially be disqualified from receiving any compensation from the estate.

CONCLUSION

While administratively insolvent estates are thankfully, rare, as can be seen from the discussion above, chapter 11 professionals fees are at serious risk of disgorgement should the case be converted and the estate become administratively insolvent. Therefore, chapter 11 professionals need to be aware of should take all necessary steps to protect their fees, to avoid the harsh consequences of § 726(b).

Notes:

[1] *See, e.g., In re Food Management Group, LLC*, 380 B.R. 677, 708 (Bankr. S.D. N.Y. 2008).

[2] Research revealed that this is the only Circuit level case regarding this issue.

[3] Interestingly, although the court referred to the disgorgement of "interim" compensation, the debtor's counsel had been awarded fees by the Bankruptcy Court upon approval of its final fee application.

[4] As noted above, this case was overruled by the Sixth Circuit Court of Appeals in *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6th Cir. 2004).

[5] The professional fees of the chapter 11 professionals had been awarded by order of the bankruptcy court approximately eight (8) years prior to the trustee bringing the disgorgement motion. Based upon this fact, it is likely that the court considered the equity of disgorgement so long after the fees had been awarded in reaching its decision.

[6] *See also In re Kearing*, 170 B.R. 1, 6-7 (Bankr. D. Co. 1994) (also distinguishing between fees awarded under a confirmed plan and those not subject to the protections of a confirmed plan.

[7] *In re Bressman,* 214. B.R. 131, 140 (Bankr. D.N.J. 1997).

[8] *Id.*

[9] As discussed below, most of the caselaw on the issue of disgorgement of retainers under § 726(b) discusses security retainers, which, tend to be the types of retainers sought by chapter 11 professionals. To the extent counsel has obtained a classic retainer or an advanced payment retainer, the cases discussed herein are likely not applicable, and because the retainer remains estate property, it likely remains subject to disgorgement.

[10] *Id.*

[11] *Id.*

[12] The possibility to disgorge security retainers under other provisions of the Bankruptcy Code is not addressed herein.

[13] Notwithstanding the foregoing, in the slightly different context of a retainer held by a chapter 7 debtor's counsel, at least one court has held that the retainer is subject to turnover to the trustee, and cannot be applied to post-petition fees incurred on the debtor's behalf. *See, e.g.*, *In re Blackburn*, 2011 WL 284437 (Bankr. D. Id. Jan. 26, 2011) (noting that to allow the retainer to be held used by the attorney would "permit the use of estate property without prior judicial review -- seemingly at odds with the gatekeeping function bestowed upon bankruptcy courts generally with respect to the use of estate property outside the ordinary course of business.").

[14] It should be noted that the chapter 11 professional in *Unique Drywall* only raised the issue of its potential security interest in the retainer in a supplemental brief, and the court refused to consider this issue. *See* 2006 WL 4452995 at *5.