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Building Blocks

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Disgorgement upon Insolvency: Continuing Uncertainty

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Ensuring an equitable distribution of a debtor's assets has been described as one of the "twin goals" sitting at the core of the Bankruptcy Code.[1] Case insolvency at either the chapter 7 or 11 administrative priority level is forcing many courts to decide whether the goal of ensuring an *equitable* distribution of assets is the same as ensuring an *equal* distribution when achieving that end would require disgorgement.

These decisions involving so-called "disgorgement upon insolvency"[2] are producing a wide range of outcomes for professionals depending on the jurisdiction in which the case is pending. Therefore, all chapter 11 and 7 professionals, including appointed ones like patient care ombudsmen and examiners, would be well served to familiarize themselves with the diverging treatment of disgorgement in administratively insolvent[3] cases.

Further complicating this issue is the fact that few of the bankruptcy court decisions on "disgorgement upon insolvency" seem to be appealed, raising the prospect that professionals will continue to operate in a zone of uncertainty in this area for a great deal longer. It will be helpful to familiarize oneself with the policy arguments on both sides of this issue, since it is unlikely there will be any controlling law in your court.

Thankfully, a leading court on this issue was recently asked to "revisit" its prior holdings that disgorgement is allowed upon administrative insolvency in light of a growing minority approach that has found no authority to compel disgorgement simply because of case insolvency.[4] Although the court declined the invitation to reverse its prior holding, the decision presents an opportunity to explore the case law on both sides of the issue as it matures and develops. It also provides a chance to think about practical steps that professionals can take to best position themselves in the event of administrative insolvency in their cases.

A Leading Court Revisits Its Prior Holding

The facts in *In re Nettel Corp.* are typical of many administratively insolvent cases. Over the course of time, several retained professionals received interim payments in accordance with § 331 for post-petition, post-conversion services rendered to the estate according to court orders authorizing the employment and temporary operation of the business.[5] There was no suggestion that the trustee or his law firm were paid for services in excess of their value; instead, the sole issue was that in the course of reviewing the trustee's proposed final distribution, the court observed that if approved, the trustee would receive 99.94 percent of his claim, his law firm would receive 98.94 percent of its claim and his accountant would receive 100 percent of his claim, whereas two other administrative priority claimants, including the U.S. Trustee, would only receive 62.042 percent of their claims.[6] Questioning whether this proposed distribution violated the mandates of the Bankruptcy Code's distribution scheme, the court then ordered a briefing and provided an opportunity for the parties to address whether fees paid to the trustee and

1 *See, e.g., In re Neff*, 824 F.3d 1181, 1187 (9th Cir. 2016), *cert. denied sub nom., DeNoce v. Neff*, 137 S. Ct. 831 (2017) (along with giving debtor a fresh start); *Moses v. CashCall Inc.*, 781 F.3d 63, 72 (4th Cir. 2015) ("Grounded in the Constitution, bankruptcy provides debtors with a fresh start and creditors with an equitable distribution of the debtor's assets.").
2 *In re Santa Fe Med. Grp. LLC*, 557 B.R. 223, 225 (Bankr. D.N.M. 2016).
3 That is, when there are insufficient funds remaining in the estate to ensure that all administrative expenses receive full payment.
4 *In re Nettel Corp.*, No. 00-01771, 2017 WL 5664840, at *6 (Bankr. D.D.C. Oct. 2, 2017).
5 *Id.* at *2.
6 *Id.* at *3.

his counsel could be disgorged to ensure *pro rata* distribution among administrative claimants.[7]

Although *Nettel* solely concerned the *pro rata* distribution of chapter 7 administrative expenses, the issue of disgorgement by professionals commonly arises in several other circumstances. For example, these same issues are implicated when, upon conversion, a chapter 7 trustee seeks disgorgement from the chapter 11 professionals to ensure *pro rata* distribution to other unpaid chapter 11 administrative claims,[8] or the chapter 7 trustee seeks disgorgement from the previously paid chapter 11 professionals for the so-called "burial expenses" of the chapter 7 case (*i.e.*, the chapter 7 administrative expenses that have statutory priority over the pre-conversion administrative claims).[9] Other times, certain unpaid chapter 11 professionals (or courts themselves) seek disgorgement from other chapter 11 professionals to achieve *pro rata* distributions.[10]

Distribution Pursuant to § 726

Section 726(b) provides that distributions to claimholders under § 507(a)(1)-(10)

> 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.

Simply put, pursuant to § 726, allowed administrative claims are to be paid on a *pro rata* basis with the exception of chapter 7 "burial expense" claims, which are given priority over the § 503(b) claims that arose during the prior chapter. Under the case law, there is no meaningful question that the congressionally approved priority scheme controls.

The developing split of authority centers instead on the courts' varying interpretations of whether, in light of this priority scheme, when an estate cannot pay all § 503(b) administrative claims in full, a court might compel a disgorgement of amounts already paid to certain professionals in order to ensure an equal distribution to all administrative claims.[11] The three primary lines of judicial thought are summarized as follows: "Some courts hold that they have the *discretion* to order disgorgement; others that they *must* order disgorgement; and still others that they *lack the authority* to order disgorgement."[12]

Disgorgement: Permitted and Required

Nettel was a reaffirmation of a 1994 holding from the same court[13] that sided with the majority of cases at that time, which read § 726(b) to permit courts to effectuate the equalized treatment of § 503(b) claimants by ordering disgorgement, with an assist to this end by § 105.[14] In addition, *Nettel* supported its reaffirmation of its prior holding by emphasizing that interim-fee applications granted pursuant to § 331 are interlocutory in nature, therefore the amounts paid pursuant to those orders are always subject to disgorgement.[15] This "permissive" view aligns in many respects with the views of those courts that believe they are *required* to order disgorgement in order to comply with the language of § 726(b) itself, which provides that distributions "shall" be *pro rata*.[16] Mandatory disgorgement upon insolvency comports — in the view of these courts — with the overarching policy in the Bankruptcy Code favoring an equality of distribution and the Code's mandate that distributions "shall" be *pro rata*.[17]

Disgorgement: Prohibited

On the other hand, a growing number of courts are resisting the call to implement § 726 through § 105, particularly in light of the U.S. Supreme Court's instruction to lower courts in *Law v. Siegel* to proceed with caution, as § 105 is not a license to do what is otherwise prohibited by the Bankruptcy Code.[18] These courts acknowledge the mandatory *pro rata* distribution called for under § 726(b), but question where the authority to order disgorgement upon insolvency lies within the Code. In these courts' views, "Section 726(b) is silent as to any remedies ... [and it] can be read to mean that any payment by the trustee must be paid in the order given by § 726(b) ... [but] [n]othing in § 726(b) dictates the source of payments."[19]

Not surprisingly, these courts are unpersuaded by the argument that interim awards of professional fees are subject to disgorgement on the basis of insolvency. Supporting their reasoning, these courts observe that disgorgement and recovery of previously paid professional fees is specifically addressed by § 330(a)(5), which provides for disgorgement *only* if the final value of the services is less than the total amount of the interim fees awarded, and *not* to equalize distributions.[20] In these courts' views, the fact that Congress specifically addressed the circumstances under which disgorgement can be ordered and did not include administrative insolvency within that list indicates that there is no such authority. The "prohibited" camp also sees § 726(b) as a distribution provision rather than a recovery provision, and finds that other Code sections set forth the scope of recovery rights under the Code, and those recovery provisions can stretch no further to accommodate a distribution provision.[21] Finally, these courts observe that disgorgement unfairly tar-

7 *Id.* at *1.
8 *In re Headlee Mgmt. Corp.*, 519 B.R. 452 (Bankr. S.D.N.Y. 2014).
9 *In re Home Loan Serv. Corp.*, 533 B.R. 302 (Bankr. N.D. Cal. 2015) (rejecting argument that court must order disgorgement). The chapter 7 administrative expenses are referred to as the "burial" expenses for the end-of-life nature of a chapter 7 proceeding. These expenses are provided priority over the chapter 11 administrative expenses by the dint of § 726, which largely incorporates the priority scheme found in § 507, but creates an important special treatment for administrative claims in a chapter 7 case that was converted from chapter 11.
10 *In re Santa Fe Med. Grp. LLC*, 557 B.R. 225 (Bankr. D.N.M. 2016).
11 11 U.S.C. § 726.
12 *Santa Fe Med. Grp. LLC*, 557 B.R. at 225.
13 *See Guinee v. Toombs (In re Kearing)*, 170 B.R. 1 (Bankr. D.D.C. 1994) (holding that it is within the court's discretion to require disgorgement of fees to ensure *pro rata* distribution of estate funds under § 726(b)).
14 11 U.S.C. § 105(a) (authorizing "any order, process or judgment that is necessary or appropriate to carry out" Bankruptcy Code).
15 *Nettel*, 2017 WL 5664840, at *7.
16 *See, e.g., In re Kingston Turf Farms Inc.*, 176 B.R. 308 (Bankr. D.R.I. 1995). ("[D]isgorgement is required as a matter of law, just to adhere to the mandatory payment scheme of the Code."); *Specker Motor Sales Co. v. Eisen*, 393 F.3d. 659, 663 (6th Cir. 2004).
17 *Headlee*, 519 B.R. at 456 (citing *Begier v. Internal Revenue Serv.*, 496 U.S. 53, 58 (1990)). As discussed herein, the *Headlee* court determined that it lacked the authority to order disgorgement.
18 *Law v. Siegel*, 571 U.S. 415, 421 (2014) ("It is hornbook law that § 105(a) does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.") (internal quotations and citations omitted).
19 *Headlee*, 519 B.R. at 458.
20 11 U.S.C. § 330(a)(5) provides that "[t]he court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate."

gets professionals as trade creditors who are not subject to the disgorgement of amounts they received post-petition in order to achieve *pro rata* distribution.[22]

Conclusion

No discussion of an "end-of-case" issue would be complete without acknowledging the Supreme Court's holding in *Jevic*[23] prohibiting a structured dismissal of a chapter 11 case that provides for distributions that do not follow the Bankruptcy Code's ordinary priority rules without the consent of the affected creditors. In light of this holding, chapter 11 professionals might face a greater risk of conversion to chapter 7 and the attendant demands of a chapter 7 trustee to disgorge interim payments. For professionals, a failed chapter 11 case or an administratively insolvent chapter 7 is already painful, and the risk of disgorgement of interim fee payments only makes it worse.

Accordingly, some of the practical steps that professionals could take to position themselves to resist (or seek) disgorgement upon insolvency include (1) seeking payment of professionals' fees directly by the secured creditor through a carve-out of proceeds from the creditor's lien; (2) seeking payment only from pre-petition security retainers, which might not be subject to disgorgement; and (3) seeking "final" approval of fees prior to conversion, since it has been held that only interim fees — and not final fees — can be disgorged. On this final point, chapter 7 trustees are well advised to immediately review and object to any efforts by pre-conversion professionals to have fee orders go final at or near the time of conversion.[24] Finally, there is no substitute for familiarity with the court in which you are appearing. abi

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21 *Santa Fe Med. Grp. LLC*, 557 B.R. at 227-31 (setting forth "five main reasons why the 'disgorgement upon insolvency' analysis does not work": (1) Section 726(b) does not contain a disgorgement remedy; (2) §§ 329, 330 and 331 address a professional's entitlement to compensation, not whether distributions must be *pro rata*; (3) ordering disgorgement upon insolvency is contrary to § 549(a)(2); (4) ordering disgorgement upon insolvency unfairly targets professionals; and (5) § 105(a) should not be used to create a disgorgement remedy that Congress did not intend).

22 *Id.* ("Making chapter 11 professionals the guarantors of administrative solvency is unfair.").

23 *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 983 (2017) (holding that bankruptcy court may not approve structured dismissal of chapter 11 case that provides for distributions that do not follow Code's ordinary priority rules without affected creditors' consent). For ABI's coverage of the *Jevic* case, including *ABI Journal* articles, visit abi.org/abisearch.

24 *Headlee*, 519 B.R. at 457-58.