

## Is Your Retainer Safe?: How *In re Two Gales* Ensures that Bankruptcy Professionals Keep their Retainer Fees

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### Introduction

In a decision that bankruptcy professionals are certain to applaud, the United States Bankruptcy Appellate Panel of the Sixth Circuit held that bankruptcy courts must not order disgorgement of attorneys' retainers in bankruptcy cases if the attorney has perfected a lien in the retainer under state law.<sup>1</sup> Prior to *In re Two Gales*, some bankruptcy courts had justified disgorgement as necessary to comply with 11 U.S.C. § 726(b), which requires administrative claimants to be compensated through *pro rata* distributions upon administrative insolvency. *In re Two Gales* confirmed what some other bankruptcy courts have already held: section 726(b) is not intended to serve as a basis for denying or disgorging an attorney's fees, but rather serves as a priority scheme for dealing with distributions on allowed claims.<sup>2</sup>

*In re Two Gales* most certainly comes as a relief to bankruptcy practitioners because it was only a few years ago, in *Specker Motor Sales Co. v. Eisen*, that the Sixth Circuit Court of Appeals held that disgorgement of professional fees was required when necessary to provide for *pro rata* distributions under 11 U.S.C. § 726(b).<sup>3</sup> After that decision, bankruptcy attorneys were

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<sup>1</sup> See *In re Two Gales*, 454 B.R. 427 (B.A.P. 6<sup>th</sup> Cir. 2011).

<sup>2</sup> *Id.* at 436.

<sup>3</sup> See *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659, 664 (6<sup>th</sup> Cir. 2004).

left scrambling to figure out how they could protect retainers and other approved payments from disgorgement. While some courts have held that disgorgement is discretionary under section 726(b), other courts, such as *Specker*, have held it to be mandatory, thus leaving bankruptcy professionals limited options when facing disgorgement of their retainers. *In re Two Gales* is a decision that can serve to unite the various court holdings; it clarifies that while section § 726(b) may indeed require mandatory disgorgement in the case of administrative insolvency, courts cannot force such a disgorgement when faced with a retainer that has been secured with a lien under state law. This memo attempts to provide bankruptcy practitioners with an understanding of the different types of retainers permitted by law and to advise them how they might ensure that their retainers are not disgorged in the case of administrative insolvency. Part I of this memo provides a background of 11 U.S.C. § 726(b) and caselaw surrounding its application to retainers. Part II then provides a summary of the various types of retainers available in bankruptcy cases. Finally, in Part III, this memo analyzes the implications of *In re Two Gales*, and explains how the decision will serve to ensure bankruptcy professionals rarely face disgorgement of their retainers.

### **Part I: 11 U.S.C. § 726(b)**

11 U.S.C. § 726 discusses distribution of property of the estate in liquidation cases under Chapter 7 of the Bankruptcy Code, following the satisfaction of secured claims. 726(b) provides the manner in which property should be distributed in the event that the estate is unable to fully satisfy each claimant within a particular category.<sup>4</sup> In this case, distributions should be pro rata

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<sup>4</sup> See 11 U.S.C. § 726(b) (2006), which provides as follows: “Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), (8), (9), (10) 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, 1307 of this title, a claim allowed under

among each of the claims which hold equal status.<sup>5</sup> Postconversion administrative expenses in a Chapter 7 liquidation converted from Chapter 11, 12, or 13 hold priority over any preconversion administrative expenses.<sup>6</sup> Therefore, this group would be considered separate from the preconversion administrative expense group of claims for purposes of allocating limited property of the estate, since they hold superior status.

§ 726(b)'s requirement that chapter 7 expenses must be paid ahead of chapter 11 expenses has left numerous bankruptcy courts to deal with a sticky question: upon the discovery of administrative insolvency, must those claimants who have been paid while the case was still in chapter 11 disgorge, or give back, some or all of what they received, so that administrative claimants may share *pro rata*? While disgorgement of attorney fees is certainly not ideal, the plain language of § 726(b) indicates that postconversion administrative expenses hold priority over preconversion administrative expenses; thus, arguably chapter 11 attorney fees, which are preconversion administrative expenses, should be disgorged for the sake of attaining *pro rata* distribution among postconversion claimants.

Courts have disagreed on the answer to this question. Some have concluded that disgorgement is discretionary. For example, in *In re Unitcast*, a debtor-taxpayer's chapter 11 case was converted to a chapter 7 case, and the Internal Revenue Service filed a motion for the disgorgement of interim fees paid to professionals prior to conversion.<sup>7</sup> The court held that

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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." 11 U.S.C. § 726(b) (2006).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *In re Unnitcast, Inc.* 219 B.R. 741, 753 (B.A.P. 9th Cir. 1998).

section 726 does not mandate disgorgement from professionals upon administrative insolvency.<sup>8</sup> According to the court, while a bankruptcy judge has authority to order disgorgement, such an order is not mandatory to comply with § 726(b).<sup>9</sup> The court noted that nothing in § 726(b), in its predecessor under prior law, or in the legislative history of the Code compels trustees of administratively insolvent estates to reach back through the prior administrative periods to recover payments to professionals.<sup>10</sup> “[D]isgorgement is a remedy within the discretion of the bankruptcy judges as the final arbiters of professional fees . . . .”<sup>11</sup> Other courts have similarly held that disgorgement of claims is not mandatory and must be decided on a case by case basis.<sup>12</sup>

Other courts, however, have held that the disgorgement of interim compensation is mandatory in cases of administrative insolvency.<sup>13</sup> *In re Specker*<sup>14</sup> is one such decision. In *Specker*, the debtor filed a chapter 11 petition and paid his counsel a retainer of \$10,000, which the court approved.<sup>15</sup> Over the course of the bankruptcy proceedings, the court approved fees of \$17,343.10 for the debtor’s counsel, but did not permit the debtor’s counsel to apply the retainer to these fees.<sup>16</sup> The debtor incurred an additional \$194,799 of unpaid administrative expenses while he continued to operate his business.<sup>17</sup> Eventually, the debtor sold his assets and the case

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *See In re Anolik*, 207 b.R. 34, 39-40 (Bankr. D. Mass. 1997). *See also In re Chute*, 235 B.R. at 702 (holding mandatory disgorgement of contingency fees inappropriate).

<sup>13</sup> *See, e.g., In re Kingston Turf Farms, Inc.*, 176, B.R. 308, 310 (Bankr. D. R.I. 1995) (holding that disgorgement is required as a matter of law in order for all claimants to be paid pro rata); *In re Kearing*, 170 B.R. 1, 7-8 (Bankr. D.C. 1994) (holding that disgorgement is mandatory).

<sup>14</sup> *In re Specker Motor Sales Co.*, 393 F.3d 659, 664 (6th Cir. 2004).

<sup>15</sup> *Id.* at 661.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

was converted to chapter 7 proceedings.<sup>18</sup> After the case was converted, only \$1,494.67 remained to pay the chapter 11 administrative fees.<sup>19</sup> The chapter 7 trustee proposed that the debtor's counsel disgorge \$9,026.59 of his prepetition retainer. This would give debtor's counsel its *pro rata* share of his chapter 11 administrative expenses of \$973.41, or a 5.6 percent distribution on his allowed chapter 11 fees. Such an arrangement would amount to the same distribution as received by other unpaid chapter 11 administrative creditors, rather than the 57.9 percent "distribution" he would realize if no disgorgement occurred. No other creditors were to be required to disgorge any post-petition administrative expenses.

The bankruptcy court approved the distribution and disgorgement.<sup>20</sup> After a number of lower court appeals, the case eventually made its way up to the Sixth Circuit Court of Appeals. The Court of Appeals affirmed the lower courts, holding that disgorgement of the retainer was mandatory under 11 U.S.C. § 726(b).<sup>21</sup> The debtor's counsel argued that the \$10,000 retainer already paid to him should not be subject to this mandatory *pro rata* distribution because the money had already been paid out of the estate. In holding that the retainer must be disgorged, the court relied on the language of section 726(b), which unambiguously states that payments within a particular class "*shall be made pro rata among claims of the kind specified in each paragraph.*"<sup>22</sup> The court reasoned that this language required disgorgement to the extent necessary to allow a *pro rata* distribution to similarly situated creditors.<sup>23</sup>

After the court's decision in *Specker*, bankruptcy professionals were left wondering what, if anything, they could do to protect their fees against disgorgement. The court, perhaps

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Specker Motor Sales Co.*, 289 B.R. 870, 871 (Bankr. W.D. Mich. 2003).

<sup>21</sup> *In re Specker* at 662.

<sup>22</sup> 11 U.S.C. § 726(b) (emphasis added).

<sup>23</sup> *In re Specker* at 662.

anticipating such a reaction, noted that “counsel is a gambler in [bankruptcy] proceedings like every other administrative creditor.”<sup>24</sup> It seemed that bankruptcy attorneys were left with little recourse in a case of administrative insolvency; they would potentially face disgorgement of retainers if necessary to achieve a *pro rata* distribution.

## **Part II: Acceptable Retainers under State Law**

The *Specker* court did not address one very important issue: the effect of an attorney’s lien on a retainer under state law. Generally, courts have found that there are two types of retainers permitted by state law: classic retainers and special retainers. Special retainers can take one of three forms: (1) security retainer; (2) advance fee retainer; or (3) evergreen retainer. The type of retainer that has been arranged may play an important role in determining whether the retainer may be disgorged. While most of these retainers might be subject to disgorgement, a security retainer may not be, due to the attorney’s lien in such a retainer. A brief discussion of the various types of retainers will clarify this point.

A classic retainer is a payment to a lawyer regardless of whether the lawyer provides the client any services.<sup>25</sup> This type of retainer serves to bind the attorney from representing another, and is simply a payment for accepting the case.<sup>26</sup> A classic retainer is entirely earned by the attorney upon payment, with the client retaining no interest in the funds.<sup>27</sup>

The first type of special retainer is a security retainer. Under a security retainer, the debtor does not give the attorney payment for future services, but rather the retainer remains the

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<sup>24</sup> *Id.*

<sup>25</sup> *See In re Pan American Hospital Corp.*, 312, B.R. 706, 709 (Bankr. S.D. Fla. 2004).

<sup>26</sup> *Id.*

<sup>27</sup> *In re McDonald Bros. Construction, Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990).

property of the debtor until the attorney applies it to charges for services actually rendered.<sup>28</sup> Any unearned funds are turned over by the attorneys.<sup>29</sup>

A second type of special retainer is the advance fee retainer. Under such a retainer agreement, the debtor pays, in advance, for some or all of the services that the attorney is expected to perform on the debtor's behalf.<sup>30</sup> This type of retainer differs from the security retainer in that ownership of the retainer is intended to pass to the attorney at the time of payment, in exchange for the commitment to provide the legal services.<sup>31</sup>

The evergreen retainer is yet another type of special retainer. This retainer agreement calls for the retainer to remain intact and for the debtor's professionals' interim compensation to be paid from the debtor's operating capital.<sup>32</sup> Accordingly, professionals holding evergreen retainers do not look to this sum until such time as a final fee application is presented and approved by the court.<sup>33</sup>

Curiously enough, the *Specker* court never considered the nature of the retainer in making its decision to order the disgorgement of the pre-petition retainer. Specifically, the court never considered how relevant state law treated the retainer at issue. Property interests are created and defined by state law,<sup>34</sup> and accordingly, state law determines the validity and extent of an attorney's lien in bankruptcy.<sup>35</sup> Thus, the state's treatment of the pre-petition retainer has a direct bearing upon whether the attorney has a valid lien in that retainer. In most states, pre-petition retainers are considered security retainers where the estate retains an interest in the

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<sup>28</sup> *In re Pan American Hosp.*, 312 B.R. at 709.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *In re McDonald* at 1000.

<sup>32</sup> *In re Pan American Hosp.*, 312 B.R. at 709.

<sup>33</sup> *Id.*

<sup>34</sup> *Butner v. United States*, 440 U.S. 48, 54-55 (1979).

<sup>35</sup> *In re Campbell*, 26 B.R. 145 (Bankr. D. Colo. 1983).

retainer, but the retainer is security for an attorney's future fees.<sup>36</sup> In such a case, the attorney has a lien in the retainer, and one might logically conclude that such a retainer cannot be disgorged under any circumstances. As long as the attorney did not specifically arrange for a different type of retainer, most states will consider the retainer to be a security retainer in which the attorney has a valid lien, even if he failed to take further steps to perfect that lien. Of course, *Specker* seemed to ignore this point and to mandate disgorgement regardless of the type of retainer at issue.<sup>37</sup>

### **Part III: *Two Gales* to the Rescue**

*In re Two Gales*, a Sixth Circuit case, addressed the important issue that *Specker* ignored: can an attorney's lien on a retainer under state law save the retainer from disgorgement? The facts of *Two Gales* were similar to those of *Specker*. The law firm of Cupps & Garrison, LLC ("C & G") represented Two Gales, Inc. (the "Debtor") as its bankruptcy counsel before the case was converted from chapter 11 to chapter 7.<sup>38</sup> The bankruptcy court ordered C & G to disgorge its \$10,000 retainer because the Debtor was administratively insolvent and, under section 726(b), chapter 7 administrative expenses are entitled to priority in proceedings converted from chapter 11 to chapter 7 where the debtor is administratively insolvent. Faced with the same issue that the *Specker* court faced, the court could have ordered disgorgement of the retainer because under *Specker*, such disgorgement is mandatory in order to achieve *pro rata* distribution. However, the court in *Two Gales* chose to interpret *Specker* narrowly. The court distinguished *Specker* on the

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<sup>36</sup> *In re Rittenhouse*, 76 B.R. 610 (Bankr. S.D. Ohio 1987).

<sup>37</sup> Of course, in the case of a classic retainer, disgorgement would not be permitted and the paid fee is entirely the property of the attorney. *Specker*, however, did not consider the type of special retainer at issue, and whether or not the attorney had a valid lien in that retainer.

<sup>38</sup> *In re Two Gales, Inc.*, 454 B.R. 427, 430 (B.A.P. 6th Cir. 2011).

grounds that it did not address the effect of an attorney's lien on a retainer under state law.<sup>39</sup> The court held that an attorney with a lien is not similarly situated to other administrative claimants, and therefore the priority scheme set forth in 11 U.S.C. § 726(b) is not applicable.<sup>40</sup> The holder of a valid security retainer under state law may not be subject to the distribution scheme in section 726(b).<sup>41</sup> The court concluded that the bankruptcy court here failed to determine the character of C & G's retainer under state law, something it should have done before ordering disgorgement.<sup>42</sup>

The court noted a number of cases that have held that a state law lien trumps, or more accurately, prevents § 726(b) from coming into play.<sup>43</sup> Though a majority of courts have concluded that section 726(b) requires mandatory disgorgement of a retainer if necessary to achieve *pro rata* distribution, this requirement will never come into play if the attorney has a valid state law lien in the retainer, i.e., the retainer is a valid security retainer and not one of the other three types of retainers. *See In re Printcrafters, Inc.*, 233 B.R. 113, 120 (D. Col. 1999) (because under Colorado law a law firm had lien on pre-petition retainer paid to it, the firm was not required to share the retainer with other administrative claimants); *In re Pannebaker Custom Cabinet Corp.*, 198 B.R. 453, 460 (Bankr. M.D. Pa. 1996) (unless excessive or unreasonable, retainer not subject to disgorgement to achieve parity among administrative claimants due to attorney's superior priority as secured creditor); *In re Printing Dimensions, Inc.*, 153 B.R. 715, 719 (Bankr. D. Md. 1993) (counsel not required to share pre-petition retainer pro rata with other administrative claimants where retainer is treated as security or held in trust).

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<sup>39</sup> *Id.* at 434.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

The decision in *Two Gales* will certainly be welcomed by bankruptcy practitioners. After *Specker*, they could not be sure that they would ever see the money that was paid into their retainers. *Two Gales* makes it clear that a bankruptcy court must not disgorge an attorney's retainer if the attorney has a valid lien on it under state law. In *Two Gales*, none of the attorneys ever even brought up the nature of the retainers. The attorneys likely assumed that after *Specker*, the nature of the retainer is irrelevant – it must be disgorged in order to achieve *pro rata* distribution. The court itself raised the issue and held that the reliance of the bankruptcy court on § 726(b) as precluding the need for consideration of whether C & G had a valid lien in the retainer was legally erroneous. That legal error left unanswered the question of whether the steps necessary under state law to perfect a lien in the retainer had been satisfied.<sup>44</sup>

Attorneys in bankruptcy cases must now simply ensure that they have properly perfected a lien in the retainer under state law in order to ensure that they keep their retainers. The process of perfecting a lien in the retainer is rather simple, since most states already consider retainers in bankruptcy proceedings to be security retainers.<sup>45</sup> Therefore, as long as the attorney followed state guidelines when he or she acquired the retainer and did not specifically designate the retainer as one of the other non-secured retainers, he or she will be allowed to keep it and not forced to disgorge it. Of course, if the attorney practices in one of those states that does not consider retainers in bankruptcy proceedings to be security retainers, he or she should follow whatever other steps state law requires to perfect a lien in the retainer, steps that vary by state. Assuming he or she follows those steps, the retainer will not be disgorged by the bankruptcy court. That will certainly be a sigh of relief to bankruptcy attorneys.

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<sup>44</sup> *Id.* at 435.

<sup>45</sup> *In re Rittenhouse*, 76 B.R. 610 (Bankr. S.D. Ohio 1987).