Getting Payment from the Bankruptcy Estate: Avoiding Traps for the Unwary

Jessica Uhlenkamp
Heidman Law Firm, P.L.L.C.; Sioux City, Iowa

Date Created: Fri, 2018-09-07 13:04

3

Getting paid as a bankruptcy professional can often be a tightrope walk. Transparency is extremely important when you receive payment from the estate, especially because you need to submit your application for payment to the court. In most cases, it becomes public record for everyone to review and scrutinize.

Preparing your fee application is daunting enough. However, you still face one more hurdle even after successfully completing this process: actually getting paid. Bankruptcy Code § 330(a)(1) allows "(A) reasonable compensation for actual, necessary services rendered by ... professional person[s], or [an] attorney ... and (B) reimbursement for actual, necessary expenses." Based on this language, you are certainly authorized to be paid as debtor's counsel, creditors' committee's counsel, trustee's counsel, or any other professional retained for the benefit of the estate. But when the debtor does not have funds to pay you immediately, are you forced to wait it out? Even worse, is there a chance that you will not be paid at all? Maybe.

Priority for Administrative Claims

Attorney fees are not paid right away. Instead, they are given priority under Bankruptcy Code § 507(a)(1). While claims for professionals jump to the head of the line, there is still a lot of risk there. If the debtor has absolutely no funds, priority isn't going to do you much good.

While you can certainly have administrative claims in every type of bankruptcy case, they are far more common in chapter 11 cases. The sheer size of most chapter 11 cases can make administrative fees fairly substantial. When a chapter 11 plan does not pan out or when the plan contemplates a liquidation, getting enough funding to cover all of your fees can be a real challenge.

Administrative Claims and Chapter 11 Plans

Under Bankruptcy Code § 1129, administrative claims must be paid as part of plan confirmation. When that is not possible because of cash-flow problems or because the chapter 11 plan actually contemplates a liquidation, converting to a chapter 7 case may be necessary.

When a chapter 11 case is converted to a chapter 7 liquidation, the chapter 7 administrative expenses are paid first. The chapter 7 expenses gain something of a "superpriority," while the chapter 11 expenses get pushed down the line. In some situations, there may not be enough to pay any chapter 11 expenses after the liquidation is completed.

This type of situation was at issue in a case in the Sixth Circuit from 2004, *Specker Motor Sales Co. v. Eisen*. [1] In that case, the chapter 11 counsel had to disgorge part of the interim fees that were already paid when the case converted to a chapter 7 liquidation because the payment was more than his *pro rata* share of the administrative expenses. His fees dropped from $10,000 to $973.41. Other courts, including the U.S. Bankruptcy Court for the Northern District of California, have declined to disgorge funds in similar situations. [2]

Options for Early Payments for Bankruptcy Professionals

The average creditor's counsel likely will not have much issue getting payment from their client because payment is completely independent from what happens in the bankruptcy. Plans for reorganization can fail hopelessly, but you are still going to get paid.

For professionals who depend on the estate for payment, there is significant risk. To combat that risk, you may be able to use some of the following tools and tactics.

Retainers

Debtor's counsel and counsel for the debtor-in-possession (DIP) should get a sizable retainer up front that they can draw upon as the case continues. While this may deter some businesses from using your services, it ensures that you are not working for free — at least up to a certain amount. Although it is far less common, creditors' committee's counsel may also be able to receive a retainer. Nonetheless, that amount will still need to be approved by the court.

As we saw in *Specker*, however, a retainer may not help you keep that money in some situations. [3]

Interim Fee Applications

You can apply for "interim" fees under Bankruptcy Code § 331. To request interim fees, you must create and submit a fee application no more than every 120 days for the court's approval. While this process may seem tedious, it helps everyone in the case keep tabs on how much your administrative claim will be for purposes of developing a chapter 11 plan. Section 331 not only allows you to apply for fees, it also allows disbursement as well. If the fees are undisputed, you may be able to request a monthly (or other regular interval) payment from the debtor's ongoing operations if there are funds available.

Carve-Outs

Another common practice is to create a "carve-out" for administrative fees. These are helpful when you know that the debtor's assets a completely encumbered by a secured creditor. In a liquidation situation, if those encumbered assets sell for anything less than what is owed to the secured lender, then there is nothing left for administrative fees. A "carve out" is an agreement between the secured lender and the professional that subordinates the lender's secured claim to an administrative expense.

The parties can set this arrangement up however they would like. Common terms include caps on fees that are subject to the carve-out, restrictions on the types of fees that can be incurred, or who receives the fees (such as for an accountant or other professional). Technically speaking, a secured creditor has no obligation to agree to a carve-out, but from a practical standpoint, they often do, because they realize the value that the professional is providing to the bankruptcy estate as a whole. Setting up this arrangement may need to be one of your first tasks as a professional who is being paid from the bankruptcy estate.

"Other Professionals" Under § 327

The trustee, DIP and the creditors' committee are permitted to retain other professional persons to help them with various aspects of the case based on Bankruptcy Code §§ 327 and 1103. These professionals may be accountants, finance experts, tax specialists and more.

These nonattorney professionals are also approved by the court and paid through the estate. However, they are far less likely to understand or appreciate the fee-application process and realize that there is some risk in working for a debtor in bankruptcy. It is important to discuss these issues up front with the professionals to avoid potential conflict in the future.

Conclusion

There is always a great deal of risk in accepting a role that relies on payment from the bankruptcy estate. As young bankruptcy attorneys, you need to make sure that you understand and appreciate these risks. It is also important that any supervising partner who may not have bankruptcy experience is aware of this risk and the potential for a serious delay that may occur in receiving payment as well.

[1] 393 F.3d 659 (6th Cir. 2004).

[2] *In re Home Loan Serv. Corp.*, 533 B.R. 302 (Banrk. N.D. Cal. 2015).

[3] The court in *Specker* determined that disgorgement was mandatory, but that is the minority view. Most courts note that disgorgement is discretionary and decline to take that type of action.