

**MAR 21 2006**

**ORDERED PUBLISHED**

**HAROLD S. MARENUS, CLERK  
U.S. BKCY. APP. PANEL  
OF THE NINTH CIRCUIT**

**UNITED STATES BANKRUPTCY APPELLATE PANEL  
OF THE NINTH CIRCUIT**

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

In re:	)	BAP No. CC-05-1139-MoPaMa
	)	
DICK CEPEK, INC.,	)	Bk. No. LA 99-19373-EC
	)	
Debtor.	)	
_____	)	
RUS, MILIBAND & SMITH,	)	
APC,	)	
	)	
Appellant,	)	
	)	<b><u>O P I N I O N</u></b>
v.	)	
	)	
TIMOTHY J. YOO, Chapter 7	)	
Trustee; ANDELA CONSULTING,	)	
	)	
Appellees.	)	
_____	)	

Argued and Submitted on November 18, 2005  
at Los Angeles, California

Filed - March 21, 2006

Appeal from the United States Bankruptcy Court  
for the Central District of California

Honorable Ellen A. Carroll, Bankruptcy Judge, Presiding.

\_\_\_\_\_

Before: MONTALI, PAPPAS and MARLAR, Bankruptcy Judges.

1 MONTALI, Bankruptcy Judge:

2  
3 Following conversion of a case from Chapter 11 to Chapter 7,  
4 the bankruptcy court ordered debtor's Chapter 11 counsel to  
5 disgorge a portion of its pre-petition retainer in order to  
6 equalize payments among all chapter 11 administrative claimants  
7 pursuant to section 726(b).<sup>1</sup> The Chapter 11 counsel appealed. We  
8 hold that a professional with a valid prepetition security  
9 retainer that has been properly documented, disclosed and approved  
10 by the bankruptcy court cannot be required to surrender it in the  
11 interest of equal treatment under section 726(b). Because the  
12 bankruptcy court did not determine the validity of the "security"  
13 of the retainer at issue, we VACATE and REMAND.

14 **I.**  
15 **FACTS**

16 Dick Cepek, Inc. ("Debtor") retained Rus, Miliband & Smith,<sup>2</sup>  
17 a Professional Corporation ("Appellant") as its general bankruptcy  
18 counsel to represent it in a Chapter 11 case. Prior to  
19 bankruptcy, Appellant received a retainer from Debtor in the  
20 amount of \$84,955.85 (the "Retainer"). Debtor filed its Chapter  
21 11 case on March 12, 1999.

22 Appellant disclosed its receipt of the Retainer to the court,  
23 creditors and the United States Trustee when it filed and served  
24 its notice of employment application in April 1999 and when it

25 \_\_\_\_\_  
26 <sup>1</sup> Unless otherwise indicated, all chapter, section and rule  
27 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and  
28 to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as  
enacted and promulgated prior to the effective date of The  
Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,  
Pub. L. 109-8, Apr. 20, 2005, 119 Stat. 23.

<sup>2</sup> Appellant was formerly known as Rus, Miliband, Williams &  
Smith, a Professional Corporation.

1 filed and served its employment application in June 1999. Neither  
2 of these documents, nor Appellant's Rule 2014 statement of  
3 disinterestedness or its Rule 2016(b) disclosure filed with the  
4 bankruptcy court, stated that Appellant held a security interest  
5 in the Retainer or considered itself a secured creditor as a  
6 result of the Retainer. At oral argument, counsel for Appellant  
7 confirmed that Appellant and Debtor did not execute a written  
8 agreement defining the terms of Appellant's representation of  
9 Debtor in the bankruptcy case.

10 The United States Trustee stated that it had no objection to  
11 the application. On July 6, 1999, the bankruptcy court<sup>3</sup> entered  
12 an order approving the employment of Appellant as Debtor's general  
13 bankruptcy counsel. The order, stating that "it appearing that  
14 [Appellant] is a disinterested person," also specifically provided  
15 that Appellant could draw upon the Retainer in accordance with the  
16 "Office of the United States Trustee Guides."<sup>4</sup>

17 From March 1999 to July 1999, Appellant filed "Professional  
18 Fee Statements" for services it rendered during that time period.  
19 No objections were filed in response to the Fee Statements and  
20 Appellant withdrew the Retainer from its client trust account.

21 On November 24, 1999, Appellant filed its first interim fee  
22 application ("First Fee Application") requesting compensation in  
23 the amount of \$100,904.50 and costs in the amount of \$31,914.86.

24

25

---

26 <sup>3</sup> At the time Applicant's employment application was filed  
27 and granted, Bankruptcy Judge Lisa Hill Fenning presided over the  
case. The case was reassigned to Bankruptcy Judge Ellen Carroll  
on May 1, 2000.

28

<sup>4</sup> The Guide to Applications for Employment adopted by the  
United States Trustee's Office in the Central District of  
California allows professionals to draw down on retainers before  
submitting a fee application if they have followed the procedure  
set forth therein.

1 In paragraph D of the First Fee Application, Debtor noted that it  
2 had withdrawn the Retainer from its client trust account, but  
3 requested the court to authorize deduction of its allowed fees and  
4 costs "from the retainer funds on hand, to the extent such  
5 retainer funds are available or become available." In February  
6 2000, before the First Fee Application could be heard, the court  
7 converted the case to Chapter 7. Appellee Timothy J. Yoo was  
8 appointed as Chapter 7 trustee ("Trustee").

9 In January 2003, Appellant filed its second and final fee  
10 application incorporating its First Fee Application and requesting  
11 the same amounts sought in the First Fee Application. Appellant  
12 has not received any funds other than the Retainer on account of  
13 services rendered in the bankruptcy case.

14 Trustee filed a final report indicating that the estate was  
15 administratively insolvent at the Chapter 11 level. The court  
16 held a hearing on Trustee's final report and all final fee  
17 applications on December 7, 2004. Even though no Chapter 11  
18 professional or other party (including Trustee) argued that  
19 Appellant should disgorge its Retainer, the bankruptcy court sua  
20 sponte raised the issue of whether disgorgement of the Retainer  
21 was required under section 726(b) in order to equalize the  
22 percentage distribution to all Chapter 11 administrative  
23 claimants. The court granted Appellant additional time to brief  
24 the issue.

25 Appellant thereafter submitted a supplement arguing that the  
26 Retainer was a security retainer. In response, Trustee argued  
27 that if Appellant held a security interest in the Retainer, it was  
28 not "disinterested" as required by section 327(a) and potentially

1 all fees would have to be disgorged. Debtor replied that it had  
2 fully disclosed the existence of the Retainer and that the court  
3 had approved its employment as a disinterested person.

4 On February 8, 2005, the bankruptcy court held a continued  
5 hearing on the final fee applications; although it approved the  
6 applications (with adjustments), it reserved the disgorgement  
7 issue for further hearing. The court noted that if the Retainer  
8 provided Appellant with a security interest in the funds retained,  
9 Appellant would not be "disinterested" as required for employment  
10 under section 327 and all fees would be subject to disgorgement.  
11 The court said: "I am not persuaded by the firm's pleadings that,  
12 you know, that it had a security interest in it's [sic] [R]etainer  
13 . . . There's nothing in [Appellant's employment application] that  
14 says the firm is claiming a security interest in that [R]etainer."

15 On February 10, 2005, the bankruptcy court entered an order  
16 approving final compensation to Appellant in the amount of  
17 \$85,246.00 in fees and \$31,914.86 in costs. On February 18, 2005,  
18 the bankruptcy court held another hearing at which it ruled that  
19 Appellant would have to disgorge the Retainer. In so holding, the  
20 court relied extensively on Specker Motor Sales Co. v. Eisen, 393  
21 F.3d 659 (6th Cir. 2004), which held that Chapter 11 counsel had  
22 to disgorge interim fees (including those paid by retainer) to  
23 guarantee pro rata distribution to all Chapter 11 administrative  
24 claimants.

25 The record is unclear whether, in ordering disgorgement, the  
26 court found that Appellant held a security interest in the  
27 Retainer. Appellant contends that the court did find that it held  
28 a security interest in the Retainer, while Trustee disagrees. At

1 the February 18 hearing, the court repeated its concern that by  
2 claiming a security interest in the Retainer, Appellant was no  
3 longer a "disinterested" person for the purposes of section 327  
4 and that all of its fees would be subject to disgorgement. Later  
5 in the hearing, however, the court dodged the issue of whether  
6 Appellant held a security interest in the Retainer which would  
7 have disqualified it as a "disinterested" professional, stating "I  
8 don't want to go there." The court also noted that the Specker  
9 decision supported disgorgement even if the fees were paid from a  
10 security retainer.

11 At the same hearing, the court made other statements which  
12 could be construed as a finding in favor of Appellant on this  
13 issue. For example, the court acknowledged Appellant's position  
14 that "it had a security interest in the retainer, which it in fact  
15 did appear to have . . ." and described the Retainer "as is the  
16 case here what is known as a security retainer."

17 On March 31, 2005, the bankruptcy court entered its order  
18 requiring Appellant to disgorge to Trustee \$54,236 of its Retainer  
19 (the "Disgorgement Order"). To add to the uncertainty whether  
20 the court found that Appellant had a security interest in the  
21 Retainer, the form of order submitted by Trustee referred to  
22 disgorgement of the "security retainer," but the court struck out  
23 the term "security." The court also entered an order granting a  
24 stay pending appeal of the Disgorgement Order. Appellant filed a  
25 timely notice of appeal on April 8, 2005.

26  
27  
28

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

**II.  
ISSUES**

1. 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)?

2. If so, did Appellant hold a security interest in the Retainer?

**III.  
STANDARD OF REVIEW**

This appeal presents primarily a question of law which we review de novo. County of El Dorado v. Crouch (In re Crouch), 199 B.R. 690, 691 (9th Cir. BAP 1996).

**IV.  
JURISDICTION**

Jurisdictional issues may be raised by us sua sponte. See Vylene Enters., Inc. v. Naugles, Inc. (In re Vylene Enters., Inc.), 968 F.2d 887, 889 (9th Cir. 1992). In determining if it has jurisdiction, a federal court examines whether the parties have standing, the case or controversy is ripe, or the issue is moot. Lee v. State of Oregon, 107 F.3d 1382, 1387 (9th Cir. 1997). “[J]usticiability requires that a dispute be ripe and present and actual controversy.” Menk v. Lapaglia (In re Menk), 241 B.R. 896, 905 (9th Cir. BAP 1999). Here, in light of our reversing the bankruptcy court’s legal conclusion while remanding for further factual findings, we must determine whether this appeal presents a justiciable issue under American State Bank v. Marks (In re MacNeil), 907 F.2d 903 (9th Cir. 1990).

In MacNeil, the Ninth Circuit held that a bankruptcy court

1 and BAP erred in holding that Chapter 7 administrative expenses  
2 are entitled to priority over Chapter 11 superpriority claims  
3 before deciding whether the claimant held a Chapter 11  
4 superpriority claim in the first place. The Ninth Circuit vacated  
5 the legal holding and remanded for the factual determination. In  
6 so doing, the panel concluded that the bankruptcy court and BAP  
7 had issued an "advisory opinion." Id. at 904. In reaching our  
8 conclusion today we have determined that we are not rendering an  
9 advisory opinion, that addressing the merits of the section 726(b)  
10 issue is appropriate, and that MacNeil no longer prohibits us from  
11 doing so.

12 The MacNeil majority held that the legal issue was not ripe  
13 for determination. As noted by the dissent in MacNeil, however,  
14 the majority confused "ordering of the issues" for resolution with  
15 ripeness and justiciability. The majority engaged in a  
16 "hyperbolic invocation[] of Article III limits to explain a  
17 common-sense refusal to decide issues that have not yet become  
18 germane in purely private litigation." 13A Charles Alan Wright et  
19 al., Federal Practice and Procedure § 3532.1 (2005 Supp.) (not  
20 addressing MacNeil specifically, but discussing misapplication of  
21 the ripeness doctrine in general by courts). Both the bankruptcy  
22 court and BAP in MacNeil were faced with a live controversy  
23 between two litigants and they resolved that controversy as a  
24 matter of law without addressing factual issues that, given the  
25 holding, were irrelevant. Courts regularly resolve cases and  
26 controversies as a matter of law without addressing factual issues  
27 within the context of Rule 56 motions for summary judgment and  
28 Rule 12(b) motions to dismiss. Otherwise, deferring resolution of



1 a dispositive legal issue just to hear and decide possibly  
2 irrelevant factual issues results in the same harm that the  
3 ripeness doctrine is designed to prevent: the court is futilely  
4 deciding unnecessary issues. It is answering questions that do  
5 not actually require answering.

6 More recent Supreme Court and Ninth Circuit decisions apply a  
7 more flexible standard of ripeness than did the MacNeil majority.  
8 Determining whether an issue is ripe for judicial review requires  
9 a court "to evaluate (1) the fitness of issues for judicial  
10 decision and (2) the hardship to the parties of withholding court  
11 consideration." National Park Hospitality Ass'n v. Department of  
12 Interior, 538 U.S. 803, 808 (2003); United States v. Braren, 338  
13 F.3d 971, 975 (9th Cir. 2003). Here, the bankruptcy court's  
14 holding that section 726(b) applies to Appellant's Retainer  
15 whether or not it was secured is fit for review. The court erred  
16 as a matter of law and its holding has been "felt in a concrete  
17 way" by Appellant. National Park Hospitality, 538 U.S. at 807.  
18 Moreover, withholding review of the court's erroneous legal  
19 conclusion would result in a significant hardship and waste of  
20 resources of Appellant, Trustee, and the judicial system. If we  
21 simply remanded for a factual determination of whether the  
22 Retainer is secured, a significant likelihood exists that the  
23 legal error will be repeated and the parties will return to an  
24 appellate court with the same issue. Refusing to decide the issue  
25 on the grounds of ripeness is inappropriate.

26 **V.**  
27 **DISCUSSION**

28 This appeal presents an issue of first impression for the

1 panel: can a bankruptcy court force a Chapter 11 administrative  
2 claimant to disgorge fees drawn from a prepetition retainer in  
3 which it holds a security interest in order to equalize the  
4 proportion of distributions to all Chapter 11 administrative  
5 claimants under section 726(b)? For the reasons set forth below,  
6 we believe that the bankruptcy court erred in concluding that it  
7 can.

8  
9 A. A Retainer is Not Subject to Disgorgement if the Claimant  
10 Holds a Security Interest in It

11 Before representing a debtor in a Chapter 11 case, counsel  
12 often require a retainer. In general, three types of retainers  
13 exist: (1) classic or true retainers, (2) security retainers, and  
14 (3) advance payment retainers. In re Montgomery Drilling Co., 121  
15 B.R. 32, 37 (Bankr. E.D. Cal. 1990), citing In re McDonald Bros.  
16 Constr., Inc., 114 B.R. 989, 997-1002 (Bankr. N.D. Ill. 1990).<sup>5</sup>

17 A security retainer is generally held as security for payment  
18 of fees for future services to be rendered by the attorney.  
19 Montgomery Drilling, 121 B.R. at 38. The retainer remains  
20 property of the client (in this case, the estate) until the  
21 attorney applies it to charges for services actually rendered.  
22 Any unearned funds are returned to the client. Id.; see also  
23 3 Collier on Bankruptcy ¶ 328.02[3][b][i] (15th ed. 2005).

24 Appellant claims that the Retainer here is a security retainer and  
25

---

26 <sup>5</sup> Classic retainers “refer to the payment of a sum of money  
27 to secure availability over a period of time.” Montgomery  
Drilling, 121 B.R. at 37. The attorney is entitled to the  
28 retainer whether or not services are needed. Id. The advance  
payment retainer occurs when a client pre-pays for expected  
services; ownership of the funds in the retainer is intended to  
pass to the attorney at the time of payment, although California  
law is unclear whether ownership does indeed pass at that time.  
Id. at 38.

1 that it held a secured interest in the funds in the Retainer. If  
2 that is true, section 726(b) would not apply.

3 Section 726(b) provides that payments specified in certain  
4 paragraphs of section 507 (including administrative claims) "shall  
5 be made pro rata" among claims of a kind specified in a particular  
6 paragraph, except that following conversion to Chapter 7, Chapter  
7 7 administrative claimants shall have priority over other  
8 administrative claimants. See 11 U.S.C. § 726(b) (emphasis  
9 added).<sup>6</sup> To achieve pro rata distribution among a class of  
10 claimants, a court can order those claimants who have received  
11 payment during the course of a case to disgorge whatever amount is  
12 necessary to equalize the percentage of payments among all  
13 creditors in that class. Shaia v. Durette, Irvin, Lemons &  
14 Bradshaw, P.C. (In re Metropolitan Elec. Supply Corp.), 185 B.R.  
15 505, 509-10 (Bankr. E.D. Va. 1995) (collecting cases at footnote  
16 4).

17 Before a court applies section 726(b), property of the debtor  
18 must be administered and reduced to cash. To the extent a party  
19 has a valid lien on property that was used to produce the cash for  
20 the estate, that lien is paid first from the proceeds of the  
21 liquidation of that property. United States v. Fed. Deposit Ins.

22  
23 <sup>6</sup> Section 726(b) provides:

24 Payment on claims of a kind specified in paragraph (1),  
25 (2), (3), (4), (5), (6), (7), or (8) of section 507(a)  
26 of this title, or in paragraph (2), (3), (4), or (5) of  
27 subsection (a) of this section, shall be made pro rata  
28 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.

1 Corp., 899 F. Supp. 50, 54 (D. R.I. 1995) ("Federal bankruptcy law  
2 provides that if the property managed by the receiver [trustee] is  
3 sold to pay debts, the proceeds of the sale are used first to  
4 satisfy valid liens on the property, next for any exemptions the  
5 debtor may claim, and finally to pay claims enumerated in  
6 [section] 726."); Waldschmidt v. Comm'r of I.R.S. (In re  
7 Lambdin), 33 B.R. 11, 13 (Bankr. M.D. Tenn. 1983).

8       The remaining funds from the liquidation of that property are  
9 distributed to the debtor to the extent he or she has claimed an  
10 exemption in it.<sup>7</sup> Lambdin, 33 B.R. at 13. Only the excess  
11 remaining after satisfaction of the lien and the exemption is  
12 available to pay claims against the estate in accordance with  
13 section 726. Id.; see also In re Am. Resources Management Corp.,  
14 51 B.R. 713, 719 (Bankr. D. Utah 1985) ("As a general rule,  
15 expenses of administration must be satisfied from assets of the  
16 estate not subject to liens. . . . Only surplus proceeds are  
17 available for distribution to creditors of the estate and  
18 administrative claimants. Therefore, absent equity in the  
19 collateral, administrative claimants cannot look to encumbered  
20 property to provide a source of payment for their claims.")  
21 (emphasis added). Consequently, before section 726(b) is even  
22 implicated, all amounts secured by the lien created by the  
23 security retainer must be paid. Because these amounts must be  
24 paid before section 726 distributions commence, disgorgement  
25 solely on the basis of section 726(b) is impermissible.<sup>8</sup>

26 \_\_\_\_\_  
27       <sup>7</sup> Inasmuch as Debtor is a corporation, it is not entitled to  
28 any exemption. 11 U.S.C. § 522(b) ("individual debtor" may claim  
exemptions).

<sup>8</sup> Of course, the court may, in the exercise of its  
discretion, order disgorgement or turnover for other reasons,  
including (but not limited to) instances when a professional has  
(continued...)

1 Applying similar reasoning, most of the courts addressing the  
2 issue of whether a security retainer must be disgorged in order to  
3 equalize distributions among Chapter 11 administrative claimants  
4 have held that the security retainer is protected from  
5 disgorgement. For example, in In re Burnside Steel Foundary Co.,  
6 90 B.R. 942, 944 (Bankr. N.D. Ill. 1988), the court held that a  
7 retainer is not subject to the provisions of section 726(b)  
8 because “[section] 726 only affects distribution priorities among  
9 holders of unsecured claims, and an attorney with a retainer is,  
10 to the extent of the retainer, the holder of a secured claim.”  
11 Burnside, 90 B.R. at 944. Similarly, the court in In re Zukoski,  
12 237 B.R. 194, 198 (Bankr. M.D. Fla. 1998), held that if a case is  
13 converted to Chapter 7 from Chapter 11, a security interest in a  
14 retainer allows a Chapter 11 professional to “avoid the  
15 subordination provisions of [s]ection 726(b) to the extent that  
16 services were provided and approved by the bankruptcy court.” The  
17 court explained:

18 The rationale for this result is simple. A prepetition  
19 retainer taken by a debtor’s lawyer generally is  
20 intended to secure future payment of fees awarded by the  
21 court. The debtor’s attorney becomes a secured creditor  
22 by taking possession of the prepetition retainer.  
23 Section 726(b), however, only affects the distribution  
24 priorities between unsecured claims because Section 507  
25 only establishes priorities between unsecured creditors.  
26 As such, Section 726(b) has no application because the  
27 attorney holds a secured claim in the prepetition  
28 retainer to the extent the fees are allowed by the  
29 court.

30 Id. at 198 (internal citations omitted).

---

31 <sup>8</sup>(...continued)  
32 not provided services commensurate with the retainer or has not  
33 properly disclosed the secured interest in the retainer. Cf.  
34 Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park-Helena  
35 Corp.), 63 F.3d 877, 881-82 (9th Cir. 1995) (holding that it was  
36 not an abuse of discretion for a bankruptcy court to deny all  
37 compensation to chapter 11 debtor’s attorneys who failed to  
38 disclose relevant information about source of a retainer).

1 Other courts have held that a professional holding a security  
2 retainer "shall not be required to share [it] with other  
3 administrative claimants." Weinman, Cohen & Niebrugge, P.C. v.  
4 Peters (In re Printcrafters, Inc.), 233 B.R. 113, 120 (D. Colo.  
5 1999); see also Commonwealth of Pa. v. Cunningham & Chernicoff,  
6 P.C. (In re Pannebaker Custom Cabinet Corp.), 198 B.R. 453, 460  
7 (Bankr. M.D. Pa. 1996) (prepetition security retainer was not  
8 subject to disgorgement simply to obtain parity among  
9 administrative claimants where funds were insufficient to pay  
10 administrative claimants in full, absent evidence of excessive or  
11 unreasonable nature of retainer); In re North Bay Tractor, Inc.,  
12 191 B.R. 186, 188 (Bankr N.D. Cal. 1996) (rejecting argument "that  
13 since retainer is property of the estate, attorney must disgorge  
14 [it] so that other claimants of equal priority receive equal  
15 dividends" because "such a rule would undermine the purpose of  
16 retainers and chill the willingness of many professionals to  
17 undertake representation of Chapter 11 debtors") (emphasis added);  
18 In re Printing Dimensions, Inc., 153 B.R. 715, 719 (Bankr. D. Md.  
19 1993) (counsel "will not be required to share a prepetition  
20 retainer pro rata with other administrative claimants, where  
21 either the retainer is treated as security or the retainer is held  
22 in trust").

23 In deciding to order disgorgement of Appellant's Retainer,  
24 the bankruptcy court relied on the Sixth Circuit's decision in  
25 Specker Motor Sales, 393 F.3d at 659, and on the published  
26 decisions of the bankruptcy court and the district court in the  
27 same case. In re Specker Motor Sales Co., 289 B.R. 870 (Bankr.  
28 W.D. Mich. 2003), aff'd, 300 B.R. 697 (W.D. Mich. 2003). While

1 the end result of the Specker decisions was that an attorney had  
2 to disgorge his retainer in order to achieve pro rata distribution  
3 to administrative claimants under section 726, the courts never  
4 considered the nature of the security interest held by the  
5 attorney in the retainer. We do not find any of the Specker cases  
6 to be persuasive because none of them squarely addressed and  
7 analyzed the issue presented here: whether a security retainer can  
8 be used in an effort to equalize distribution percentages under  
9 section 726(b).

10 Rather, all three cases focused entirely on a separate issue:  
11 whether disgorgement of amounts paid is discretionary or mandatory  
12 under section 726(b). Previously, the Bankruptcy Appellate Panel  
13 for the Sixth Circuit had held that bankruptcy courts have the  
14 discretion to order (or not) under section 726(b) disgorgement of  
15 fees allowed and paid on an interim basis. See United States v.  
16 Schottstein, Zox & Dunn (In re Unitcast, Inc.), 219 B.R. 741 (6th  
17 Cir. BAP 1998). The Specker court overruled Unitcast, holding  
18 that disgorgement was mandatory under section 726; otherwise, a  
19 "super-category" above the hierarchy of 507(a) would be created.  
20 Specker, 393 F.3d at 664.

21 The Sixth Circuit's only mention of retainers in its decision  
22 was that they are subject to re-examination and adjustment as they  
23 "are held in trust for the estate, and remain property of the  
24 estate."<sup>9</sup> Id. at 663. Neither the Sixth Circuit (nor the

---

26 <sup>9</sup> In In re US Flow Corp., 332 B.R. 792, 795 n.7 (Bankr. W.D.  
27 Mich. 2005), the court noted another possible distinction between  
28 Specker and the case here. In Specker, the Sixth Circuit stated  
that after the petition date, the bankruptcy court authorized the  
employment of counsel "[a]t that time" the attorney received his  
retainer. In other words, the Sixth Circuit indicates that the  
retainer was postpetition, not prepetition (although, as the US  
Flow court notes, the record shows that the retainer was paid  
prepetition). To the extent the Sixth Circuit's decision is based

(continued...)

1 district court nor the bankruptcy court) considered the issue of  
2 whether the professional held a security interest in the retainer  
3 funds thereby protecting the retainer from section 726(b)  
4 disgorgement. For this reason, we will not follow Specker but  
5 will follow the line of cases cited above that do address this  
6 issue squarely. We hold that prepetition security retainers are  
7 not subject to disgorgement simply to achieve equal distribution  
8 among similar creditors under section 726(b).

9  
10 B. Did Appellant Hold a Security Interest in the Retainer?

11  
12 Having concluded that valid security retainers are not  
13 subject to section 726(b) disgorgement, we now face the issue of  
14 whether Appellant held such a security retainer. As noted, it  
15 appears from the record that the bankruptcy court did not resolve  
16 this issue, having concluded that Specker applied whether or not  
17 the Retainer was a security retainer.

18 Appellant argues that as a matter of law, it is a secured  
19 creditor in the amount of the Retainer by virtue of Appellant's  
20 possession and retention of the Retainer funds. There is ample  
21 law to support Appellant's position. As noted by Collier on  
22 Bankruptcy:

23 With respect to "secured" retainers, courts generally  
24 hold that a professional with such a prepetition  
25 retainer is a "secured creditor" and has a security  
26 interest in the retainer, noting that the professionals  
27 receiving prepetition retainers to insure payments of  
28 fees to be earned in the chapter 11 case (or  
postpetition retainers authorized by the court) become  
secured creditors by virtue of a possessory interest in

---

<sup>9</sup>(...continued)

on an assumption that the retainer was postpetition, however, it  
is further distinguishable from this case and all of the cases  
holding that prepetition security retainers are not subject to  
section 726(b) disgorgement.



1 cash. The professional's status as a secured creditor  
2 by virtue of the retainer does not disqualify the  
3 professional from being retained by the estate as  
4 required by section 327 of the Code.

5 3 Collier on Bankruptcy ¶ 328.02[4] (emphasis added and internal  
6 footnotes omitted), citing In re K & R Mining, Inc., 105 B.R. 394,  
7 397-98 (Bankr. N.D. Ohio) (attorney "possesses a security interest  
8 in the retainer to secure payment of its attorney's fees and  
9 expenses;" attorney is not disqualified as "not disinterested"  
10 merely because it holds a security interest in the retainer  
11 funds)<sup>10</sup>; Burnside, 90 B.R. at 944 (attorney "who receives a

---

12 <sup>10</sup> Even though section 328 specifically allows an estate  
13 professional to be employed on a retainer, the bankruptcy court  
14 here expressed concern that retention of a security retainer would  
15 render Appellant "not disinterested" under section 327, thus  
16 disqualifying it. We disagree for two reasons. First, the court  
17 already found that Appellant appeared to be disinterested.  
18 Second, holding a security retainer does not per se disqualify  
19 Appellant. A "creditor" is not "disinterested." See 11 U.S.C.  
20 § 101(14). But retention of a security interest to secure payment  
21 of fees not yet incurred does not render a professional a  
22 "creditor." All professionals become "creditors" when they  
23 perform services for which the estate must pay. When the services  
24 are performed, the professional is not thereupon disqualified as  
25 not disinterested. The fact that the professional holds a  
26 security retainer is irrelevant in determining whether it is a  
27 creditor. As noted by the First Circuit:

28 At first blush, [section 327] would seem to foreclose  
the employment of an attorney who is in any respect a  
"creditor." But, such a literalistic reading 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

(continued...)

1 prepetition retainer to insure payment of fees to be earned in the  
2 Chapter 11 case . . . becomes a secured creditor, secured by a  
3 possessory security interest in cash”).

4 California law is consistent with Collier and this case law.  
5 In In re GOCO Realty Fund I, 151 B.R. 241, 252 (Bankr. N.D. Cal.  
6 1993), the court held that a security retainer is property of the  
7 estate, but that a professional holding such a retainer “has a  
8 validly perfected security interest in the funds in his  
9 possession.” The attorney “perfects a security interest in money  
10 by taking possession of the funds” as permitted by the Uniform  
11 Commercial Code. Id. at 251.

12 We agree with Printcrafters and the other case law cited  
13 above that a professional holding a security interest in a  
14 prepetition retainer cannot be forced to share that retainer with  
15 other administrative claimants solely to achieve pro rata  
16 distribution under section 726(b). We also agree with Collier and  
17 K & R Mining that retention of a security retainer by an estate  
18 professional does not per se disqualify the professional as not  
19 “disinterested” under section 327, but we recognize that the  
20 inquiry into whether the professional holds interests adverse to  
21 the estate, is disinterested or otherwise is impaired by conflict  
22 of interest (actual or potential) is necessarily case- and fact-  
23 specific.

24  
25

26 <sup>10</sup>(...continued)  
27 regard to the charges endemic to current and future  
28 representation.

28 In re Martin, 817 F.2d 175, 180 (1st Cir. 1987) (footnote  
omitted).

1 There must be at a minimum full and timely disclosure of  
2 the details of any given arrangement. Armed with  
3 knowledge of all of the relevant facts, the bankruptcy  
4 court must determine, case by case, whether the security  
5 interest coveted by counsel can be tolerated under the  
6 particular circumstances. In so doing, the court should  
7 consider the full panoply of events and elements: the  
8 reasonableness of the arrangement and whether it was  
9 negotiated in good faith, whether the security demanded  
10 was commensurate with the predictable magnitude and  
11 value of the foreseeable services, whether it was a  
12 needed means of ensuring the engagement of competent  
13 counsel, and whether or not there are telltale signs of  
14 overreaching. The nature and extent of the conflict  
15 must be assayed, along with the likelihood that a  
16 potential conflict might turn into an actual one. An  
17 effort should be made to measure the influence the  
18 putative conflict may have in subsequent decisionmaking.  
19 Perceptions are important; how the matter likely appears  
20 to creditors and to other parties in legitimate interest  
21 should be taken into account. There are other salient  
22 factors as well: whether the existence of the security  
23 interest threatens to hinder or to delay the  
24 effectuation of a plan, whether it is (or could be  
25 perceived as) an impediment to reorganization, and  
26 whether the fundamental fairness of the proceedings  
27 might be unduly jeopardized (either by the actuality of  
28 the arrangement or by the reasonable public perception  
of it).

16 Martin, 817 F.2d at 182.

17 Prudence, ethical considerations and general proof  
18 requirements all suggest that an arrangement whereby a  
19 professional is granted a security interest in a debtor's funds be  
20 adequately documented. The Bankruptcy Code and Rules require full  
21 disclosure of all interests held by a professional who seeks  
22 employment on behalf of the estate. If a professional holds a  
23 secured interest in assets of the estate, that security interest  
24 must be disclosed. Here, the bankruptcy court must decide if  
25 Appellant made an adequate disclosure of its secured interest in  
26 the Retainer. It must further decide whether there is adequate  
27 evidence in the record to show under state law that Debtor granted  
28 Appellant an enforceable security interest in the funds. The

1 bankruptcy court is in a better position to make these and any  
2 other necessary factual findings. We therefore REMAND for a  
3 determination of whether Appellant holds a valid security  
4 retainer; if so, the Retainer is not subject to disgorgement under  
5 section 726(b).

6  
7  
8 **VI.**  
9 **CONCLUSION**

10 For the foregoing reasons, we hold that security retainers  
11 are not subject to disgorgement under section 726(b) of the  
12 Bankruptcy Code. We therefore VACATE and REMAND for a  
13 determination of whether Appellant holds such a security retainer.

14 PAPPAS, Bankruptcy Judge, concurring:

15  
16 I concur with the analysis and reasoning in the Panel's  
17 opinion. I write separately to acknowledge the genuine concerns  
18 expressed in the dissent about the potential for problems and  
19 policy implications of allowing chapter 11 debtors to grant their  
20 attorneys a secured interest in their cash assets as a condition  
21 of employment in bankruptcy cases. To be sure, I am no fan of  
22 secured professional employment arrangements, having shunned them  
23 on occasion when proposed. As a general rule, it may be  
24 profoundly unwise for a bankruptcy court to allow an attorney the  
25 leverage inherent in a security interest in funds given by the  
26 chapter 11 debtor as a retainer. When that is the case, the  
27 bankruptcy judge may and should reject such an arrangement.

28 But that said, I see no per se prohibition on such agreements

1 under the Bankruptcy Code, and I do not believe we in the majority  
2 "turn our backs on a clear Congressional statutory mandate . . . ."  
3 To the contrary, Congress' supposed condemnation of secured  
4 retainers is far from "clear." Instead, Congress has instructed  
5 that a bankruptcy court may authorize a chapter 11 debtor to retain  
6 counsel "on any reasonable terms and conditions of employment,  
7 including a retainer . . . ." 11 U.S.C. § 328(a) (emphasis added).  
8 But this provision confers no unfettered authority on the debtor  
9 and its lawyer. All significant terms of a professional's  
10 employment by a chapter 11 debtor, whether they include security or  
11 not, are subject to full disclosure and prior court approval after  
12 evaluation by the presiding bankruptcy judge. 11 U.S.C. § 327(a);  
13 Fed. R. Bankr. P. 2014(a). Even if the arrangement is approved,  
14 all fees secured by the attorney's lien must be reasonable in  
15 amount, and are subject to further review and approval by the  
16 court. 11 U.S.C. § 330(a)(1)(A). Finally, "if such [employment  
17 terms] prove to have been improvident in light of developments not  
18 capable of being anticipated at the time of the fixing of such  
19 terms and conditions . . . , " the arrangement can be scrapped by  
20 the bankruptcy court. 11 U.S.C. § 328(a).

21 I agree with the dissent that a professional's decision to  
22 require a secured retainer may lead it to encounter difficult  
23 ethical decisions, and potentially may develop into "an interest  
24 materially adverse to the interest of the estate" such that the  
25 professional risks disqualification, and even loss of compensation,  
26 later in the case. 11 U.S.C. § 101(14)(E). But whether the  
27 potential costs associated with future adverse interests outweighs  
28 the possible benefits from such an employment relationship is, in

1 the first instance, for the attorney and chapter 11 debtor to  
2 decide. If a secured retainer seems a reasonable and necessary  
3 step to counsel and client, the proposal must yet pass muster  
4 before the bankruptcy court. But if a secured retainer  
5 arrangement clears all these hurdles, I think Congress intended  
6 that the professional's status be respected as against the claims  
7 of unsecured claimants.

8  
9

10 MARLAR, Bankruptcy Judge, dissenting:

11

12 I must respectfully dissent.

13 The majority's premise is that an insolvent chapter 11  
14 debtor's counsel's security retainer is tenable under the Code in  
15 the first place. It is with this fundamental view that I disagree.

16 Congress did not intend for chapter 11 professionals  
17 (especially the debtor's counsel) to favor themselves over other  
18 professionals by obtaining employment as a "secured" creditor and  
19 thereby bootstrapping an alleged superpriority for themselves.

20 One of the Code's fundamental concepts is "equitable  
21 distribution." "Bankruptcy law accomplishes equitable distribution  
22 through a distinctive form of collective proceeding. This is a  
23 unique contribution of the Bankruptcy Code that makes bankruptcy  
24 different from a collection of actions by individual creditors."  
25 Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198, 1203 (9th  
26 Cir. 2005), cert. denied, 126 S. Ct. 397 (2005).

27 Notwithstanding this well-settled principle, the opinion in  
28 this case elevates normal state law concepts for obtaining a

1 "secured" retainer above the bankruptcy scheme. In so doing, the  
2 majority alters the long-established statutory and case-law  
3 authority which, for generations, has adhered to the fundamental  
4 precepts of bankruptcy's equality principles.

5 For an attorney seeking fees, the principle of equitable  
6 distribution begins with Section 327 compliance. The Supreme Court  
7 has stated that "[t]he plain meaning of legislation should be  
8 conclusive, except in the 'rare cases [in which] the literal  
9 application of a statute will produce a result demonstrably at odds  
10 with the intentions of its drafters.'" United States v. Ron Pair  
11 Enters., 489 U.S. 235, 242 (1989) (alteration in original)  
12 (citation omitted).

13 Section 327(a) provides that a debtor in possession, "with the  
14 court's approval, may employ one or more attorneys . . . that do  
15 not hold or represent an interest adverse to the estate, and that  
16 are disinterested persons . . . ." 11 U.S.C. § 327(a). See Movitz  
17 v. Baker (In re Triple Star Welding, Inc.), 324 B.R. 778, 790 (9th  
18 Cir. BAP 2005) (valid employment under § 327(a) is a prerequisite  
19 to compensation). A "'disinterested person' means [a] person that  
20 --(A) is not a creditor, an equity security holder, or an insider;  
21 . . . and . . . (E) does not have an interest materially adverse to  
22 the interest of the estate or of any class of creditors or equity  
23 security holders, by reason of any direct or indirect relationship  
24 to, connection with, or interest in, the debtor . . . or for any  
25 other reason[" 11 U.S.C. § 101(14) (emphasis added).

26 A "creditor" is an "entity that has a claim against the debtor  
27 that arose at the time of or before the order for relief concerning  
28 the debtor[" 11 U.S.C. § 101(10).

1           Clearly, under Section 327(a), an attorney who receives a  
2 prepetition security retainer, and who becomes a "secured creditor"  
3 pursuant to state law, is not "disinterested" under the Code's  
4 plain terms. See In re Lackawanna Med. Group, P.C., 323 B.R. 626,  
5 630 (Bankr. M.D. Pa. 2004).

6           If, as here, a bankruptcy court has determined such an  
7 attorney to be disinterested initially, it may revisit the issue,  
8 for the Section 327(a) requirements apply not only at the time of  
9 retention but also throughout the case. See Sec. Pac. Bank Wash.  
10 v. Steinberg (In re Westwood Shake & Shingle, Inc.), 971 F.2d 387,  
11 391 (9th Cir. 1992) (Section 327 orders are preliminary and not  
12 conclusive due to the bankruptcy judge's continuing supervision);  
13 In re Plaza Hotel Corp., 111 B.R. 882, 891 (Bankr. E.D. Cal. 1990),  
14 aff'd mem., 123 B.R. 466 (9th Cir. BAP 1990) (bankruptcy court may  
15 revisit issues such as conflicts whenever appropriate). See also §  
16 328(c) (court may deny compensation "if, at any time during such  
17 professional person's employment under section 327 . . . such  
18 professional person is not a disinterested person . . . .").

19           Thus, even assuming, arguendo, that the disinterestedness  
20 component is not implicated per se upon an attorney's retention of  
21 a prepetition security retainer, it definitely arises when a case  
22 is converted from chapter 11 to chapter 7. Section 726(b) provides  
23 that the chapter 7 administrative expenses have a priority of  
24 payment over the chapter 11 administrative expenses. If the  
25 chapter 7 estate cannot pay all chapter 11 administrative expenses  
26 in full, they are then paid pro rata. It is illogical to pretend  
27 that a professional who enjoys a preferred security interest in the  
28 retainer received--above all other professionals in the chapter 11



1 or any chapter 7 case which follows--is "disinterested."

2 In addition to the disinterestedness requirement, the Code  
3 attempts to treat claimants of the same class equally. Chapter 11  
4 debtors' attorneys must apply for and obtain approval of their fees  
5 under Section 330, notwithstanding the existence of a retainer  
6 agreement or attorney's lien. See DeRonde v. Shirley (In re  
7 Shirley), 134 B.R. 940, 943 (9th Cir. BAP 1992) ("Court approval of  
8 the employment of counsel for a debtor in possession is *sine qua*  
9 *non* to counsel getting paid."); Lamie v. United States Trustee, 540  
10 U.S. 526, 537-39 (2004) (chapter 7 debtor's attorney must be  
11 employed under § 327 in order to be compensated from the estate  
12 under § 330); Shapiro Buchman LLP v. Gore Bros. (In re Monument  
13 Auto Detail, Inc.), 226 B.R. 219, 224 (9th Cir. BAP 1998); 3  
14 Collier on Bankruptcy ¶ 330.02[1][c], at 330-9 (15th ed. rev. 2005)  
15 ("Absent compliance with the Code or Bankruptcy Rules, there is no  
16 right to compensation.").

17 When their fees are approved, attorneys thereby become  
18 administrative claimants. See § 503(b)(2). Thus, although a  
19 "retainer" may be authorized under § 328(a), a "security retainer,"  
20 which elevates the attorney to the level of a "secured creditor,"  
21 is inconsistent with § 330.<sup>11</sup> Furthermore, Section 330 does not  
22 expressly grant an attorney holding a security retainer a

---

23  
24 <sup>11</sup> Several courts have opined that § 330 trumps nonbankruptcy  
25 law in other contexts. For example, in Monument Auto Detail, we  
26 held that "the Code and Rules preclude fee awards for services  
27 performed on behalf of a bankruptcy estate based on state law  
28 theories not provided for by the Code, such as quantum meruit."  
Monument Auto Detail, 226 B.R. at 224. Another court has held  
that "bankruptcy policy must hold sway over the policies of the  
Federal Arbitration Act as to disputes involving § 327 through  
§ 330." Home Express, Inc. v. Alamo Group, LLC (In re Home  
Express, Inc.), 226 B.R. 657, 659 (Bankr. N.D. Cal. 1998).

1 superpriority, and therefore such attorney is on a par with all  
2 other chapter 11 administrative claimants.

3 Which brings us once again to Section 726, the Code's  
4 distribution priority scheme. This statute provides superpriority  
5 status only for the so-called "burial expenses" incurred in the  
6 administration of the superseding chapter 7 case in order to  
7 encourage trustees and other professionals to participate in the  
8 liquidation and maximize the benefit for creditors of the estate.  
9 In re Hers Cosmetics Corp., 114 B.R. 240, 246 (Bankr. C.D. Cal.  
10 1990); § 726(b). It cannot be reconciled that the Code's priority  
11 scheme is meant to do more than it does. In a case converted from  
12 chapter 11 to chapter 7, that scheme (§ 726(b)) gives first  
13 priority to chapter 7 administrative expenses, then to chapter 11  
14 administrative expenses, and then to the other creditors. Each  
15 group shares pro rata unless there is enough cash to pay each group  
16 in full. Nowhere does the Code imply that a chapter 11 debtor's  
17 counsel may receive a different and preferred treatment.

18 This equality-of-treatment philosophy has prevailed even where  
19 creditors have actually held superpriority administrative claims  
20 but have been subordinated to the Section 726(b) scheme. See  
21 Temecula v. LPM Corp. (In re LPM Corp.), 300 F.3d 1134, 1138 (9th  
22 Cir. 2002) ("Although Congress gave post-chapter 11 rent  
23 administrative priority in chapter 11 proceedings, it did not  
24 authorize super-priority over other administrative expenses in the  
25 event the case is converted to a chapter 7. To the contrary,  
26 Section 726(b) gives Chapter 7 administrative claims priority over  
27 Chapter 11 administrative claims."); Citibank, N.A. v. Transam.  
28 Commercial Fin. Corp. (In re Sun Runner Marine, Inc.), 134 B.R. 4,

1 6 (9th Cir. BAP 1991) (a superpriority claim granted for lack of  
2 adequate protection was necessarily an administrative expense  
3 claim, and did not take priority over chapter 7 administrative  
4 expenses, pursuant to § 726(b)).

5 I have no quarrel with California's concept of security  
6 retainers within the boundaries of California law and the usual  
7 two-party dispute regimen. But state law must take a back seat to  
8 federal law. The Supreme Court has held that the bankruptcy  
9 court's jurisdiction over fees is "paramount and exclusive." Brown  
10 v. Gerdes, 321 U.S. 178, 183-84 (1944) (Bankruptcy Act), and this  
11 policy remains intact.

12 Therefore, a state statute which purports to disrupt  
13 bankruptcy law's major goal of equitable distribution is plainly  
14 preempted by federal law. Sherwood Partners, 394 F.3d at 1203-05  
15 (California law appointing a general assignee to recover a  
16 preferential transfer was preempted by Code). Cf. Shearson Lehman  
17 Mortgage Corp. v. Laguna (In re Laguna), 114 B.R. 214, 216 (9th  
18 Cir. BAP 1990) (holding that ruling contrary to state law also  
19 impedes the bankruptcy goal of equitable distribution among  
20 creditors unless there is a "clear statutory mandate" for such  
21 ruling).

22 The policy underlying the bankruptcy distribution scheme in a  
23 converted chapter 7 case is crystal clear: "Those who must wind up  
24 the affairs of a debtor's estate must be assured of payment, or  
25 else they will not participate in the liquidation or distribution  
26 of the estate." H.R. Rep. No. 95-595, at 186-87 (1977), reprinted  
27 in 1978 U.S.C.C.A.N. 5787, 6147.

28 The flaw in the majority's opinion, in my view, is that a cash

1 retainer for chapter 11 services, by merely calling it a "secured"  
2 retainer under California law, and complying with the requirements  
3 to create the security interest, can thereby immunize it from  
4 disgorgement attack if the reorganization fails and the case  
5 converts to chapter 7. The parties, who then potentially suffer,  
6 are the very parties to whom Congress granted the first priority on  
7 available cash--the chapter 7 professionals--while the chapter 11  
8 debtor's counsel, who voluntarily took the case when it came in the  
9 door, and who had to pass the "disinterestedness" test in order to  
10 be counsel in the first place, gathers up all the acorns because he  
11 or she was clever enough to call the retainer "secured."

12       The majority fears that invalidating security retainers will  
13 "chill" representation for chapter 11 debtors. This theory has a  
14 flip side. If we now change the rule to prefer chapter 11  
15 professionals over chapter 7 professionals, it would seem that the  
16 chapter 7 professionals will lose their incentive to administer  
17 what is left of the estate. In other words, the "chill" now  
18 transfers to the chapter 7 professionals.

19       I therefore disagree with my bankruptcy judge colleagues who  
20 also believe that anything less than a "secured" retainer will  
21 "chill" many professionals from representing chapter 11 debtors.  
22 In my professional judgment and experience, such fear is unfounded.  
23 Chapter 11 debtors have enjoyed a vast stable of qualified  
24 professionals--without "secured" retainers, I might add --since the  
25 memory of man runneth not to the contrary. On the other hand,  
26 allowance of secured creditor status or superpriority for chapter  
27 11 attorneys will definitely "chill" efforts in any later chapter 7  
28 liquidation.

1 Like it or not, every bankruptcy professional, because of  
2 these long-settled, equality of distribution principles, takes a  
3 case with the understanding that full payment of any fee is always  
4 dependent upon a debtor's or trustee's financial successes and/or  
5 available resources. Chapter 11 debtors' counsel are risk takers,  
6 just the same as other administrative creditors, whose awareness of  
7 possible disgorgement in the event of conversion merely encourages  
8 them to attain a fruitful reorganization. See Specker Motor Sales  
9 Co. v. Eisen, 393 F.3d 659, 664 (6th Cir. 2004).<sup>12</sup>

10 I believe the opinion breaks new ground in the employment of  
11 bankruptcy professionals, and leads down a path that I, for one, am  
12

---

13 <sup>12</sup> The majority states that Specker, on which the bankruptcy  
14 court relied, did not discuss whether the attorney's prepetition  
15 retainer was a security retainer which protected it from  
16 disgorgement under § 726(b). They are correct, but miss the  
17 larger picture.

18 In Specker, the attorney's \$10,000 retainer was not  
19 categorized, however the Sixth Circuit applied the general rule  
20 that retainers are considered to be property of the estate and  
21 subject to disgorgement. Specker, 393 F.3 at 663. It is  
22 generally recognized that only "security retainers" and "advance  
23 retainers" are property of the estate, whereas "classic retainers"  
24 are not. See S.E.C. v. Interlink Data Network of Los Angeles,  
25 Inc., 77 F.3d 1201, 1205 (9th Cir. 1996); see generally, C.R.  
26 Bowles Jr., "Your Retainer: Pocket Aces or a 7-2 Off Suit?" 24-May  
27 AM. BANKR. INST. J. 28 (2005).

28 The facts in Specker were that, after conversion and  
completed liquidation, only five chapter 11 administrative claims  
remained. Specker Motor Sales Co. v. Eisen, 300 B.R. 687, 688  
(W.D. Mich. 2003), aff'd, 393 F.3d 659 (6th Cir. 2004). Even  
though the attorney had a retainer, the Sixth Circuit held that §  
726(b) mandated pro rata distribution among the administrative  
claimants. In order to accomplish that, the attorney was ordered  
to disgorge his interim fees, and the Sixth Circuit affirmed the  
disgorgement order. Specker, 393 F.3d at 661.

Clearly, the import of this opinion was that § 726(b) trumps  
an attorney's interest in a retainer that is property of the  
estate. See In re Raynard, 327 B.R. 623, 631 (Bankr. W.D. Mich.  
2005) (citing Specker for the proposition that "attorneys who  
represent Chapter 11 debtors must disgorge interim compensation  
received in order to equalize distribution among Chapter 11  
administrative claimants.")

1 unwilling to tread. If we endorse the concept espoused by the  
2 majority, we will no doubt enjoy immense popularity among  
3 bankruptcy professionals--especially chapter 11 debtors' counsel  
4 (the only ones fortunate enough to be able to grab a "secured"  
5 retainer before placing the debtor into chapter 11 in the first  
6 place). In so doing, however, we do a grave injustice to other  
7 bankruptcy professionals who are not so fortunate as to dictate  
8 their terms of repayment, including over whom they have priority  
9 once the case goes south.

10 We also turn our backs on a clear Congressional statutory  
11 mandate, lead bankruptcy law in the wrong direction, and enable  
12 nonbankruptcy state law concepts to obtain unwarranted supremacy  
13 over federal law.

14 I therefore respectfully DISSENT.

15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28