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Fall 2018

### Milking the Estate

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#### Recommended Citation

David R. Hague, *Milking the Estate*, 121 W. Va. L. Rev. 83 (2018).

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## MILKING THE ESTATE

*David R. Hague\**

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*Recent Chapter 7 bankruptcy cases are exposing a widespread problem. Chapter 7 trustees are retaining their own law firms to represent them and then—in clear breach of their fiduciary duties to creditors—requesting illegitimate legal fees to be paid by the estate. This practice is immoral and particularly harmful to creditors. Indeed, every dollar paid to the trustee and his firm is a*

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dollar that will not be distributed to creditors. The Bankruptcy Code, remarkably, allows a trustee to retain his own law firm to represent him in his capacity as a trustee. But this inherently conflicted arrangement is not a license for the trustee and his firm to milk the estate for all it is worth. While courts have recognized the dangers attendant to the trustee's retention of himself to serve as his own paid employee, they are routinely allowing it and only requiring the trustee to make one opaque showing: that the selection of the trustee's own law firm is in the "best interest of the estate."

This approach is significantly flawed. In nearly all cases, the trustee is able to satisfy the nebulous "best-interest" standard and secure employment of his law firm. However, the impropriety of such arrangement does not manifest itself until months or years later, when the trustee and his firm have already milked the estate. Instead of dealing with this issue when the damage to the estate has already been done—or in some cases ignoring it—courts need to adopt protective measures, and this Article outlines several. Abusive fee tactics in bankruptcy will never disappear, but implementing the safeguards discussed herein will curtail the milking (and the bilking).

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*"The [bankruptcy] estate is not a cash cow to be milked to death by professionals seeking compensation for services rendered to the estate which have not produced a benefit commensurate with the fees sought."*<sup>1</sup>

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*"While the Code expressly allows a trustee to retain his own law firm to represent him in his capacity as a trustee, this is not a license for the trustee and his firm to milk the estate for all it is worth."*<sup>2</sup>

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## I. INTRODUCTION

Imagine you hire a lawyer and his firm to represent you in a breach of contract case where approximately \$50,000 is at stake. Things are moving along rather smoothly, until you receive an invoice from your attorney for more than \$3,000 in travel expenses to attend oral argument approximately five hours away. Surely, you think, this must be a mistake. Perhaps the lawyer mistakenly added an extra "0" to the invoice. But as you dig deeper, you realize there is no mistake. This is really an invoice that your lawyer wants you to pay. Through further investigation, you find out that your attorney traveled with his wife, also a member of his firm, and their two children, to this hearing. You also become

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<sup>1</sup> *In re Chas. A. Stevens & Co.*, 105 B.R. 866, 872 (Bankr. N.D. Ill. 1989).

<sup>2</sup> *In re King*, 546 B.R. 682, 737 (Bankr. S.D. Tex. 2016).

aware that their hotel was \$359 a night, with additional hotel charges of \$450. And even though the hearing was scheduled for a short amount of time on a single day, you learn that your lawyer remained at the hotel with his family for five nights. In addition, you find out that a charge of \$220 for meals has also been added to your invoice as a cost. Would you pay? What would you say to your lawyer when you receive this invoice? Would you accuse him of breaching his fiduciary duties to you by attempting to charge you for the extended stay when no legitimate purpose existed for the extended stay?

Or suppose that in the same breach of contract case, which had been going on now for nearly four years, you receive your *first* invoice from your lawyer for \$55,000 in legal fees. Would you pay? Would you call up your lawyer and ask him why he has not billed you in four years and why he is seeking \$55,000 in fees and costs for services rendered, which, at best, might result in a \$50,000 judgment—i.e., a \$5,000 loss to you? If the legal fees exceed the recovery, how can you possibly benefit? Did your lawyer breach his fiduciary duty to you? At the very least, did your lawyer have a duty to consider the amount in dispute and discount that by the likelihood of success in order to properly evaluate the worth of the litigation? Did he have a duty to recommend that no action be commenced if the cost of the battle would exceed the value of the victory?

What if, in this same hypothetical, your lawyer was unsuccessful because he failed to timely pursue your breach of contract case? Or, what if, you actually had a solid case on the law and the facts, but, the defendant was insolvent at the time litigation commenced? Did your lawyer have a duty to tell you that your case—albeit strong—should not be pursued because the potential costs exceeded any reasonably-expected recovery?

There is at least one clear answer to all of these questions posed: you, the client, absolutely would not pay for the unnecessary fees and costs billed to you by your lawyer. You would fight him tooth and nail over payment. Unfortunately, each of these hypotheticals mentioned has happened in recent bankruptcy cases.<sup>3</sup> But the victims in these cases—i.e., the unsecured creditors—did not have the same leverage that the ordinary client might have regarding the legal fees. Indeed, their representatives—the Chapter 7 Trustee and his law firm—were already in possession of the funds. In other words, in these cases, the unsecured creditors could not withhold payment for the improper charges because their money was being held in the trustee's piggybank, ready to be applied to these unnecessary fees and costs.

Why is the behavior identified above becoming so prevalent in Chapter 7 cases? A few reasons exist, but surprisingly, it is the Bankruptcy Code and some bankruptcy judges that are allowing trustees to put the interest of themselves and their personal law firms ahead of the interest of the estate.

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<sup>3</sup> See, e.g., *In re IFS Fin. Corp.*, 803 F.3d 195 (5th Cir. 2015); *In re McLean Wine Co.*, 463 B.R. 838 (Bankr. E.D. Mich. 2011); *In re Minich*, 386 B.R. 723 (Bankr. C.D. Ill. 2008).

Section 327(d) of the Code actually allows a trustee to employ himself (and his firm) as attorney for the estate.<sup>4</sup> There is inherent impropriety in such an arrangement. First, the trustee has a duty to monitor all legal fees in the bankruptcy case to ensure that they are reasonable, necessary, and likely to provide a benefit to the estate.<sup>5</sup> This duty, alone, automatically puts the trustee at odds with his law firm, to whom he also owes fiduciary duties as a shareholder. Indeed, he now occupies a position of serving two masters when he is (a) required to maximize distributions to creditors of the estate while (b) retaining a substantial pecuniary interest in seeing that he and his law firm obtain recovery of fees and costs expended on the case, regardless of whether such fees are necessary and beneficial to the estate.

Moreover, by allowing this employment arrangement, § 327(d) is also facilitating trustee and attorney wrongdoing. As one court observed, “[a] disturbing trend has developed among Chapter 7 panel trustees . . . to disregard the Bankruptcy Code and Bankruptcy Rules as they administer their assigned cases.”<sup>6</sup> This occurs, for instance, when the trustee’s firm is seeking to be reimbursed for duties that are solely the responsibility of the trustee. The Bankruptcy Code precludes reimbursing a law firm or an individual attorney for work of the type that is generally performed by a trustee without the aid of legal counsel.<sup>7</sup> But when the trustee is sharing the same bed as his law firm and trying to fill dual roles as the trustee and the attorney for the trustee, the lines and legal duties between trustee and attorney become significantly blurred and, thus, so do the legal fees.

Surprisingly, there is only one hurdle in place when the trustee wants to employ himself and his firm to act as attorney for the estate. Under § 327(d), “[t]he court may authorize the trustee to act as attorney . . . for the estate if such authorization is in the *best interest of the estate*.”<sup>8</sup> The term “best interest of the estate,” however, is not defined in the Code, and courts, practitioners, and scholars have interpreted this phrase in various ways. Further, several judges simply “rubber-stamp” these employment applications without ever conducting a hearing or taking testimony from the trustee about why he has chosen to hire his own firm and why such retention is in the best interest of the estate. But even if the court—after a careful review of the application and perhaps a hearing—makes a finding that employment is in the “best interest of the estate,” there still exists a fundamental problem that bankruptcy judges are ignoring. Now that all of the legal work is “in-house” and the representation has been approved by the court, there are literally no checks and balances in place to keep the trustee and

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<sup>4</sup> 11 U.S.C. § 327(d) (2018).

<sup>5</sup> *Id.* § 704(a)(5) (effective Dec. 22, 2010).

<sup>6</sup> *In re McCollom Interests, LLC*, 551 B.R. 292, 294–95 (Bankr. S.D. Tex. 2016).

<sup>7</sup> 11 U.S.C. § 328(b).

<sup>8</sup> *Id.* § 327(d) (emphasis added).

his firm honest and motivated to maximize the estate. The trustee's litigation partners will be financially motivated to litigate rather than to find more cost-effective means to resolve disputes. Will the trustee truly be comfortable questioning the litigation strategies or the excessive billing of his partners when the trustee himself stands to gain financially as higher and unnecessary fees are billed to the estate? At the same time, the trustee may be encouraged to "double dip" by billing certain tasks as an "attorney" when it is clear he might otherwise perform the same task as an administrative function of his job as a trustee. This billing strategy puts significantly more cash in the trustee's pocket, but it obviously depletes the estate.

The Bankruptcy Code that allows this employment arrangement is flawed. Likewise, bankruptcy judges are abdicating their solemn responsibility to protect the estate by allowing trustees and their firms to get away with these deceptive billing practices. The current approach for dealing with in-house retention yields substantial problems and diminution to the bankruptcy estate. This Article contends that more conditions and controls should be put in place before courts approve the trustee's application to employ himself and his law firm. But that is not all. This Article suggests that even after employment, additional safeguards must exist in order to protect creditors and to minimize the milking of the estate.

Part II of this Article provides an overview of Chapter 7 bankruptcy and a detailed discussion on the duties of a Chapter 7 trustee. Part III discusses how the Bankruptcy Code and courts deal with in-house employment and compensation schemes. Part IV identifies the built-in conflicts and the harm to the bankruptcy estate as a result of these arrangements. Finally, Part V suggests that courts order trustees and their firms to produce a preliminary budget and asset-recovery plan at the inception of employment or as a condition to employment. This will allow courts and creditors to observe and fully understand contemplated litigation and contested matters that will hopefully bring value to the estate. Part V also encourages courts to establish an interim-report framework, whereby, the trustee submits periodic reports detailing the pending litigation, the likelihood of settlement, the fees and costs incurred thus far, and additional contemplated litigation. By reviewing these reports at various stages of litigation, both the court and the creditors can decide whether the fees and costs are outweighing any potential benefit to the estate. At this juncture, the court and creditors can encourage or perhaps even force the trustee to abandon these fruitless-producing claims. As part of the interim-reporting requirement, trustees and their counsel should also be required to file quarterly fee applications. Lastly, Part V discusses an alternative mechanism for dealing with this inherent problem: a repeal of § 327(d) of the Bankruptcy Code.

## II. CHAPTER 7 BANKRUPTCY

A. *Liquidation and Property of the Estate*

To fully understand how the trustee and his firm are able to milk the estate, one must grasp the overall concept of Chapter 7 bankruptcy and how everyone gets paid. Chapter 7 of the Bankruptcy Code is entitled “Liquidation” or “Straight Bankruptcy” and is the most common chapter used by debtors.<sup>9</sup> Its purpose is to provide debtors with a fresh start. In a Chapter 7 case, a trustee is appointed and his duty is to collect the nonexempt property of the debtor, convert that property to cash, and distribute that cash to creditors in accordance with the distribution scheme of the Bankruptcy Code.<sup>10</sup> Essentially, the debtor gives up all nonexempt property she owns at the time of the filing of the bankruptcy petition in exchange for a discharge of all her debts.<sup>11</sup>

In a very simplified overview, the basic stages of a Chapter 7 case are: (1) the Chapter 7 petition is filed, (2) the filing of the petition results in the stay of creditor collection activity<sup>12</sup> and the appointment of a trustee to administer the case,<sup>13</sup> (3) the debtor exercises exemption rights with respect to her property,<sup>14</sup> (4) the trustee collects and sells or liquidates any property available for distribution to the creditors,<sup>15</sup> (5) the proceeds from the sale of the property are used to pay administrative expenses and the claims of the creditors according to the Bankruptcy Code’s priority scheme,<sup>16</sup> and (6) the debtor *may* be discharged from any remaining prepetition debts<sup>17</sup> that are not exempted from discharge.<sup>18</sup>

Because one of the essential duties of the trustee is to collect and reduce to money “property of the estate,”<sup>19</sup> which then (hopefully) gets distributed to creditors, understanding the meaning of “property of the estate” and its

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<sup>9</sup> See *In re Brooks*, 784 F.3d 380, 381 (7th Cir. 2015) (stating that Chapter 7 is the most “common form of bankruptcy in the United States”).

<sup>10</sup> 11 U.S.C. § 704(a).

<sup>11</sup> The right to a discharge is not absolute, and some types of debt are not discharged. For example, if the debtor has committed some bad act enumerated in § 727 of the Bankruptcy Code, the debtor may not be entitled to any discharge. *Id.* § 727(a). Moreover, certain enumerated debts set forth in § 523(a) are not dischargeable. *Id.* § 523(a). Additionally, bankruptcy discharge does not extinguish consensual liens on the debtor’s property. *Young v. Wells Fargo Bank (In re Young)*, No. 04-32102, 2007 WL 1159952, at \*2 (Bankr. S.D. Tex. Apr. 16, 2007).

<sup>12</sup> 11 U.S.C. § 362(a).

<sup>13</sup> *Id.* § 701(a).

<sup>14</sup> *Id.* § 522(b).

<sup>15</sup> *Id.* § 704(a).

<sup>16</sup> *Id.* § 726.

<sup>17</sup> *Id.* § 727.

<sup>18</sup> *Id.* § 523(a).

<sup>19</sup> *Id.* § 704(a)(1).

application in bankruptcy cases is crucial for trustees, judges, practitioners, and creditors. When a debtor files for Chapter 7 bankruptcy, a new legal person—the estate—is automatically created. Bankruptcy Code § 541(a) provides that the estate consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>20</sup> Congress intended this section to be construed as broadly as possible to encompass all types and kinds of property.<sup>21</sup> Property of the estate, therefore, “describes the assets in any particular bankruptcy proceeding that are used to satisfy pre-filing claims as well as the costs of the bankruptcy proceeding. But for the bankruptcy filing, these assets would have belonged to the debtor.”<sup>22</sup>

Because the definition of “property of the estate” is so broad, and because it is the source from which creditors are paid, it also, innately, “includes causes of action, which are considered property of the bankruptcy estate ‘if the claim existed at the commencement of the filing and the debtor could have asserted the claim on his own behalf under state law.’”<sup>23</sup> In fact, “[e]very conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, is within the reach of” the bankruptcy estate.<sup>24</sup> Thus, as representative of the estate, the Chapter 7 trustee succeeds to all causes of action held by the debtor, including, among others, causes of action for preferential and fraudulent transfers, breaches of contract, turnover and accounting, etc.<sup>25</sup> Accordingly, “once a Chapter 7 petition is filed, the debtor no longer has standing to pursue a cause of action which existed at the time the Chapter 7 petition was filed, because the trustee has the sole authority to prosecute such causes of action.”<sup>26</sup>

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<sup>20</sup> *Id.* § 541(a)(1).

<sup>21</sup> See S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868; H.R. REP. NO. 95-595, at 367–68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6322–24.

<sup>22</sup> AM. BANKR. INST., *Bankruptcy Concepts*, in BANKRUPTCY ISSUES FOR STATE TRIAL COURT JUDGES, § A (Michaela M. White ed., 2012). Some of the debtor’s assets, although initially characterized as property of the estate, “later exit this category when they are exempted by the debtor, abandoned by the trustee as burdensome or inconvenient, redeemed by the debtor, or sold by the trustee.” *Id.* at § B.

<sup>23</sup> *In re Emoral*, 740 F.3d 875, 879 (quoting Bd. of Trs. of Teamsters Local 863 Pension Fund v. Foodtown, Inc., 296 F.3d 164, 169 n.5 (3d Cir. 2002)).

<sup>24</sup> *Ritchie Capital Mgmt. v. Gen. Elec. Capital Corp.*, 121 F. Supp. 3d 321, 333 (S.D.N.Y. 2015) (quoting *Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 122 (2d Cir. 2008)).

<sup>25</sup> *Detrick v. Panalpina*, 108 F.3d 529, 535 (4th Cir. 1997); *see also In re Hagen Const. Serv.*, 104 B.R. 233, 234 (Bankr. D.N.D. 1989) (stating that “[i]n furtherance of the power to collect property of the estate, the trustee is empowered with extraordinary abilities to avoid and recover various liens and transfers including those that are fraudulent and preferential”).

<sup>26</sup> *Blumark, Inc. v. Geeks on Call Holdings, Inc.*, No. 2:09CV322, 2010 WL 28720, at \*3 (E.D. Va. Jan. 5, 2010); *see also Richman v. First Woman’s Bank*, 104 F.3d 654, 656 (4th Cir. 1997) (stating that after the conversion from Chapter 11 to Chapter 7, the trustee was the party who was entitled to prosecute the lawsuit, and debtor lacked standing); *Marshall v. Honeywell Tech.*



With these principles in mind, it is clear that “one of the [many] duties of the bankruptcy trustee is to prosecute all causes of action accruing to the bankrupt estate that may result in additional income for the satisfaction of the bankrupt’s debt.”<sup>27</sup> Indeed, these causes of action are frequently the only mechanism of generating funds to pay creditors.

### *B. The Trustee and His Duties*

As a representative of the estate,<sup>28</sup> the trustee is commended with multiple fiduciary obligations and duties.<sup>29</sup> A trustee’s fiduciary obligations are those specifically owed to unsecured creditors as well as the bankruptcy court.<sup>30</sup> These essential obligations encompass “the duties of loyalty, distribution maximization, diligence, due care, accountability, competence, claims review, information disclosure, candor, civility, proper litigation preparation and conduct, impartiality and its appearance, enforcement, supervision, compliance, and good faith and fair dealing.”<sup>31</sup> An appreciation of these duties is central to this Article. The notion of a “conflict,” or “self-dealing,” or lack of “disinterestedness” when it comes to the trustee’s retention of himself and his law firm would be shallow if the trustee’s duties were characterized as minimal or insignificant.

Section II.B.1 discusses the trustee’s obligations as a fiduciary in bankruptcy cases, outlining the trustee’s role to each party. Section II.B.2 notes the trustee’s principal duties, as called for under 11 U.S.C. § 704. Finally, Section II.B.III names the most fundamental duties a trustee has, the common law duties of loyalty and care.

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Sols., Inc., 675 F. Supp. 2d 22, 25 (D.D.C. 2009) (stating that debtor no longer has standing to pursue claims which are property of the estate because the trustee assumes the status of the real party in interest for purposes of Federal Rule of Civil Procedure 17); *Cain v. Hyatt*, 101 B.R. 440, 442 (E.D. Pa. 1989) (stating that “[o]nly the trustee, as representative of the estate, has the authority to prosecute and/or settle such causes of action”).

<sup>27</sup> Bd. of Dirs. of the Chestnut Grove Condo. Unit Owners’ Ass’n v. Resolution Tr. Corp., 161 B.R. 860, 862 (D.D.C. 1993).

<sup>28</sup> See 11 U.S.C. § 323(a) (2018) (“The trustee in a case under this title is the representative of the estate.”); see also 1 BANKRUPTCY LAW MANUAL § 4:7, n.1 (5th ed. 2016) (providing case law analyzing 11 U.S.C. § 323(a)).

<sup>29</sup> See generally Hon. Steven Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 AM. BANKR. L.J. 147 (2006) (suggesting Chapter 7 trustee’s fiduciary obligations and institutional obligations are often at odds).

<sup>30</sup> *Id.* at 148–49 (pointing out that a trustee’s professional obligations fall into two different groups: “fiduciary” and institutional).

<sup>31</sup> *Id.* at 154.

## 1. The Trustee as a Fiduciary

Even though the Bankruptcy Code does not specifically utilize fiduciary terminology in respect to a Chapter 7 Trustee,<sup>32</sup> “the cases uniformly refer to a Chapter 7 Trustee as a fiduciary and to the trustee’s obligations in a bankruptcy case as fiduciary obligations.”<sup>33</sup> The Chapter 7 Trustee Canon of Ethics, adopted by the National Association of Bankruptcy Trustees (NABT)<sup>34</sup> in 2005, refers to a trustee as a fiduciary situated in a “significant position of trust and responsibility.”<sup>35</sup> The preamble reads as follows:

A Chapter 7 Trustee is committed to excellence in the administration of bankruptcy cases and to carry out all duties with the utmost integrity, diligence, and professionalism. Parties are entitled to service that adheres to the highest standards of professional, moral, and ethical conduct. As a fiduciary, a trustee occupies a significant position of trust and responsibility and is accountable to all in the bankruptcy system and the public at large.<sup>36</sup>

Case law has repeatedly reiterated that a Chapter 7 Trustee is a fiduciary<sup>37</sup> “and the obligations imposed upon them to administer the bankruptcy estate are fiduciary obligations as well.”<sup>38</sup> A Chapter 7 Trustee owes these fiduciary duties not just to the estate, but also to all the parties in interest in the bankruptcy proceedings.<sup>39</sup> The trustee, therefore, serves a dual function of representing the rights of debtors and interests of creditors. The Bankruptcy Law Manual

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<sup>32</sup> See 11 U.S.C. § 704 (defining Chapter 7 Trustees duties and obligations).

<sup>33</sup> Rhodes, *supra* note 29, at 218 n.35.

<sup>34</sup> *The Association, NAT’L ASS’N OF BANKR. TRS.*, <https://www.nabt.com/AboutUs.cfm> (last visited Oct. 5, 2018) (providing the historical background and mission of NABT’s formation, which goes back to 1982).

<sup>35</sup> NAT’L ASS’N OF BANKR. TR., CHAPTER 7 TRUSTEE CANON OF ETHICS (2005) [hereinafter NABT CANON OF ETHICS], *reprinted in* David P. Lebowitz, Presentation to the Bankruptcy Section of the Minnesota State Bar Association, <http://documents.jdsupra.com/b72c9162-9ce0-4308-98f7-fdf5167aab1d.pdf>.

<sup>36</sup> *Id.* (emphasis added).

<sup>37</sup> See *In re AFI Holding, Inc.*, 530 F.3d 832, 845 (9th Cir. 2008) (recognizing that a violation of the trustee’s “fiduciary” responsibilities constitutes “cause” and could lead to a panel trustee’s removal from a bankruptcy case); see also *In re Robert Plan Corp.*, 439 B.R. 29, 38 (Bankr. E.D.N.Y. 2010), *rev’d sub nom.* U.S. Dep’t of Labor v. Kirschenbaum, 508 B.R. 257 (E.D.N.Y. 2014).

<sup>38</sup> *In re Robert Plan Corp.*, 439 B.R. at 38 (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (U.S. 2000)).

<sup>39</sup> See *In re Mehr*, 153 B.R. 430, 434 (Bankr. D.N.J. 1993), *superseded by statute*, 26 U.S.C. § 121 (2018), *as recognized in In re DiDario*, 232 B.R. 311 (Bankr. D.N.J. 1999) (“The assets are in the hands of the Trustee/estate for the benefit of creditors and parties in interest.”).

provides, “as a representative of the estate . . . a fiduciary . . . owes fiduciary duties to the estate and its constituencies.”<sup>40</sup> These “constituencies” include both secured and unsecured creditors,<sup>41</sup> shareholders,<sup>42</sup> and a solvent debtor,<sup>43</sup> although the Bankruptcy Manual clarifies that the duty to creditors supersedes the ones owed to shareholders.<sup>44</sup> Case law has reiterated the trustee’s fiduciary duty is to “each creditor of the estate.”<sup>45</sup> Although the courts have recognized the trustee’s obligation to ensure unsecured creditors are satisfied first,<sup>46</sup> the trustee “may not be the representative of any particular creditor, but must represent *all creditors* without partiality.”<sup>47</sup>

Moreover, the trustee is meant to function independently,<sup>48</sup> not necessarily as a specific representative for a specific party in interest. Indeed,

[w]hile the trustee’s obligation is to marshal assets for the benefits of creditors, that task is assumed as a fiduciary relationship to the estate itself and not as some sort of “hired gun.” The trustee is not the employee or agent of the creditors; they do not have the right to direct how the trustee chooses to perform the statutory duties of the position. The trustee is in essence an independent third party charged with the responsibility of maximizing assets for the estate. A bankruptcy trustee is an officer of the court that appoints him or her.<sup>49</sup>

As an independent third party, the trustee is, therefore, not mandated to hire attorneys to assist with any of the trustee’s obligations. In *In re WHET, Inc.*,<sup>50</sup>

<sup>40</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28, § 4:7.

<sup>41</sup> *Id.*; see *In re Troy Dodson Constr. Co.*, 993 F.2d 1211, 1216 (5th Cir. 1993) (“The trustee owes a fiduciary duty to *all* the creditors, not just to the unsecured creditors.”).

<sup>42</sup> *In re Troy Dodson Constr. Co.*, 993 F.2d at 1216.

<sup>43</sup> See *In re George Schumann Tire & Battery Co.*, 145 B.R. 104, 107 (Bankr. M.D. Fla. 1992) (“There is hardly any doubt that upon the showing of surplus funds in the estate after distribution to creditors, a Chapter 7 debtor is considered a party in interest.”); see also *In re Woods*, 139 B.R. 876, 877 (Bankr. E.D. Tenn. 1992) (emphasizing “unless the estate is solvent, the debtor has no pecuniary interest”).

<sup>44</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28, § 4:7 n.21

<sup>45</sup> *Pereira v. Foong (In re Ngan Gung Restaurant)*, 254 B.R. 566, 570 (Bankr. S.D.N.Y. 2000) (analyzing the fiduciary duties of a Chapter 11 Trustee and stating they also apply in this Chapter 7 case).

<sup>46</sup> See *In re Balco Equities, Ltd.*, 323 B.R. 85, 97 (Bankr. S.D.N.Y. 2005).

<sup>47</sup> *In re Russo*, 18 B.R. 257, 270–71 (Bankr. E.D.N.Y. 1982) (emphasis added).

<sup>48</sup> *In re Jack Greenberg, Inc.*, 189 B.R. 906, 910 (Bankr. E.D. Pa. 1995) (“Section 323 provides that the trustee is the representative of the estate. In that capacity, the trustee is a fiduciary and intended to be independent.”).

<sup>49</sup> *In re Vazquez*, 325 B.R. 30, 37–38 (Bankr. S.D. Fla. 2005).

<sup>50</sup> 750 F.2d 149 (1st Cir. 1984).

for example, the sole stockholder and CEO of the debtor corporation appealed the bankruptcy court's decision rejecting his petition to act as counsel, or to appoint another attorney for the debtor.<sup>51</sup> In upholding the bankruptcy court's ruling, the First Circuit focused on 11 U.S.C. § 323 of the Bankruptcy Code, which states "[a] trustee . . . is a 'representative of the estate,' . . . and as such he owes a fiduciary duty to debtor and creditors alike to act fairly and protect their interests."<sup>52</sup> Although the trustee may hire attorneys to assist him with furthering his duties in representing the estate, there is no such mandate when the trustee is "fairly protect[ing] the debtor's interests."<sup>53</sup>

Further, a trustee owes no duty to third parties or insolvent debtors. The Bankruptcy Manual states "[t]he trustee owes no fiduciary duty to strangers to the estate or the case; that is, third parties who may be involved in case matters but who are not the debtor, creditors, or other parties in interest."<sup>54</sup> Courts have often blurred the lines "between two types of actions against trustees: breach of fiduciary duty claims brought by parties interested in the administration of the estate, and claims in tort or contract brought by third parties."<sup>55</sup> It is well settled, however, that third parties alleging claims sounding in tort against the trustee simply lack standing to assert such claims.<sup>56</sup> In regard to the debtor, the Bankruptcy Manual claims a fiduciary duty *may* be owed when the estate is solvent.<sup>57</sup> An insolvent debtor has been found to have "no standing to object to the trustee's sale of property unless a successful appeal would create an estate with assets in excess of liabilities."<sup>58</sup> For example, in *In re Ebel*,<sup>59</sup> the court found the estate to be "hopelessly insolvent" and as such, the trustee owed no fiduciary duties to the Chapter 7 debtor.<sup>60</sup>

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* (citing *Citibank N.A. v. Andros*, 666 F.2d 1192, 1194 (8th Cir. 1981)).

<sup>53</sup> *Id.*; cf. *In re Holliday's Tax Servs., Inc.*, 417 F. Supp. 182 (E.D.N.Y. 1976), *aff'd sub nom.* *Holliday's Tax Servs., Inc. v. Hauptman*, 614 F.2d 1287 (2d Cir. 1979).

<sup>54</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28; see also 2 BANKRUPTCY LAW MANUAL § 10:13 n.41 (5th ed. 2016) (citing *In re C.R. Stone Concrete Contrs.*, 346 B.R. 32 (Bankr. D. Mass. 2006)).

<sup>55</sup> *Lassman v. Reilly (In re Feeley)*, 393 B.R. 43, 49 (Bankr. D. Mass. 2008) (citing *In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1 (1st Cir. 1999)).

<sup>56</sup> *Id.* at 50.

<sup>57</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28 ("[A trustee] may owe such duties to the debtor where the estate is solvent . . .").

<sup>58</sup> *Willemain v. Kivitz*, 764 F.2d 1019, 1022 (4th Cir. 1985).

<sup>59</sup> 338 B.R. 862 (Bankr. D. Colo. 2005).

<sup>60</sup> *Id.* at 873.

## 2. The Chapter 7 Trustee's Duties Under 11 U.S.C. § 704

Section 704 of the Bankruptcy Code provides for the majority of a trustee's statutory obligations to the estate and its creditors.<sup>61</sup> "The trustee . . . at a minimum is under a duty to perform the statutory duties given to the trustee in the Code in an ordinarily prudent manner."<sup>62</sup> In examining the Bankruptcy Code's statutory framework regarding trustee duties, § 4:7 of the Bankruptcy Law Manual outlines the "[r]ole and capacity of the trustee"<sup>63</sup> to include "expeditiously gather[ing] assets of the estate and administer[ing] them; preserv[ing] the assets of the estate[,] . . . invest[ing] the assets of the estate prudently and mak[ing] distributions, if any, in timely fashion."<sup>64</sup> This fiduciary obligation, provided by § 704(a)(1) of the Bankruptcy Code, to "collect and reduce to money the property of the estate . . .,"<sup>65</sup> is seen as the trustee's *principal* responsibility. This duty equates to realizing the maximum benefit<sup>66</sup> for the estate's unsecured creditors.<sup>67</sup> Case law also has specifically highlighted § 704(a)(1) as the Trustee's main duty.<sup>68</sup> As one court noted, "[t]he duty to close the estate as quickly and expeditiously as is compatible with the best interests of the parties in interest has been called the trustee's 'main duty.'"<sup>69</sup> This same court also claimed that the other provisions were "merely directory as to what the trustee shall do in accomplishing the main objective and purpose of the appointment . . ."<sup>70</sup>

These "directory" provisions under § 704 of the Bankruptcy Code are summarized in detail in Section 10:13 of the Bankruptcy Law Manual.<sup>71</sup> Aside

<sup>61</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28, at nn.18–19 ("The trustee owes fiduciary duties to all creditors, whether unsecured or secured.").

<sup>62</sup> See 11 U.S.C. § 704 (2018) (charging a Chapter 7 Trustee with specific duties); see also 1 BANKRUPTCY LAW MANUAL, *supra* note 28, at § 4:7 ("[T]rustee at a minimum is under a duty to perform the statutory duties given to the trustee in the Code.").

<sup>63</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28.

<sup>64</sup> *Id.*

<sup>65</sup> 11 U.S.C. § 704 (a)(1) (2018); see also *In re Robert Plan Corp.*, 439 B.R. 29, 38 (Bankr. E.D.N.Y. 2010) (deeming 11 U.S.C. § 704 (a)(1) as a Chapter 7 trustee's primary obligation).

<sup>66</sup> See *In re Balco Equities, Ltd.*, 323 B.R. 85, 98 (Bankr. S.D.N.Y. 2005) (citing *In re Mondie Forge, Inc.*, 148 B.R. 499, 502 (Bankr. N.D. Ohio 1992)) (emphasizing a trustee's duty to "realize the maximum return for the estate for further distribution to the Debtor's creditors").

<sup>67</sup> *In re Poage*, 92 B.R. 659, 662 (Bankr. N.D. Tex. 1988) (citing *Fox v. Anderson (In re Thu Viet Dinh)*, 80 B.R. 819, 822 (Bankr. S.D. Miss. 1987)) (highlighting a trustee's primary obligation of ensuring unsecured creditors are satisfied first).

<sup>68</sup> See 2 BANKRUPTCY LAW MANUAL, *supra* note 54, § 10:13 n.19 (providing case law exploring § 704(a)(1)).

<sup>69</sup> *In re Riverside-Linden Inv. Co.*, 85 B.R. 107, 111 (Bankr. S.D. Cal. 1988).

<sup>70</sup> *Id.*

<sup>71</sup> See 2 BANKRUPTCY LAW MANUAL, *supra* note 54, § 10:13.

from collecting and reducing the property of the estate to cash, the provisions also include filing a complete inventory; “keeping records of receipts and the disposition of money and property, and filing reports with the court and the U.S. Trustee with respect to the financial condition and progress of the administration of the estate[;]” ensuring a debtor accomplishes the statement of intention; conducting investigations concerning the debtor’s financial affairs; examining proofs of claim and objecting to the allowance of any claims when necessary;<sup>72</sup> challenging a debtor’s discharge if necessary; providing any needed information in regards to the bankruptcy proceedings; filing “periodic reports and summaries of the operation of the business” if the business is still operational; filing “a final report and fil[ing] a final account of the administration of the estate[;]” and advising “a domestic support creditor in writing of the existence of and right to use support enforcement and collection agencies during the case and also provid[ing] notice of such a claim to the enforcement agencies.”<sup>73</sup>

The Supreme Court has also reiterated the extensive powers encompassed by a Chapter 7 trustee in bankruptcy proceedings.<sup>74</sup> In *Commodity Futures Trading Comm’n v. Weintraub*,<sup>75</sup> the Supreme Court listed a trustee’s broad powers to include the “[responsibility] for all property received”; “duty to maximize the value of the estate”; duty to “investigate the debtor’s financial affairs”; ability to “sue officers, directors, and other insiders to recover on behalf of the estate, fraudulent or preferential transfers of the debtor’s property,” ability to “use, sell or lease property of the estate” as long as the Court authorizes it; and even “operate the debtor’s business” in reorganization.<sup>76</sup>

### 3. Common Law Duties of Loyalty and Care

Finally, “[t]he trustee owes the general common law duties that a trustee owes as a fiduciary,” which are known as the duty of loyalty and duty of care.<sup>77</sup> The duty of loyalty, “the duty not to act in the fiduciary’s own interest,”<sup>78</sup> is “the most fundamental duty owed.”<sup>79</sup> In *Wooten v. Wooten*,<sup>80</sup> the Tenth Circuit Court

<sup>72</sup> See *In re Nortel Networks Inc.*, No. 09-10138, 2017 WL 932947, at \*4 (Bankr. D. Del. 2017) (stating a trustee acted prudently because he filed and amended proofs of claim).

<sup>73</sup> 2 BANKRUPTCY LAW MANUAL, *supra* note 54, § 10:13.

<sup>74</sup> See Rhodes, *supra* note 29, at 152.

<sup>75</sup> 471 U.S. 343 (1985).

<sup>76</sup> *Id.* at 352.

<sup>77</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28.

<sup>78</sup> *Id.*

<sup>79</sup> Rhodes, *supra* note 29, at 156 (stating the duty of loyalty “prohibits retaining professionals that have that first hand knowledge,” and those with claims against the estate).

<sup>80</sup> 151 F.2d 147 (10th Cir. 1945).

of Appeals underscored the importance of the fiduciary duty of loyalty imposed on trustees:

The standards of conduct for a trustee rise far above the ordinary morals of the market place. Not honesty alone, but a punctilio of honor the most sensitive is the standard of behavior required of a trustee. He must completely efface self-interest. His loyalty and devotion to his trust must be unstinted. Its well-being must always be his first consideration. These principles are inveterate and unbending.<sup>81</sup>

Although discussing these duties in the context of an executor of an estate, the *Wooten* case has been cited several times by bankruptcy courts when discussing the fiduciary duties of a bankruptcy trustee.<sup>82</sup>

Further, § 704 of the Bankruptcy Code discusses the duty of loyalty by requiring an appointed trustee to be a disinterested party<sup>83</sup> and therefore avoiding potential self-dealing. A trustee's independent and disinterested judgment would obviously be compromised if there were self-dealing.<sup>84</sup> More importantly, this duty of loyalty and obligation to remain impartial, "extends to the trustee's professionals."<sup>85</sup> In general, any professional who has a "financial stake in maximizing the estate" cannot assist the trustee.<sup>86</sup> There is a peculiar exception to this general rule in regard to a trustee (and his law firm) functioning as an attorney during the bankruptcy proceedings. Section 327 of the Bankruptcy Code explicitly authorizes such action if "such authorization is in the best interest of the estate."<sup>87</sup> As discussed *infra*, this provision of the code authorizing this inherently-conflicted arrangement causes serious problems when compensation is sought by the trustee and his firm.

Courts tend to assess the law of trusts when determining if the duty of loyalty has been violated.<sup>88</sup> The Law of Trusts and Trustees states

[a] trustee is under a duty to the beneficiary of the trust to administer the trust solely in the interest of the beneficiary. The trustee must exclude all self-interest, as well as the interest of a

<sup>81</sup> *Id.* at 149–50.

<sup>82</sup> *See, e.g., In re Republic Fin. Corp.*, 128 B.R. 793, 802 (Bankr. N.D. Ok. 1991) (discussing the Tenth Circuit's decision in *Wooten* and applying trust principles to the bankruptcy trustee).

<sup>83</sup> 11 U.S.C. § 704 (a)(1) (2018); *see also* 1 THE LAW OF TRUSTS AND TRUSTEES § 543 (2d ed. 1993) (discussing the "obvious conflict between the individual interest of the trustee and the interest of the trust and its beneficiary in the transaction involving trust property").

<sup>84</sup> *Id.*

<sup>85</sup> Rhodes, *supra* note 29, at 159.

<sup>86</sup> *Id.* at 160.

<sup>87</sup> 11 U.S.C. § 327(d).

<sup>88</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28.

third party, in his administration of the trust solely for the benefit of the beneficiary. The trustee must not place himself in a position where his own interests or that of another enters into conflict, or may possibly conflict, with the interest of the trust or its beneficiary. Put another way, the trustee may not enter into a transaction or take or continue in a position in which his personal interest or the interest of a third party is or becomes adverse to the interest of the beneficiary.<sup>89</sup>

In dissecting the duty of loyalty under the Uniform Trust Code, one author focused on human nature and how that may inevitably cause a trustee to favor himself over those to whom he owes fiduciary duties.<sup>90</sup> “The trust law concept . . . acknowledges that human nature will cause any person to favor his or her personal interests . . . and it is this assumption of disloyalty that gives rise to the strict prohibitions of trustee conflicts of interest required under the label of ‘duty of loyalty.’”<sup>91</sup> This favoritism of one’s personal interests is particularly widespread in cases where a fiduciary has retained himself to serve as his own paid employee.

While the duty of care has not been codified in the Bankruptcy Code, it has been addressed by case law, including the Supreme Court of the United States. The duty of care emphasizes the requirement to act reasonable in carrying out all other duties and obligations, and not to act negligently.<sup>92</sup> In *Ford Motor Credit Co. v. Weaver*,<sup>93</sup> the Sixth Circuit explained “[t]he measure of care, diligence and skill required of a trustee is that of ‘an ordinarily prudent man in the conduct of his private affairs under similar circumstances and with a similar object in view.’”<sup>94</sup> The Supreme Court echoed the sentiment more than forty years prior, “[b]y the common law every trustee or receiver of an estate has the duty of exercising reasonable care in the custody of the fiduciary estate unless relieved of such duty by agreement, statute, or order of court.”<sup>95</sup>

In short, as a clear fiduciary, the trustee is charged with several duties and obligations—“perhaps [even] at a heightened level”<sup>96</sup>—when carrying out his responsibilities to the estate. The most critical concern, however, is the question of whether the trustee is meeting the fiduciary duty incumbent upon him

<sup>89</sup> 1 THE LAW OF TRUSTS AND TRUSTEES, *supra* note 83.

<sup>90</sup> Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code*, 67 MO. L. REV. 279, 279 (2002).

<sup>91</sup> *Id.*; see also 1 THE LAW OF TRUSTS AND TRUSTEES, *supra* note 83.

<sup>92</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28.

<sup>93</sup> 680 F.2d 451 (6th Cir. 1982).

<sup>94</sup> *Id.* at 461 (quoting *In re Johnson*, 518 F.2d 246, 251 (10th Cir. 1975)).

<sup>95</sup> *United States ex rel. Willoughby v. Howard*, 302 U.S. 445, 450 (1938).

<sup>96</sup> 1 BANKRUPTCY LAW MANUAL, *supra* note 28, § 4:7 n.30 (citing *Maxwell v. KPMG, LLP*, 520 F.3d 713 (7th Cir. 2008)).



to maximize the value of the estate and conserve the estate's assets. There are obvious issues with this obligation when the payment pecking order in Chapter 7 liquidation is fully comprehended.

### C. *The Payment Pecking Order*

Section 726 of the Bankruptcy Code controls the distribution of property in a liquidation case.<sup>97</sup> This section sets forth the order in which assets (which, at this point, likely have been reduced to cash) are to be distributed to different classes of claimants, beginning with what the Code refers to as “priority claimants” and ending with the debtor. It states in relevant part: “(a) [P]roperty of the estate shall be distributed—(1) *first*, in payment of claims of the kind specified in, and in the order specified in section 507 of this title . . . .”<sup>98</sup> Section 507 of the Bankruptcy Code is the priority scheme that is followed in a liquidation case under Chapter 7.<sup>99</sup> Priorities of claims are significant in bankruptcy because they determine the order in which claims are paid from property of the bankruptcy case.<sup>100</sup> Payment of claims, of course, assumes there is actually property available in the bankruptcy estate for distribution to creditors. But the reality is that most Chapter 7 cases have no assets available for distribution.

First in line for distribution in a Chapter 7 case are the secured creditors. The holder of a secured claim will either get its collateral or get the proceeds of its collateral to the extent of its claim in a Chapter 7 case.<sup>101</sup> Oftentimes, the trustee will simply abandon the collateral and let the debtor and secured creditor work out payment arrangements outside of the bankruptcy case. Thus, as a general rule, all unsecured claims, including priority claims, come behind all secured claims.<sup>102</sup>

Assuming there are funds and other unencumbered assets available, next in line for distribution are “administrative expenses” allowed under § 503(b). An administrative expense allowed under this section is the highest priority claim to be paid in a bankruptcy case.<sup>103</sup> In Chapter 7 liquidation, administrative claims are paid in *full* before any other distribution may be made.<sup>104</sup> Of relevance to this Article is § 503(b)(2), which provides in relevant part as follows: “(b) After notice and a hearing, there shall be allowed, administrative expenses . . .

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<sup>97</sup> 11 U.S.C. § 726(a) (2018).

<sup>98</sup> *Id.* (emphasis added).

<sup>99</sup> *See id.* § 507.

<sup>100</sup> *Id.* § 507.

<sup>101</sup> *Id.* §§ 506(a), 725.

<sup>102</sup> *See id.* § 507.

<sup>103</sup> *Id.* § 507(a)(1)(C).

<sup>104</sup> *Id.* § 726(a)(1).

including—(2) compensation and reimbursement awarded under section 330(a) of this title . . . .”<sup>105</sup>As flushed out in further detail in Part III of this Article, § 327(a) of the Bankruptcy Code provides that a trustee may employ attorneys (and other professionals) to represent or assist him in carrying out his duties.<sup>106</sup> Section 330(a)(1), in turn, provides that the court may award to a trustee and his lawyers reasonable compensation for fees and costs.<sup>107</sup> By making express provisions for employment under § 327, payment under § 330, and priority under § 503(b)(2), the Code makes one thing very clear: the Chapter 7 trustee and his lawyers must be paid all of their fees and costs in full before unsecured creditors receive a dime.<sup>108</sup>

Because of this exacting pecking order, requests for administrative expenses should be subject to strict scrutiny by the court.<sup>109</sup> As one court stated, “[i]t is well settled that ‘administrative expense priorities are to be narrowly construed to foster the paramount principle in bankruptcy of equitable distribution among creditors.’”<sup>110</sup> This is because administrative expenses deplete the funds available to general unsecured creditors. Indeed, “every dollar that [a bankruptcy court] authorizes the Trustee to pay to the Firm is a dollar that will not be distributed to unsecured creditors . . . .”<sup>111</sup> But while the award of fees to the trustee and his lawyers are supposedly given strict scrutiny by the court, the requirements for in-house retention are rather loose and ill-defined.

### III. EMPLOYMENT AND COMPENSATION SCHEMES

#### A. In-House Employment

The law is clear that if a debtor has filed a lawsuit, or has the right to file suit, after the debtor files for Chapter 7 relief, that lawsuit, or whatever rights the debtor had in that lawsuit, belongs to the debtor’s estate. Consequently, the debtor’s Chapter 7 trustee is the one who has the authority and the duty to go forward with that suit. And as explained, the reason why the trustee must be the one to prosecute actions is because the trustee has serious fiduciary responsibilities. A “Chapter 7 trustee’s duty is to reduce to money the legal or equitable interests owned by the debtor in these various assets so that the

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<sup>105</sup> See *id.* § 503(b)(2).

<sup>106</sup> *Id.* § 327(a).

<sup>107</sup> *Id.* § 330(a)(1)(A), (B).

<sup>108</sup> See *id.* §§ 327, 330, 503(b)(2).

<sup>109</sup> *In re Cardinal Indus., Inc.*, 151 B.R. 833, 837 (Bankr. S.D. Ohio 1992) (citation omitted).

<sup>110</sup> *In re New England Software, Inc.*, 204 B.R. 334, 335 (Bankr. D. Conn. 1996) (quoting *In re New York Trap Rock Corp.*, 137 B.R. 568, 572 (Bankr. S.D.N.Y. 1992)).

<sup>111</sup> *In re McCollom Ints., LLC*, 551 B.R. 292, 298 (Bankr. S.D. Tex. 2016).

proceeds may be distributed to unsecured creditors in accordance with Section 726.”<sup>112</sup>

In order to comply with this duty to gather assets, prosecute the debtor’s choses in action, and liquidate assets in an efficient manner for the benefit of creditors, the Bankruptcy Code specifically authorizes a trustee to employ attorneys and other professionals. Two sections of the Bankruptcy Code address the employment of an attorney to represent the trustee and the estate in bankruptcy, namely § 327(a), which is discussed in Section III.A.1, and § 327(d), which is discussed in Section III.A.2.<sup>113</sup>

### 1. Section 327(a)

Bankruptcy Code § 327(a) authorizes the trustee to employ legal counsel: “Except as otherwise provided in this section, the trustee, with the court’s approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent . . . the trustee in carrying out the trustee’s duties under this title.”<sup>114</sup>

The threshold question for the employment of any professional is the necessity of employment.<sup>115</sup> Additionally, “the trustee needs to determine at the outset the level of professional work required and the estimated costs and benefits associated with the work.”<sup>116</sup> The trustee’s application for the profession should include,

the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant’s knowledge, all of the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States trustee.<sup>117</sup>

The Bankruptcy Code explicitly prohibits the trustee from retaining professionals who are not disinterested or who hold or represent any interest adverse to the bankruptcy estate.<sup>118</sup>

<sup>112</sup> *In re Talbert*, 268 B.R. 811, 819 (Bankr. W.D. Mich. 2001).

<sup>113</sup> 11 U.S.C. §§ 327(a), (d).

<sup>114</sup> *Id.* § 327(a).

<sup>115</sup> U.S. DEP’T OF JUSTICE EXEC. OFFICE FOR U.S. TRS., HANDBOOK FOR CHAPTER 7 TRUSTEES 4-19(c) (2012), [https://www.justice.gov/ust/file/handbook\\_for\\_chapter\\_7\\_trustees.pdf/download](https://www.justice.gov/ust/file/handbook_for_chapter_7_trustees.pdf/download).

<sup>116</sup> *Id.*

<sup>117</sup> See FED. R. BANKR. P. 2014(a).

<sup>118</sup> 11 U.S.C. § 327(a).

While the trustee generally has wide latitude in choosing his own attorney—subject to bankruptcy court approval—the trustee must meet a higher standard when he seeks to appoint himself or his own law firm as attorney.

## 2. Section 327(d)

The appointment of a trustee as legal counsel for the estate is governed by § 327(d), which provides: “The court may authorize the trustee to act as attorney . . . for the estate if such authorization is in the *best interest of the estate*.”<sup>119</sup>

Bankruptcy Rule 2014(b) specifies the consequence to a trustee’s law firm of the appointment of the trustee as counsel: “If, under the Code and this rule . . . a named attorney . . . is employed, any partner . . . or regular associate of the . . . individual may act as attorney . . . so employed, without further order of the court.”<sup>120</sup>

Under this rule, it is clear that the employment of a trustee as counsel for the estate is the functional equivalent of the employment of the trustee’s law firm. It is also clear that the only hurdle in the trustee’s way is to show that this arrangement is in the “best interest of the estate.”

The term “best interest of the estate” is not defined by the Code, and courts have interpreted this phrase in several different ways. Some courts have interpreted the meaning of “best interest of the estate” to include avoiding the conflict of interest that a law firm representing an estate may have when a member of the firm is the trustee of that estate.<sup>121</sup> Other courts focus on different multi-factor tests. In *In re Butler Indus.*,<sup>122</sup> for example, the court weighed the following factors when construing the “best interest” requirement:

- (1) “where the estate’s assets consist principally in causes of action, such as for preferences and fraudulent conveyances, and legal counsel would have to look to the recovery for payment of fees”;
- (2) “where there is relatively little legal work to perform, which does not merit the effort and expense of hiring an outside law firm”;
- (3) “where substantial legal action must be taken immediately, and the trustee cannot wait for the completion of the appointment process for outside counsel”;
- and (4) “where

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<sup>119</sup> *Id.* § 327(d) (emphasis added).

<sup>120</sup> FED. R. BANKR. P. 2014(b).

<sup>121</sup> *In re Butler Indus.*, 114 B.R. 695, 698–99 (Bankr. C.D. Cal. 1990).

<sup>122</sup> 114 B.R. 695 (Bankr. C.D. Cal. 1990).

the trustee can demonstrate that such appointment will result in a substantial reduction of costs to the estate.”<sup>123</sup>

In another case, *In re Interamericas, Ltd.*,<sup>124</sup> the court employed the following nine-factor test:

(1) The qualifications of the members of the firm compared to the complexity of the case; (2) Whether the firm is regularly hired by others to handle similar litigation; (3) Whether the anticipated litigation predominantly involves issues of bankruptcy law with which the law firm has particularized expertise; (4) Whether the time commitment required to handle the case is consistent with the size of the firm and the balance of the firm’s time commitments; (5) Whether only a nominal amount of work must be performed; (6) The availability of other qualified firms to handle the case; (7) The rates charged by the firm compared to the rates charged by other qualified firms; (8) Whether there will be material cost savings to the estate; and (9) Other case-specific factors.<sup>125</sup>

Both of these “best-interest” tests have been criticized by courts. The *Interamericas* test, for example, has been found to be too heavily focused “on the qualifications and expertise of the trustee’s firm and whether the size and composition of the firm is a good fit for the case.”<sup>126</sup> While these are important factors to consider in hiring any firm, courts have found that these factors do not necessarily help answer the question of when a trustee should be allowed to hire his own firm.<sup>127</sup> The *Butler* test, although narrower in scope, and perhaps more useful considering that it attempts to identify the benefits that an estate may realize through such hiring, has also been criticized.<sup>128</sup> For example, the first factor mentioned in the *Butler* test—whether counsel will have to work on a contingency basis—is not entirely useful because many firms will accept such employment regardless of their expertise in the manner.<sup>129</sup>

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<sup>123</sup> See Spencer D. Solomon, *Keeping Things In-House: Increasing Scrutiny of the Chapter 7 Trustee’s Selection of Counsel*, 55 S. TEX. L. REV. 665, 679 (2014) (summarizing *In re Butler Indus., Inc.*, 101 B.R. 194 (Bankr. C.D. Cal. 1989)).

<sup>124</sup> 321 B.R. 830 (Bankr. S.D. Tex. 2005).

<sup>125</sup> *In re Interamericas, Ltd.*, 321 B.R. 830, 834 (Bankr. S.D. Tex. 2005).

<sup>126</sup> *In re Wolfson*, 575 B.R. 522, 526 (Bankr. D. Colo. 2017).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

Simply put, there are fundamental problems with any multi-factor test because those factors are not exclusive and, in fact, they rarely compel a given result.<sup>130</sup> As one court noted in discussing these factors:

They do not indicate whether all or even most of the factors must be present. They say nothing about how much weight a judge may or must give to any one factor. In short, they give the appearance of an analytical framework and rigorous analysis, but in reality, judges use them to justify the exercise of their discretion. Whenever any decision is discretionary and tied to the particular facts of a case, counsel struggle to predict how a court will rule.<sup>131</sup>

In short, the Bankruptcy Code has not erected a blanket ban against a trustee hiring in-house since § 327(d) expressly authorizes it with a nebulous “best-interest-of-estate” test. Nonetheless, the practice of appointing a trustee and his law firm as counsel for the estate must “be severely limited so as to prevent abuse and the appearance of impropriety.”<sup>132</sup> This abuse is particularly rampant when it comes to compensation of the trustee and his attorneys.

### *B. The Compensation Schemes*

“One of the most unpleasant judicial duties bankruptcy judges are called upon to perform involves reviewing fee applications submitted by professionals.”<sup>133</sup> This task of reviewing fee applications “is especially unpleasant when the Trustee is permitted to serve not only as trustee but also as the attorney for the trustee, because in such instances, [courts are] . . . generally presented with two fee requests.”<sup>134</sup> This first request is by the trustee and the second by the trustee as attorney.<sup>135</sup>

#### 1. The Compensation Scheme for Trustees

In exchange for managing and liquidating property of the estate, § 330(a) of the Code allows a court to award reasonable compensation to trustees for

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *In re Mich. Interstate Ry. Co.*, 32 B.R. 325, 326 (Bankr. E.D. Mich. 1983).

<sup>133</sup> *In re Perkins*, 244 B.R. 835, 838 (Bankr. E.D. Mont. 2000); *see also In re First Colonial Corp.*, 544 F.2d 1291, 1301 (5th Cir. 1977) (stating that “the determination of what constitutes reasonable compensation for services furnished by an attorney in a bankruptcy proceeding can be a distasteful task”).

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

actual, necessary services and reimbursement for actual, necessary expenses.<sup>136</sup> This compensation award, however, is limited by § 326(a). Section 326(a) imposes a ceiling on the amount that can be awarded to the trustee, with the award amount limited to an amount:

Not to exceed 25 percent on the first \$5,000 or less, 10 percent on any amount in excess of \$5,000 but not in excess of \$50,000, 5 percent on any amount in excess of \$50,000 but not in excess of \$1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of \$1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.<sup>137</sup>

Accordingly, one source of income for the trustee is payment for performing his duties under § 704(a).

There is another available avenue for the trustee to earn money. As discussed, the Bankruptcy Code allows a trustee to retain counsel to provide legal assistance to the trustee.<sup>138</sup> If the trustee is a licensed attorney, which he usually is, the Bankruptcy Code also authorizes the trustee to serve in a dual capacity as the attorney for the estate.<sup>139</sup> And when the trustee is associated with a firm—either as a partner or associate—the trustee is allowed to retain his own law firm as counsel for the estate.<sup>140</sup> Consequently, a trustee can earn an additional source of income simply by representing the estate himself or by being a partner or associate at a law firm that represents the estate, the latter being particularly beneficial to a trustee. Indeed, a trustee will act as the lawyer for the estate and earn his own legal fees, but then in most cases, he will likely get an “origination” cut from other lawyers in his firm who are providing legal work for the trustee’s “client.” As an example, assume the trustee’s law firm and the trustee, together, bill \$200,000 to the estate. Of that \$200,000, assume \$50,000 of it is for time the trustee has billed wearing his lawyer hat. The other \$150,000 is work performed by his various partners and associates. A very conservative origination credit would be 10%. Thus, the other lawyers would take \$150,000 from the estate, but be required to pay the trustee \$15,000 from that amount because he originated the work. This is the ideal situation for a trustee. Of course, any compensation awarded in this situation must be done pursuant to a fee application with the bankruptcy court, but the origination credit and bonuses provided by the firm to

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<sup>136</sup> 11 U.S.C. § 330(a) (2018).

<sup>137</sup> *Id.* § 326(a).

<sup>138</sup> *Id.* § 327(a).

<sup>139</sup> *Id.* § 327(d).

<sup>140</sup> *Id.*

the trustee for bringing in the work are done entirely in-house and behind closed doors.

## 2. The Compensation Scheme for The Trustee's Own Law Firm

The Bankruptcy Code provisions governing fee requests made by the trustee's own law firm are § 328(b) and § 330(a). "The purpose of § 328(b) is to ensure that the trustee's firm is not compensated for rendering services that the trustee himself has a duty to undertake pursuant to § 704(a)."<sup>141</sup> The purpose of § 330(a), on the other hand, is to "ensure that the fees awarded to the trustee's firm are reasonable and only for services that were actually necessarily rendered."<sup>142</sup>

Accordingly, when a trustee and his law firm have been hired to represent the estate and thereafter seek fees to be paid from the estate, the court must undertake an analysis under both § 328(b) and § 330(a). First, under § 328(b), the court "must ensure that the services provided by the attorneys representing the estate are *not* services that fall within the statutory duties of the trustee."<sup>143</sup> This part of the analysis is critical. As stated succinctly by one bankruptcy judge:

If the court were to approve fees for services rendered by the attorneys representing the estate that fall within the trustee's duties under § 704(a), then the court would be awarding a windfall to the trustee; and, by doing so, the creditors of the estate would suffer, as the trustee would be pocketing more funds from the estate that would otherwise be distributed to the creditors.<sup>144</sup>

Once the court has performed its analysis under § 328(b), then it must analyze the actual legal services pursuant to § 330(a) to determine whether those services were reasonable and necessary.<sup>145</sup>

## IV. MILKING THE ESTATE

When a trustee wants to keep legal work in-house, there are two mechanisms in place under the Bankruptcy Code that are intended to prevent and curtail abusive fee tactics. The first is § 327(d).<sup>146</sup> This section provides that a

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<sup>141</sup> *In re King*, 546 B.R. 682, 692 (Bankr. S.D. Tex. 2016).

<sup>142</sup> *Id.* at 692–93.

<sup>143</sup> *Id.* at 693 (emphasis in original).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *See* 11 U.S.C. § 327(d) (2018).



trustee is allowed to retain his law firm upon a showing that such employment is in the best interests of the estate.<sup>147</sup> But the term “best interest of the estate” is not defined by the Code, and courts have struggled to define it and come up with meaningful and effective tests. Furthermore, it is rare for creditors to even object to any application to employ because they lack a fundamental understanding of its significance to the bankruptcy estate. In fact, a substantial amount of creditors would probably be surprised to learn that trustees and their lawyers are paid (1) directly from the estate and (2) before all unsecured creditors. As a result, it is my opinion that a fair amount of bankruptcy judges merely rubber stamp employment applications without giving any thought as to whether the employment arrangement is truly in the “best interest” of the estate or whether it presents a conflict of interest.

The second mechanism to combat abuse is the analysis conducted, sanguinely, under § 328(b) and § 330(a) once the fee applications are filed. These provisions exist to ensure (1) that the services provided by the attorneys representing the estate are not services that fall within the statutory duties of the trustee and (2) that such services are reasonable and necessary.

These two mechanisms—although necessary to protect the estate and creditors—expose a critical gap. Section 327(d) functions as nothing more than an opaque gatekeeper with minor entry requirements. At the backend, §§ 328(b) and 330(a) clearly serve a purpose, but the problems inherent with in-house employment do not become an issue for the court until compensation is sought, which could be years after the § 327(d) analysis is performed. In other words, there are statutory devices in place to deal with abusive fee issues at the frontend and backend of the case, but nothing in place to remediate or constrain trustee and attorney activity during the pendency of the bankruptcy case.

And it is during this substantial gap period when most problems arise for which the forward-looking approach of § 327(d) and the backward-looking analysis of § 328(b) and § 330(a) cannot cure. Indeed, *after* a trustee is authorized to employ himself and his own law firm to represent the estate, and *before* the fee applications are filed, three clear areas of conflict arise which have an enormous economic impact on the estate. The first touches on the classification of services. The second deals with the trustee’s responsibility to monitor legal fees. The third is the inherent financial self-interest of the trustee.

#### *A. The Trustee-Attorney Blur*

When a trustee has employed himself and his law firm as attorneys for the estate, both to be paid from the receipts of the estate, a clear problem arises. Unquestionably, this arrangement presents a situation that is “rife with conflict”

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<sup>147</sup> *Id.*

because the lines between trustee and attorney inevitably become blurred and breached.<sup>148</sup>

It may be impossible to articulate a definitive line between the legally compensable duties of a trustee and those of a professional appointed to assist the trustee. Nevertheless, it is imperative that the court attempt to identify this line in each case in order to prevent depletion of estates and derogation of the principles underlying the Code. Such an attempt is especially important in a case like this where the only distributions are to the trustee and her hired professionals.<sup>149</sup>

The Bankruptcy Code precludes reimbursing a law firm for work of the type that is supposed to be performed by the trustee. The duality of the attorney-trustee's role as trustee and as a member of the law firm is problematic. Because of their close relationship, it is difficult to ascertain whether the law firm is rendering services that, by express statute, are to be discharged by the trustee. Courts should not be put to the tedious and arduous task of second-guessing attorneys' classifications of billable time. When a trustee's law firm is retained as counsel to the trustee, "there is substantial temptation for the trustee to charge administrative duties as legal services, and thereby attempt to obtain double compensation."<sup>150</sup>

The temptation to describe charges as legal rather than managerial is too tempting, especially when "legal" time can be compensated on an hourly basis and "managerial" time cannot . . . [and] it would be naïve to hold that on marginal matters, the trustee would not tend to classify the services as legal rather than as managerial.<sup>151</sup>

If the fee application of the trustee's law firm does not carefully and accurately segregate between services rendered by the trustee and the services rendered by the law firm, which is more likely than not to happen, the trustee will improperly benefit from non-legal services billed as legal services, which is a clear violation of his fiduciary duties.<sup>152</sup>

The following recent cases are instructive and provide clear examples of this widespread problem.

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<sup>148</sup> *In re Peterson*, 566 B.R. 179, 191 (Bankr. M.D. Tenn. 2017).

<sup>149</sup> *In re King*, 88 B.R. 768, 770 (Bankr. E.D. Va. 1988).

<sup>150</sup> *In re Butler Indus.*, 101 B.R. 194, 197 (Bankr. C.D. Cal. 1989).

<sup>151</sup> *In re Mich. Interstate Ry. Co.*, 32 B.R. 325, 326 (Bankr. E.D. Mich. 1983).

<sup>152</sup> *S.E.C. v. Kenneth Bove & Co.*, 451 F. Supp. 355, 359 (S.D.N.Y. 1978).

1. *In re McCollom* (2016)

The first sentence of this opinion begins with the following: “A disturbing trend has developed among Chapter 7 panel trustees . . . to disregard the Bankruptcy Code and Bankruptcy Rules as they administer their assigned cases.”<sup>153</sup> In *McCollom*, the following exchange took place:

- Court: Can you tell me why are you conferring with the [realtor] regarding the sale of property?
- Lindstrom: If my memory serves me correctly, I believe I was telling her that the order had been signed by the Court.
- Court: Is that not something that Mr. Tow in his capacity as Trustee shouldn't be doing as opposed to you? . . . Are you rendering a legal service to the estate by calling the [realtor] and giving the [realtor] this information?
- Lindstrom: . . . I believe that I—I'm not rendering a legal opinion. I want to make sure I heard you correctly. I'm not giving a legal opinion.<sup>154</sup>

Among many other infractions, the court found that “the [t]rustee, not [his lawyer], should be conferring with his realtor to inform her that court approval has been given for the sale of property that the realtor has been marketing.”<sup>155</sup> “The Trustee’s attorney in this case should not be billing the estate for services that the Trustee himself should be rendering under his statutory duties. And, the Trustee should not be allowing the Firm’s attorneys to charge the estate for services that he himself should be performing.”

The court found another timekeeping breach: “Confer and correspond with buyer’s agent for easement property.”<sup>156</sup> “Once again . . . communications with prospective purchasers for sales of estate property fall within the Trustee’s statutory duties.” The trustee’s lawyer “should not be billing the estate for communicating with a prospective purchaser’s agent. That is the Trustee’s duty, and that is why the Trustee receives a fee under § 326(a) of the Code.”<sup>157</sup>

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<sup>153</sup> *In re McCollom Interests, LLC*, 551 B.R. 292, 294–95 (Bankr. S.D. Tex. 2016).

<sup>154</sup> *Id.* at 303.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

## 2. *In re King* (2016)

The *King* case involves a final fee application of a law firm representing a trustee who is also a named partner of the firm.<sup>158</sup> It begins as follows:

In assessing this application, it is painfully apparent that this trustee . . . has failed to abide by the strict rules and norms of the bankruptcy system regarding what can be billed to the estate. Stated differently, he has *violated his fiduciary duty* to the creditors in this case by allowing his firm to seek illegitimate fees from the estate. In complying with its duty to be a ‘keeper of the temple of justice,’ this Court will now take steps to minimize the chances of future violations.<sup>159</sup>

A very important aspect of the *King* case—like several other Chapter 7 cases—is the economics involved with the fee application and the impact on the estate. In *King*, the trustee had approximately \$191,000 to distribute to holders of allowed claims.<sup>160</sup> If the court were to approve the fee applications, the trustee’s law firm would receive approximately 67% of the proceeds; the trustee would receive approximately 16% of the proceeds; and the unsecured creditors would receive approximately 10% of the proceeds—i.e., \$19,000.<sup>161</sup> Due to the size of the largest unsecured claim, \$18,855.60 would go to this large unsecured claim, with the remaining \$144.40 (i.e., 0.76%) to be paid to the other five unsecured creditors.<sup>162</sup>

One of the frustrating aspects in the *King* case was the fact that a substantial amount of the firm’s fees were for services rendered that were non-legal in nature—i.e., fees for which the estate should not have to bear. Indeed, the court found that the trustee had “exhibited woeful control and fee monitoring of his firm, and his willingness to let his firm seek fees from the estate in the amount of \$123,282.25 [was] assuredly not in the best interest of creditors and the estate.”<sup>163</sup> In fact, the court found that the trustee’s firm was “seeking compensation for many services that have nothing to do with the practice of law and have everything to do with the ordinary duties that any trustee can fulfill without having to receive legal advice.”<sup>164</sup> The following is a small example of some of the law firm’s time entries that the *King* court properly disallowed as having nothing to do with the practice of law and being non-legal in nature:

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<sup>158</sup> *In re King*, 546 B.R. 682, 685 (Bankr. S.D. Tex. 2016).

<sup>159</sup> *Id.* (emphasis added).

<sup>160</sup> *Id.* at 689.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at 736.

<sup>164</sup> *Id.* at 736–37.

- *Organization of client's life insurance accounts.*
- *Review of documents provided by debtor.*
- *Review of information on personal property appraisal.*
- *Review of documents regarding valuation of development.*
- *Meeting with debtor's ex-husband.*
- *Telephone conference regarding status of bankruptcy.*
- *Telephone conference with real estate broker regarding listing issues.*
- *Telephone conference with real estate broker regarding terms of sale.*
- *Review of documents for closing.*
- *Review of title report.*<sup>165</sup>

Based on these time entries, and other duplicate, excessive, and unnecessary work, the *King* court entered a rather bold and unconventional order: it disapproved fees in the amount of \$81,141.50 and expenses in the amount of \$847.77 and, accordingly, changed the unsecured creditor distribution from \$19,000 to \$100,989.27.<sup>166</sup> In concluding its order, the *King* court made a strong admonition and set a remarkable precedence in the underlying bankruptcy district:

[T]his Court will now impose procedures to ensure, as much as possible, that whenever a Chapter 7 trustee retains his own law firm to represent him, the firm does not receive fees for services that the trustee should provide in his capacity as trustee. Specifically, in the future, for every fee application that a trustee's own law firm files, this Court will hold a hearing—even if no objections are lodged—and, at a minimum, require the trustee himself to give testimony explaining how the services rendered by the firm involve 'unique difficulties' beyond the trustee's own ability to resolve.<sup>167</sup>

...  
[T]he Court wants to emphasize to all Chapter 7 trustees in this district, and all the trustee-affiliated law firms who represent them, that they need to pay heed to § 328(b) so that they are not billing the estate for providing non-legal services or legal services that do not involve 'unique difficulties' beyond the trustees' ability to handle. To the extent that the trustees and their law firms contend that they have always billed for such services—and that therefore they have been abiding by the

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<sup>165</sup> *Id.* at 701–08.

<sup>166</sup> *Id.* at 736.

<sup>167</sup> *Id.* at 737.

norms of the system—this Opinion is intended to disabuse them of believing that they can do so in the future—at least in cases pending before the undersigned judge. Henceforth, this Court will be closely reviewing every entry of their timesheets to ensure that they are not improperly billing the estate.<sup>168</sup>

### 3. *In re Peterson* (2017)

Finally, in April 2017, another trustee and her law firm were heavily reprovved.<sup>169</sup> And again, the economics were exceptionally off-putting. The trustee’s firm’s fee application sought compensation in the total amount of \$84,794.20.<sup>170</sup> Approval of that application, coupled with previously awarded administrative fees of \$51,161.86, plus the anticipated trustee compensation under § 326, “would result in a dividend to creditors of 2.82%.”<sup>171</sup> This fee application was the first and only application filed with the court and it was filed four years after the entry of an order employing the trustee’s law firm to represent her.<sup>172</sup>

The trustee, who also testified as the attorney in the fee application hearing, provided some disturbing testimony. When asked to explain how certain services were not trustee services being billed as attorney services, for example, she answered “Well, if it is in that fee application, then it is for attorney work.”<sup>173</sup> And “an attorney talking to an attorney equals attorney time.”<sup>174</sup> At several times during the hearing when asked about her fees, services, and actions in the bankruptcy case, her common response was “I don’t know,” “I don’t remember,” and, the most alarming, “because that’s the way we’ve always done it in this district.”<sup>175</sup>

The trustee services for which her firm sought compensation were as follows:

- *Phone calls to counsel for lienholders.*
- *Employment of professionals.*
- *Correspondence regarding commissions as assets of the estate.*
- *Attending a hearing in third-party bankruptcy on behalf of the estate.*

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<sup>168</sup> *Id.* at 738.

<sup>169</sup> *In re Peterson*, 566 B.R. 179 (Bankr. M.D. Tenn. 2017).

<sup>170</sup> *Id.* at 185.

<sup>171</sup> *Id.* at 185–86.

<sup>172</sup> *Id.* at 187.

<sup>173</sup> *Id.* at 188.

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

- *Review of mail and documents from financial institutions.*
- *Motion to extend discharge objection deadline.*
- *Administrative objection to closure of case.*
- *Agreement regarding stay relief of lienholder.*
- *Initial review of bank statements.*
- *Initial meetings/conferences regarding possible Ponzi scheme.*
- *Communications and objection to application for administrative expenses.*
- *Preparation of fee application for special counsel and accountant.*<sup>176</sup>

This list represents a clear breach of the trustee's fiduciary duties. These services were delegated to the trustee's firm, even though these are services expressly identified in § 704 as trustee services. "The appropriate exercise of billing judgment necessarily includes the proper delegation of tasks so as to avoid charging the estate an inflated rate for a task that could and should be performed by a less costly employee."<sup>177</sup> But herein lies the problem: this misappropriation of duties does not even become apparent for the court until compensation is actually sought. If no one objects to the fee application, and if the court fails to conduct its own thorough and independent review, creditors may be left with a *de minimis* distribution. In point, if the bankruptcy court took the conventional rubber-stamping approach and approved the fee application, distribution to creditors in the *Peterson* case would amount to a paltry 2.82%.<sup>178</sup> Fortunately, that is not what the court did. Instead, like the *King* case, the *Peterson* court delivered some strong words to trustees:

In essence, the Court is only requiring the panel trustees to do what is common practice in the legal field: justify their fees to their clients. Again, the trustee's duty is to the estate, and the "clients" in this context include the general unsecured creditors, who are then intended beneficiaries of the estate and the principal reason the estate is being administered. Had the instant Application been submitted to a client outside the bankruptcy context, one can only imagine what such a client would say about a bill encompassing four years, and the severe lack of information and explanation regarding the contents of that bill.

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This Memorandum Opinion provides clear and direct guidance as to the expectations of the Court. Therefore, the United States

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<sup>176</sup> *Id.* at 194.

<sup>177</sup> *Id.* at 196.

<sup>178</sup> *Id.* at 185–86.

Trustee . . . is directed to distribute this Opinion to all of the panel trustees in this district.<sup>179</sup>

The above-cited cases demonstrate the dangers attendant to a trustee's retention of himself to serve as his own paid employee. Because of their close relationship, the services of the trustee and his law firm become heavily blurred. Recent case law clearly shows that the trustee is profiting from non-legal services to the estate in violation of his fiduciary duties.

### *B. Lack of Checks and Balances*

The second area of conflict that emerges when a trustee employs his own law firm as trustee's counsel is the trustee's duty to monitor all fees in the bankruptcy case and object to any inappropriate fees pursuant to § 704(a)(5) of the Code.<sup>180</sup> The duality of the attorney-trustee's role as trustee and as member of the law firm basically erases the checks and balances necessary to maximize returns to creditors. "The checks and balances inherent in the traditional attorney-client relationship become virtually meaningless when the client is permitted to review and pass upon the bills he submits to himself."<sup>181</sup> And when the time comes to review his firm's fees, "the trustee may find herself loathe to vigorously scrutinize the propriety of the charges."<sup>182</sup>

As an example, in *King*, there were several instances where attorneys were billing time for the exact same conference to one another.<sup>183</sup> In addition to possibly being duplicative, what is even more concerning is the fact that these conferences were billed for different amounts of time.<sup>184</sup> In one entry, for example, Attorney A lists .40 hours for conference with Attorney B.<sup>185</sup> On that same day Attorney B lists .20 hours for conference with Attorney A.<sup>186</sup> Which time entry is accurate, .40 or .20? Why is the trustee not catching these errors? The attorneys are sharing the same office space as the trustee. A simple review of the invoices and a discussion with his counsel would easily remediate this inconsistency. Although .20 hours is not a lot of time, the *King* opinion illustrates several of these inconsistencies, which do, of course, add up and dilute the estate.

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<sup>179</sup> *Id.* at 200.

<sup>180</sup> 11 U.S.C. § 704(a)(5) (2018); *see also In re Butler Indus.*, 101 B.R. 194, 196 (Bankr. C.D. Cal. 1989) (stating that the "trustee has a statutory duty to object to any fee application where the fees requested are not appropriate" and citing to § 704(a)(5) of the Code).

<sup>181</sup> *In re Kurtzman*, 220 B.R. 801, 804 (Bankr. S.D.N.Y. 1998).

<sup>182</sup> *In re Gem Tire & Serv. Co.*, 117 B.R. 874, 880 (Bankr. S.D. Tex. 1990).

<sup>183</sup> *In re King*, 546 B.R. 682, 726-27 (Bankr. S.D. Tex. 2016).

<sup>184</sup> *Id.*

<sup>185</sup> *See id.* at 727.

<sup>186</sup> *Id.*



Simply put, it seems nearly impossible for a trustee to exercise the same manner and type of billing judgment that he would exercise for private clients. When the trustee is sharing the same bed as his counsel, who will write off the duplicative hours or excessive time? Who will reduce time for services not beneficial to the estate? Probably not the trustee. He is more interested in obtaining the largest fee recovery on behalf of his firm than he is in fulfilling his statutory duty to object to any fees that are not appropriate. This presents an actual conflict of interest for the trustee.

### C. *Financial Self-Interest*

The third area of conflict that arises when a trustee retains his own law firm is his economic self-interest. Judge Friendly summed up these concerns well:

The reasons are plain enough. The conduct of bankruptcy proceedings not only should be right but must seem right. Even when litigation is likely to be the trustee's chief responsibility, there must always be doubt whether he can make a truly disinterested determination that his own firm, no matter what its overall merit, is best qualified to be his counsel in the circumstances of the particular case. . . . Some creditors may doubt, as here, whether a trustee is able to take quite the same objective and critical attitude toward the amount and quality of effort being put forward by his own law firm that he would toward another. On the other hand, in contrast to the situation in this case, there may be instances where creditors would believe the relationship had caused a trustee to be overly litigious. Finally, even the most experienced attorney who becomes a trustee in a complicated bankruptcy can benefit from the advice of an independent general counsel; we need not go so far as the familiar adage concerning self-representation by a lawyer to say that a second head is not without value in such matters simply because the first is exceedingly good.<sup>187</sup>

Simply put, the "trustee has a fiduciary duty to bring in funds, not friends."<sup>188</sup>

In *S.E.C. v. Kenneth Bove & Co.*,<sup>189</sup> the court expressed the view that the representation of the trustee by his own law firm is problematic because of the

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<sup>187</sup> *In re Ira Haupt & Co.*, 361 F.2d 164, 168-69 (2d Cir. 1966).

<sup>188</sup> *In re Bechuck*, 472 B.R. 371, 377 (Bankr. S.D. Tex. 2012).

<sup>189</sup> 451 F. Supp. 355 (S.D.N.Y. 1978).

“commingling of interests which occurs when a trustee’s lawyers also are his law partners, and they share one another’s fee.”<sup>190</sup> The court stated that a court

should be able to rely on the trustee for assistance in assessing the necessary expenses of administration. Yet a trustee who is represented by his own firm disables himself from offering such assistance with respect to the application for counsel fees. Thus, although the trustee is not prohibited from utilizing his own firm, to do so causes serious problems when compensation is sought.<sup>191</sup>

Another economical conflict that emerges is the possibility of a malpractice claim by the trustee against his own law firm and his natural disincentive to pursue such claim. This, again, presents an actual conflict. On the one hand, pursuing a viable malpractice action against the trustee’s law firm could result in a substantial payout to unsecured creditors. On the other hand, the malpractice claim could have a severe financial impact on the law firm and, consequently, the trustee, as member of the firm, including an increase in insurance premiums which would inevitably be absorbed by the firm’s partners. Naturally, the trustee is not going to pursue this claim.

Bankruptcy practitioners have also recognized dangers attendant to a trustee’s retention of his own law firm. “A trustee who represents himself has a built-in conflict in most cases in that his economic self-interest will tempt him to characterize his work as legal, not managerial.”<sup>192</sup> Moreover, research shows that in most cases where professionals are retained, the cost of administration frequently results in a decrease in ultimate distribution to creditors.<sup>193</sup>

Consider *In re McLean Wine Co.*<sup>194</sup> The *McLean* case dealt with the trustee’s counsel seeking \$113,627.06 in fees and costs for services rendered.<sup>195</sup> In one adversary proceeding commenced by trustee’s counsel, the maximum possible recovery from the litigation, based on the actual complaint filed, was approximately \$30,000.<sup>196</sup> Yet, the trustee’s counsel expended nearly \$28,000 in

<sup>190</sup> *Id.* at 358.

<sup>191</sup> *Id.* at 358–59.

<sup>192</sup> Robin E. Phelan & John D. Penn, *Bankruptcy Ethics, an Oxymoron*, 5 AM. BANKR. INST. L. REV. 1, 40 (1997).

<sup>193</sup> Marcy J.K. Tiffany, *Is Chapter 7 Cost Effective? An Analysis of Trustee Distribution Statistics in the Region 16 for Calendar Year 1996*, CAL. BANKR. J., at T1, T11–T13.

<sup>194</sup> 463 B.R. 838 (Bankr. E.D. Mich. 2011).

<sup>195</sup> *Id.* at 846.

<sup>196</sup> *Id.* at 851.

an attempt to recoup the \$30,000 for the estate, and actually ended up losing \$5,000.<sup>197</sup>

In another adversary proceeding, the complaint sought to recover alleged fraudulent transfers and the turnover of a truck or its value.<sup>198</sup> As set forth in the complaint, the trustee sought recovery of cash payments of \$2,055.06 or the truck's value of \$4,500.<sup>199</sup> Against a maximum possible recovery of only \$4,500, the trustee's counsel rendered services in excess of \$31,000.<sup>200</sup>

From an initial cost-benefit analysis, or at some point during the litigation process, a reasonable cost-benefit analysis "would have indicated that fees and costs were quickly rising to a level very near the maximum possible recovery."<sup>201</sup> Once it became reasonably obvious that the prospective costs of commencing or continuing litigation exceeded any benefit to the estate, were the trustee and the firm not duty-bound to abandon the claim? When a cause of action has a known maximum recovery, does a trustee not abuse his discretion when he (or his counsel) renders services significantly in excess of that amount? But who wants to "call out" his own firm for excessive fees? The trustee clearly has this independent fiduciary duty to the estate, but when his firm will inevitably fill his own pockets, why not roll the dice and make some money?

Telling a third-party firm, with whom the trustee has no financial interest, to abandon fruitless litigation, reduce duplicative or unnecessary fees, and conserve assets does not seem entirely that difficult. However, making efforts to maximize the estate by substantially reducing the fees of the firm who pays you a salary and significant origination presents an entirely different financial dilemma. On the one hand, the trustee is in a position to make a significant chunk of change. On the other hand, he has the ability to conserve the assets of the estate so that creditors receive a greater distribution. Which route will he choose? In most cases, the trustee's economic self-interest will likely motivate him to remain silent about the services his firm is rendering, even if those fees are entirely out of sync with the value of the asset sought to be recovered.

*In re McCollom* is another compelling case.<sup>202</sup> In that case, the trustee hired a firm to represent him.<sup>203</sup> The firm, however, was not independent of the trustee. In fact, the trustee's daughter was employed as an attorney at the firm.<sup>204</sup>

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<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 851–52.

<sup>199</sup> *Id.* at 852.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.* at 851.

<sup>202</sup> *In re McCollom Interests, LLC*, 551 B.R. 292 (Bankr. S.D. Tex. 2016).

<sup>203</sup> *Id.* at 295.

<sup>204</sup> *Id.* at 296.

This critical fact was not disclosed to the court or the creditors.<sup>205</sup> In the fee application filed by the firm, the firm estimated that there would be no distribution at all to the general unsecured creditors.<sup>206</sup> One can only imagine how creditors felt when this information eventually came to light. In addition to the erosion of creditor confidence in the trustee, the creditors likely saw the fee application and questioned whether the trustee even gave the application filed by the firm any scrutiny. Indeed, if the trustee's daughter would be financially harmed if the trustee reined in the litigation, reduced fees, or looked for more cost-effective ways to resolve disputes, would he do it? Perhaps not. As an example, according to the firm's invoice, one of the trustee's attorneys made two duplicative time entries.<sup>207</sup> If the trustee had reviewed the invoice as carefully as he should have, given his fiduciary duty to creditors, he likely would have caught the issue. Maybe he did catch it, but saw more of a downside to disputing the time entry. At the very least, both the trustee's and the firm's billing business judgment was lacking.

The bankruptcy court also saw the trustee-attorney relationship and the fees in this case as problematic. It stated,

the failure of both the trustee and the firm to make disclosure about [the trustee's daughter, who was employed by the firm], and also to obtain approval for [the daughter] to render services for the estate, reflects a glaring omission of experienced and board-certified professionals that greatly concerns this Court.<sup>208</sup>

The court added:

By supporting an unjustified fee request that, if approved, would put dollars into the pockets of the [law firm] that employs his daughter, the Trustee is thumbing his nose at the unsecured creditors in this case, who would receive some or all of the dollars that the Trustee wants this Court to authorize him to remit to the Firm.<sup>209</sup>

Lastly, in *In re IFS Financial Corp.*,<sup>210</sup> the Fifth Circuit Court of Appeals was presented with the following issue on appeal: whether a trustee's conduct in attempting to bill the bankruptcy estate for a trip that he made with his wife and children was a breach of his fiduciary duty and amounted to "cause" for removal

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<sup>205</sup> *Id.*

<sup>206</sup> *Id.* at 308.

<sup>207</sup> *Id.* at 305–06.

<sup>208</sup> *Id.* at 301.

<sup>209</sup> *Id.* at 300–01.

<sup>210</sup> 803 F.3d 195 (5th Cir. 2015).

as trustee.<sup>211</sup> In short, Smith and his law firm were required to defend an appeal of a judgment.<sup>212</sup> Oral arguments were scheduled before the Fifth Circuit in New Orleans.<sup>213</sup> Smith, the trustee, attended as lawyer and trustee.<sup>214</sup> His wife, Ms. Smith, attended as the trustee's lawyer.<sup>215</sup> Their two children also attended.<sup>216</sup> The estate was billed approximately \$3,500 in travel expenses related to the oral argument.<sup>217</sup> These expenses were incurred over a five-day period, and included hotel room charges of over \$1,600, over \$600 in food charges, \$900 in airline tickets, and \$170 in taxi fares.<sup>218</sup>

Because the bills were from Smith's own law firm, his fiduciary duty required him to assure that the transactions with his law firm were subject to the highest standards of fundamental fairness.<sup>219</sup> At the bankruptcy court level, the court found that "[t]he history of th[e] case reflect[ed] Smith ha[d] consistently acted to advance his law firm's interests to the detriment of the estate."<sup>220</sup> And that his "prior conduct is evidence of his intent to act against his fiduciary responsibilities."<sup>221</sup> The trustee's disturbing conduct was highlighted by the bankruptcy court as follows:

- Smith sought to retain his own firm as counsel, alleging that retention was justified, in part, because retention would benefit his firm. He alleged that it was fair to retain his firm in this potentially profitable case, because his firm accepted unprofitable representation of other Estates. This reasoning was rejected by the Court.
- When Smith was subsequently authorized to retain his own firm on a contingent fee basis, Smith attempted to shift expenses (that were required to be borne by his firm) to the Estate. This too was rejected.
- When a creditor challenged Smith's misguided attempt to shift expenses to the Estate, Smith (acting in his trustee

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<sup>211</sup> *Id.*

<sup>212</sup> *Id.* at 199.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *In re* IFS Fin. Corp., Nos. 04-34514, 04-34515, 04-34516, 04-34517, 04-34519, 04-34520, 04-34521, 04-34523, 04-34525, 04-34526, 04-34529, 04-34530, 2013 WL 2018540, at \*2 (Bankr. S.D. Tex. May 13, 2013).

<sup>220</sup> *Id.* at \*8.

<sup>221</sup> *Id.*

capacity) filed a retaliatory lawsuit against the creditor. The lawsuit was designed solely to punish the creditor for acting against Smith's firm. Although Smith denied that the lawsuit was retaliatory, the Court finds that his testimony on this issue lacked credibility.

- When the Court issued an expense ruling that was favorable to the Estate, but detrimental to Smith's firm, Smith (in his trustee capacity) sought reconsideration of the order and eventually appealed the order. This conduct, taken in his trustee capacity, was designed to benefit his firm and injure the Estate.
- Smith then charged the Estate for \$3,486.37 in expenses to attend oral argument in New Orleans. A substantial portion of the charges are wholly unjustified. No reasonable person would have authorized the Estate to reimburse Smith's firm for the unjustified expenses.<sup>222</sup>

The Fifth Circuit agreed with the bankruptcy court that Smith's conduct justified removal since his conduct was found to be a "violation of the trustee's fiduciary duties, misconduct or failure to perform the trustee's duties."<sup>223</sup> The Fifth Circuit also recognized that the best interests of the estate must be considered, and it found that the bankruptcy court did by stating that "[t]he court, and parties in interest, must not be called upon to examine each action taken by a trustee . . . . [They] should have confidence that a trustee will never intentionally breach a fiduciary obligation."<sup>224</sup> In this case, he most certainly did.

In the above-cited cases, who is the beneficiary of the trustee's misconduct? It is the trustee's law firm and, of course, the trustee. These cases demonstrate the clearest example of self-dealing and intentional breaches of fiduciary duties. One cannot ignore the fact that when a trustee retains his own law firm, a built-in conflict of interest exists. Yet, the Bankruptcy Code authorizes this arrangement if the "best-interest-of-the-estate" test is demonstrated. Based upon just the few cases discussed herein, is this showing even possible? When a trustee retains his firm, his firm holds an interest adverse to the estate whenever compensation is sought. The trustee will not have "the same objective and critical attitude toward the amount and quality of effort being put forward by his own law firm that he would toward another."<sup>225</sup> It is clear from the cited cases that "[t]he trustee occupies a position of divided loyalty when she is required to zealously represent the interests of the estate while

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<sup>222</sup> *Id.* at \*8–9.

<sup>223</sup> *In re IFS Fin. Corp.*, 803 F.3d 195, 207 (5th Cir. 2015).

<sup>224</sup> *Id.*

<sup>225</sup> *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

retaining at least some interest in seeing that her firm obtain recovery of its fees for time and resources expended on the case.”<sup>226</sup> Consequently, “[i]t is not unreasonable to imagine that a typical bankruptcy trustee . . . might rely to a greater or lesser extent on the resources of the trustee’s firm to effectively carry out the trustee’s administrative duties.”<sup>227</sup>

In short, the employment of the trustee’s law firm arguably creates an impermissible conflict of interest and is never in the best interest of the estate. How will a trustee not succumb to the various temptations to make more money at the estate’s cost? It seems nearly impossible, especially when one understands how simple it is to disguise attorney-trustee fees and provide obscure and ambiguous invoices. Nonetheless, the Code expressly allows this employment arrangement. And until Congress repeals § 327(d), which it may never, creditors are stuck with the issues and financial harm identified in this Article. Courts, however, can take several steps to minimize the milking.

## V. MINIMIZING THE MILKING

Courts need to do more to protect the estate and creditors, and at this moment, they are not. This Article is not identifying a minor problem occurring in very limited situations—the problem is widespread. As one court noted, “[d]espite having an experienced group of panel trustees, through the years, the practice of hiring their own firms to represent estates has become a routine rather than being an exception.”<sup>228</sup> In the *Peterson* case, for example, the trustee testified that she has been a Chapter 7 trustee for 28 years and in that position, for that period of time, she “handled thousands of cases in her role as Trustee and, she stated, hundreds wherein she employed the firm to represent her as Trustee.”<sup>229</sup> Surely this is not the first time the trustee in *Peterson* misappropriated her fiduciary duties. This cannot be the first instance where this trustee improperly charged fees to the estate.

The Code charges bankruptcy courts with an independent duty to review all fee applications presented in all bankruptcy cases.<sup>230</sup> This review, of course, is to ensure that the requested fees are reasonable, necessary, and justified and that estates are being administered economically. One of the main resources a

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<sup>226</sup> *In re Gem Tire & Serv. Co.*, 117 B.R. 874, 879 (Bankr. S.D. Tex. 1990).

<sup>227</sup> *Id.*

<sup>228</sup> *In re Peterson*, 566 B.R. 179, 198–99 (Bankr. M.D. Tenn. 2017).

<sup>229</sup> *Id.* at 192. This Author recognizes that in some jurisdictions, the incestuousness of trustee firms is still problematic because of the referral network and possible fee-sharing that occurs between them. Thus, the safeguards discussed herein are not only to keep the trustee and his firm in check, but also to keep the trustee and his closely-allied firms in check when he chooses to hire “outside” counsel. Indeed, in some closely-connected situations, “outside” counsel may be tantamount to in-house counsel.

<sup>230</sup> 11 U.S.C. § 330 (2018).

bankruptcy judge uses to assist in maintaining the integrity of the bankruptcy system is the trustee assigned to a case. After all, the trustee is on the frontlines of the bankruptcy system. However, when the trustee has employed himself and his law firm as attorneys for the trustee, both to be paid from the receipts of the estate, the court stands alone in this endeavor. When this happens, the court's oversight of the trustee and the estate becomes particularly important. Section 327(d)'s "best-interest" test and § 328's limitation on compensation of professionals employed by the estate, is wholly insufficient to deal with the attorney-trustee fee abuse.

Furthermore, when it comes to the trustee's own fees, rather than encouraging bankruptcy judges to undertake an independent evaluation of the fees being sought and whether the trustee's services were actual and necessary, recent case law mandates an automatic maximum commission-based approach for the Chapter 7 trustee. On January 26, 2018, the Fifth Circuit Court of Appeals was presented with the following issue: whether §§ 326 and 330 of the Bankruptcy Code allow a court to reduce a trustee's commission.<sup>231</sup> In addressing this issue, the Fifth Circuit identified two approaches for determining the appropriate "commission" for Chapter 7 trustees. One approach is that "Section 326(a) is not simply a maximum but also a presumptively reasonable fixed commission rate to be reduced only in rare instances or 'extraordinary circumstances.'"<sup>232</sup>

The second approach declines to presume § 326(a) percentages as reasonable because the "bankruptcy court has discretion to award reasonable compensation only for actual and necessary services, and may award an amount less than that requested by the trustee."<sup>233</sup> Under this approach, "the court can and should consider all surrounding facts and circumstances in deciding whether to award something less than the Section 326 commission . . . ."<sup>234</sup>

After discussing these approaches, the Fifth Circuit chose to adopt the interpretation aligned with the first approach—i.e., that the percentage amounts listed in § 326 are presumptively reasonable for Chapter 7 awards.<sup>235</sup> This holding is troubling and harmful to creditors. Determining a trustee's compensation based strictly on a percentage rather than on a factor-based assessment of the trustee's services opens the fee-abuse door even wider than it already is. Under this holding, trustees are under no obligation to demonstrate that their compensation is reasonable or proportionate. They are under no obligation to show that the work they performed was for actual and necessary services on behalf of the estate. In fact, this holding basically means that trustees

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<sup>231</sup> *In re JFK Capital Holdings, L.L.C.*, 880 F.3d 747 (5th Cir. 2018).

<sup>232</sup> *Id.* at 753.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

<sup>235</sup> *Id.*



have an absolute right to be paid the maximum commissions allowed under § 326(a) and that bankruptcy judges must slavishly award the maximum even if the fee is substantially disproportionate in relation to the value of the trustee's services. Taking away the bankruptcy court's discretion when it comes to trustee awards is simply another failure on the part of a system designed to protect creditors and the bankruptcy estate.

The United States' trustee perpetuates this problem. Without referring to any statute or other authority, the U.S. trustee program announced that it would not object to maximum commissions for Chapter 7 trustees except in "extraordinary circumstances" that it "expected to arise only in rare and unusual circumstances."<sup>236</sup> This is merely the U.S. trustee's statement of policy issued without rulemaking authority and, thus, lacks force of law. Yet, its pronouncement encourages further trustee fee abuse, considering it has now been communicated to trustees that the U.S. trustee will neither scrutinize nor review their fee requests. Instead, the U.S. trustee will simply punt to the bankruptcy court and creditors and allow them to sift through all of the problems inherent in the fee applications. As one court put, "[i]t is an announcement that the U.S. trustee, except in 'extraordinary' circumstances that can be as rare as the U.S. trustee pleases, will focus attention elsewhere and leave chapter 7 trustee compensation to parties and the courts."<sup>237</sup>

Paradoxically, one of the U.S. trustee's fundamental principles is that "a trustee shall not administer an estate or an asset in an estate where the proceeds of liquidation will primarily benefit the trustee."<sup>238</sup> One is left to wonder how that principle is not offended when the U.S. trustee—and now the Fifth Circuit—permits the Chapter 7 trustee to appropriate the lion's share of available funds through excessive, unreasonable, and disproportionate commissions. And, "[w]hile the trustee . . . has a duty to monitor, comment, and object to fees, it does not do its duty."<sup>239</sup> An example of this was shown in *In re Scoggins*,<sup>240</sup> where the bankruptcy court noted that in a two-year period, there were

<sup>236</sup> U.S. DEP'T. OF JUSTICE EXEC. OFFICE FOR U.S. TRS., *supra* note 115, at 2-1.

<sup>237</sup> *In re Scoggins*, 517 B.R. 206, 215 (Bankr. E.D. Cal. 2014).

<sup>238</sup> U.S. DEP'T. OF JUSTICE EXEC. OFFICE FOR U.S. TRS., *supra* note 115, at 4-1. The "fundamental principle" from the U.S. Trustee Handbook reads in its entirety as follows:

A chapter 7 case must be administered to maximize and expedite dividends to creditors. A trustee shall not administer an estate or an asset in an estate where the proceeds of liquidation will primarily benefit the trustee or the professionals, or unduly delay the resolution of the case. The trustee must be guided by this fundamental principle when acting as trustee. Accordingly, the trustee must consider whether sufficient funds will be generated to make a meaningful distribution to unsecured creditors, including unsecured priority creditors, before administering a case as an asset case.

*Id.* (emphasis added).

<sup>239</sup> *In re Scoggins*, 517 B.R. at 221.

<sup>240</sup> 517 B.R. 206 (Bankr. E.D. Cal. 2014).

approximately 62,000 Chapter 7 cases filed in the Eastern District of California, yet the U.S. trustee filed *zero* “comments” or “oppositions” to Chapter 7 trustee fees during that period.<sup>241</sup>

One may also ask: what is the harm in a disproportionate and excessive trustee fee if nobody objects? “The harm is the loss of public confidence in the integrity of the bankruptcy system if it comes to be regarded as managed primarily for the benefit of those who operate it.”<sup>242</sup> Moreover, the ease at which trustees and their counsel can milk the estate creates discontentment and, in some cases, apathy amongst the judiciary. Judges who once diligently and independently scrutinized fee applications are now compelled by case law to turn a blind eye absent “extraordinary circumstances.” Presiding over a broken system must be a cumbersome and weighty endeavor. One can imagine that a “if-you-can’t-beat-’em-join-’em” mentality is pervasive amongst the bankruptcy judiciary.

In an ideal world, creditors and the U.S. trustee would exploit the estate milking, but in the real world, this is not happening. The U.S. trustee is failing in its duty to monitor and object to fees, and creditors rarely object because they are not given transparent information from which to object. Further, even if a creditor was given this information, the costs and fees of hiring lawyers and objecting to fee applications would, in almost all cases, exceed the amount of the creditor’s entire claim. Fortunately, even in the absence of help from creditors and the U.S. trustee, there are several mechanisms courts can effortlessly adopt to protect the estate, creditors, and the sanctity of the bankruptcy process.

#### *A. The Preliminary Budget and Asset-Recovery Plan*

When a trustee files an application to employ a particular firm to represent the estate, bankruptcy courts should focus on whether the proposed professional will maximize the value for the estate. If an application lacks sufficient information to convince the bankruptcy court that the proposed lawyer is the best choice to represent the estate, the court has substantial discretion to deny the application.<sup>243</sup> At a minimum, the application should disclose (1) the history of success of the proposed lawyer and past representations of trustees; (2) how often the proposed lawyer has undertaken the specific tasks assigned to them in the underlying case; and (3) the fees charged in prior trustee representations and the value of their services on the estate. But even after the court determines that the attorney is qualified and is the best choice to maximize the estate, it cannot go dormant.

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<sup>241</sup> *Id.*

<sup>242</sup> *Id.*

<sup>243</sup> *In re* Bechuck, 472 B.R. 371, 375 (Bankr. S.D. Tex. 2012).

Courts should require the Chapter 7 trustee to file a litigation budget and asset-recovery plan as part of the employment application or shortly after employment has been authorized. Currently, neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure require that the trustee prepare or obtain litigation budgets or litigation plans. Yet, “[t]he most powerful tools for managing litigation expense are the litigation plan and budget.”<sup>244</sup> Evaluating the risk and likelihood of success in pursuing causes of action or other assets for the benefit of the estate should be a crucial part of the trustee’s job, which the creditors expect the trustee to fulfill. This undertaking of providing the court and the creditors advance direction of the steps that will be taken in the prosecution of the matter and a reasonable prediction of what it may cost to take those steps, even if there are some uncertainties, should not be problematic. Necessitating a reasonable litigation plan and corresponding budget would substantially curtail the widespread fee abuse. For example, when the trustee and his professionals file their fee applications with their attached invoices, the court and creditors can, among other things, match the time entries against the previously filed budget and plan.

Not surprisingly, “[v]irtually every company employing lawyers today has written guidelines, whether internal or published to outside counsel, which purport to support the goal of reducing legal spending. More often than not, the guidelines require that counsel prepare and submit a budget for any significant legal matter.”<sup>245</sup> If this is such common practice in the legal world, why are courts not requiring it from the trustee and his counsel? Guidelines and budgets comport with the basic premise that “one of the obvious steps required to reduce legal costs are trying to determine what they are, what they will be in the future, where they go and the extent to which they are necessary. A budget can help a client [and creditors] with these determinations.”<sup>246</sup>

Another purpose of the budget and plan beyond simply managing costs is it facilitates advance consideration and discussion about the assets the trustee is considering chasing and whether any value truly exists in those assets. Among other things, a budget and plan would force the trustee and his lawyers to (1) evaluate the merits of all potential claims; (2) analyze the solvency of the potential defendants and the collectability of a judgment; (3) consider the likelihood of settlement; and (4) map out a strategy that would provide an actual positive return to the estate.

Furthermore, the budget and plan are not solely for benefit of the court and creditors. Indeed, these tools would help the trustee and his counsel immensely. In addition to functioning as a valuable blueprint for the particular

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<sup>244</sup> JOHN TOOTHMAN & DOUGLAS DANNER, TRIAL PRACTICE CHECKLIST § 1:4 (2d ed. 2018).

<sup>245</sup> Michael Bridwell & Daryl Vance, *Creating and Managing a Case Budget*, 36 *ADVOC.* 7, 7 (2006).

<sup>246</sup> *Id.*

bankruptcy case, an early budget prepared by the trustee and his lawyers could mitigate cost concerns when fee applications are filed. For example, creditors would be hard pressed to challenge fees which were expressly and transparently predicted in the budget and plan. Questioning the trustee's decision and discretion to pursue a particular cause of action would be frivolous, at best, if that action was identified in the litigation plan and the creditor made no such challenge at that time. While the creditor's inaction to the initial litigation plan would likely not operate as a complete waiver, a fairly strong estoppel argument could be made by the trustee and his counsel. This, alone, confers a benefit on the trustee.

Obviously, one important issue is how the trustee and his counsel create the budget and litigation plan. The purpose of this Article is not to generate a sample budget or litigation plan, as this author does not believe any one type of approach is best. In addition, all claims and causes of action possess a fair amount of idiosyncrasies, so coming up with a model plan or a one-size-fits-all approach is a wasteful endeavor. Instead, this Article offers a few simple suggestions for courts to consider. In any adversary proceeding, there are five basic cost points: pleadings, discovery, motion practice, hearings/trial, and appeals. The litigation plan and budget should reduce to writing how these cost points will be managed in each adversary proceeding commenced by the trustee. A well-designed litigation plan and budget should include the projected cost of the adversary proceeding as well as the projected costs of the basic cost points. This undertaking can be accomplished without forcing the trustee to furnish any privileged information or litigation strategy. Indeed, the trustee and his counsel are doing nothing more than identifying causes of action and projecting the reasonable costs.

For the most part, neither the trustee nor his counsel should have problems preparing a realistic legal fee budget. The majority of adversary proceedings filed by the trustee involve avoidance claims under the Bankruptcy Code. And the majority of contested matters brought by the trustee generally involves asset sales, turnover motions, or other similar asset-recovery claims. The trustee and his counsel can use experience and historical data from other similar cases and matters to establish price tags for each step of the plan. While the trustee and his counsel may balk at this endeavor, preparing a budget and plan is arguably part of fulfilling their fiduciary duties. Courts have recognized that counsel for the trustee has a fiduciary duty to "realistically weigh the maximum possible success of any litigation against the costs to be incurred pursuing the litigation."<sup>247</sup> "A lawyer hired by a trustee in bankruptcy to do legal work for the estate, like the trustee himself, is a fiduciary of the estate."<sup>248</sup> In order to weigh the success of the litigation against the costs, and maximize the

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<sup>247</sup> *In re McLean Wine Co.*, 463 B.R. 838, 850 (Bankr. E.D. Mich. 2011).

<sup>248</sup> *In re Taxman Clothing Co.*, 49 F.3d 310, 314 (7th Cir. 1995).

value of the estate, a litigation budget and plan are necessary. “The attorney in his or her fiduciary capacity, bears not only a duty to conserve the estate’s net assets, but to maximize the value of the estate.”<sup>249</sup> “A trustee and his attorney must undertake the same analysis that attorneys make in all types of cases to determine whether the potential costs and risks of litigation are justified.”<sup>250</sup> And this “analysis, balancing costs versus benefits, *must* be taken at the time services are rendered.”<sup>251</sup>

A lawyer must consider the amount in dispute and discount that by the likelihood of success in order to properly evaluate the worth of litigation, and then owes a professional duty to the client to recommend that no action be commenced if the cost of the battle exceeds the value of the litigation.<sup>252</sup>

Without a transparent plan and budget, it is more likely than not that the trustee’s counsel will not undertake this evaluation, especially if there are already substantial funds in the estate to pay the legal fees. Instead, they might just start milking the estate.

Interestingly, in several Chapter 11 cases, the United States Trustee ordinarily will seek the use of fee and expense budgets and staffing plans, either with the consent of the parties or by court order as soon as feasible after the commencement of the bankruptcy case.<sup>253</sup> In fact, the use of budgets in Chapter 11 is so important that the United States Trustee considers fee applications in the context of budgets used in the case and counsel is urged to consult with the United States Trustee whether they anticipate delays in formulating a budget.<sup>254</sup> As part of this budget, counsel is suggested to disclose the number of lawyers expected to work on the matter during the budget period, including years of experience.<sup>255</sup> Further, budgets can and should be amended as necessary to reflect changed circumstances or unanticipated events.

As part of this process, the United States Trustee may also seek a court order expressly authorizing the exchange of budgets by counsel for the debtor-in-possession and the officer committees once they are approved by their respective clients or whenever amended. And these budgets may be provided subject to an appropriate confidentiality agreement and redacted to protect all

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<sup>249</sup> *In re Allied Comput. Repair, Inc.*, 202 B.R. 877, 887 (Bankr. W.D. Ky. 1996).

<sup>250</sup> *In re Minich*, 386 B.R. 723, 728 (Bankr. C.D. Ill. 2008).

<sup>251</sup> *In re Williams*, 378 B.R. 811, 826 (Bankr. E.D. Mich. 2007) (emphasis added).

<sup>252</sup> *In re Arnold*, 162 B.R. 775, 779 (Bankr. E.D. Mich. 1993).

<sup>253</sup> 6A HON. WILLIAM HOUSTON BROWN, ET AL., WEST’S FED. FORMS, BANKRUPTCY COURTS § 9:10 (4th ed. 2018).

<sup>254</sup> *Id.*

<sup>255</sup> *Id.*

privileged or confidential information. “The confidential and prospective exchange of budgets between these *fiduciaries* concerns the administration of the case and potentially avoids duplication.”<sup>256</sup>

If this budgetary practice in Chapter 11 cases is so customary and routine, Chapter 7 trustees and their counsel should have no problem following similar guidelines and mandates.

### *B. Interim Reports, Applications, and the Duty to Abandon*

As some of the cases discussed throughout this Article demonstrate, without a clear roadmap for the litigation matter, trustee’s counsel may spare no expense in an effort to prevail. A litigation plan and budget, however, filed with the court, would help avoid the Pyrrhic victory that some trustees are known for obtaining. But courts should not stop there. The trustee and his counsel should also be required to file interim reports and fee applications with the bankruptcy court providing updates of the various proceedings commenced by the trustee, the fees and costs incurred and requested thus far, the likelihood of settlement or obtaining judgment, and the likelihood of collecting.

Courts routinely find that the fiduciary duties discussed in this Article also require counsel for the trustee to discontinue litigation when it becomes apparent that the fees charged will outpace the maximum possible recovery. “This duty obligates the lawyer for the estate to abandon litigation once it becomes reasonably obvious that the cost of pursuing litigation over a particular matter is out of sync with the value of the asset sought to be recovered.”<sup>257</sup> “Once it becomes reasonably obvious that the prospective costs of commencing or continuing litigation will exceed any benefit to the estate, the attorney is duty bound to abandon the claim.”<sup>258</sup> The “reasonably obvious” standard is objective and asks, “did a time come when a reasonable lawyer in [the counsel’s] position would have abandoned the suit?”<sup>259</sup> Thus, it is abundantly clear that counsel for the trustee is only justified in pursuing litigation “only until it [becomes] reasonably obvious that further litigation would cost more than it was likely to bring into the estate.”<sup>260</sup>

But who will suggest that the trustee and his counsel dump fruitless claims and save the estate money if the creditors and the court are not receiving interim updates regarding the status of the litigation as well as periodic or quarterly fee requests? This exact scenario occurred in *In re McLean Wine Co.*,<sup>261</sup>

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<sup>256</sup> *Id.* (emphasis added).

<sup>257</sup> *In re Allied Comput. Repair, Inc.*, 202 B.R. 877, 887 (Bankr. W.D. Ky. 1996).

<sup>258</sup> *In re Keene Corp.*, 205 B.R. 690, 696 (Bankr. S.D.N.Y. 1997).

<sup>259</sup> *In re Taxman Clothing Co.*, 49 F.3d 310, 315 (7th Cir. 1995).

<sup>260</sup> *In re Eckert*, 414 B.R. 404, 411 (Bankr. N.D. Ill. 2009).

<sup>261</sup> 463 B.R. 838 (Bankr. E.D. Mich. 2011).

discussed previously, where the trustee's counsel sought \$113,627.06 in fees and costs for services rendered as counsel for the trustee.<sup>262</sup> In one adversary proceeding, the maximum possible recovery from the litigation, based on the actual complaint filed, was approximately \$30,000.<sup>263</sup> Yet, the trustee's counsel expended nearly \$28,000 in an attempt to recoup the \$30,000 for the estate, and actually ended up losing \$5,000.<sup>264</sup> In another adversary proceeding, the complainant sought to recover alleged fraudulent transfers and the turnover of a truck or its value.<sup>265</sup> As set forth in the complaint, the trustee sought recovery of cash payments of \$2,055.06 or the truck's value of \$4,500.<sup>266</sup> Against a maximum possible recovery of only \$4,500, the trustee's counsel rendered services in excess of \$31,000.<sup>267</sup>

Had the bankruptcy court mandated detailed interim reports regarding all outstanding litigation in the *McLean* case, as well as quarterly fee applications, both the court and creditors could have forced the trustee and his counsel to abandon these actions that were clearly not yielding a benefit to the estate. Case law demonstrates that neither the trustee nor his counsel are exercising this critical, independent professional judgment to discontinue litigation where costs of continuing litigation will exceed any benefit to the estate. As such, courts should mandate interim litigation and cost reports from the trustee and his counsel. These updates are an excellent way of keeping the trustee, the court, and the creditors updated. Additionally, courts must mandate that the trustee and his counsel file periodic fee applications on a quarterly basis, at a minimum. If these additional suggestions are adopted, trust in the system would be strengthened and the trustee's counsel would be forced to become more sensitive to the costs involved. These minimal requirements will pay extraordinary dividends to the bankruptcy estate.

### C. *A Call for Repeal of § 327(d)*

A bankruptcy judge made a recent invitation to Congress that merits consideration:

Whenever Congress next considers amending the Code, it might want to change the existing provision allowing trustees to retain firms with which they are affiliated. *IFS Financial Corp.*, *King*, and the case at bar—which involve three different Chapter 7 trustees in this District—suggest that trustees, instead

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<sup>262</sup> *Id.* at 846.

<sup>263</sup> *Id.* at 851.

<sup>264</sup> *Id.*

<sup>265</sup> *Id.* at 851–52.

<sup>266</sup> *Id.* at 852.

<sup>267</sup> *Id.*

of looking out for the interests of unsecured creditors to whom they owe a fiduciary duty, are looking out more for the interests of their affiliated law firms and themselves to the detriment of unsecured creditors. Indeed, these cases reveal an unsavory side of the bankruptcy practice that harkens back to an era when bankruptcy was considered by many to be a corrupt practice of the law.<sup>268</sup>

When code provisions conflict and cannot be harmonized, or when they are failing in their purpose, a repeal or amendment may be appropriate. Section 327(d) conflicts with § 327(a). When the trustee hires himself as his own attorney, there is an inherent conflict of interest and real potential for abuse. Section 327(a) provides that a trustee may employ attorneys “that do not hold or represent an interest adverse to the estate, and that are disinterested persons.”<sup>269</sup> As one court observed: “The Code states that the attorney must be both disinterested and not hold or represent an interest adverse to the estate. § 327(a) is [a] qualification section, and as such, failure to meet either element mandates disqualification.”<sup>270</sup> Thus, to be qualified under § 327(a), attorneys must meet two requirements: (1) they must not hold or represent an interest adverse to the estate; and (2) they must be disinterested persons within the meaning of the Code.<sup>271</sup> “Together, the statutory requirements of disinterestedness and no interest adverse to the estate ‘serve the important policy of ensuring that all professionals appointed pursuant to § 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities.’”<sup>272</sup>

To “hold an adverse interest to the estate” means “(1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate.”<sup>273</sup> A “disinterested person” is defined in § 101(14) as, among other things, a person that “does not have an interest materially adverse to the interest of the estate.”<sup>274</sup> One bankruptcy court stated:

Bankruptcy Code 101(13)[(14)(C)] was adopted from Bankruptcy Rule 10–202(c)(2)(D). “It appears broad enough to include anyone who in the slightest degree might have some

<sup>268</sup> *In re McCollom Interests, L.L.C.*, 551 B.R. 292, 309 (Bankr. S.D. Tex. 2016).

<sup>269</sup> 11 U.S.C. § 327(a) (2018).

<sup>270</sup> *In re Leisure Dynamics*, 32 B.R. 753, 754 (Bankr. D. Minn. 1983).

<sup>271</sup> *Id.*

<sup>272</sup> *In re 7677 E. Berry Ave. Assocs.*, 419 B.R. 833, 841 (Bankr. D. Colo. 2009).

<sup>273</sup> *Id.* at 842.

<sup>274</sup> 11 U.S.C. § 101(14)(C).



interest or relationship that would color the independent and impartial attitude required by the Code.” 2 Collier on Bankruptcy Para. 327.03[f], p. 327–16 (15th Ed.1981). The purpose of the rule is to prevent a conflict without regard to the person’s integrity. Conflicting loyalties may arise even from remote or indirect associations. 2 Collier P. 327.03[f]. The goal should be not to prevent actual evil in this particular case, but the *tendency to evil* in all cases.<sup>275</sup>

Despite the requirements found in § 327(a)—being disinterested and not holding an interest adverse to the estate—and “even in the face of legitimate conflict of interest concerns regarding delegation of work between the trustee and the trustee-as-attorney,”<sup>276</sup> Congress somehow approved § 327(d) of the Bankruptcy Code, which expressly allows a trustee to retain his own law firm to represent him in his capacity as a trustee.<sup>277</sup> That section requires nothing more than a showing that such employment be in the “best interests of the estate.”<sup>278</sup> This term, as discussed previously, is not defined by the Code and courts have been unable to formulate a precise meaning or test. Because of this ambiguity and uncertainty, it is appropriate to examine § 327(d)’s legislative history. The legislative history for the “best interests” test pre-dates the current Code section. In adopting the 1978 Code, however, legislative history emphasized the need for reform

to eliminate the abuses and detrimental practices that had been found to prevail [under the Bankruptcy Act of 1898]. Among such practices was the cronyism of the “bankruptcy ring” and attorney control of bankruptcy cases. In fact, the House Report noted that “[i]n practice . . . [t]he bankruptcy system operates more for the benefit of attorneys than for the benefit of the creditors.”<sup>279</sup>

In short, “[a]ll of § 327 is aimed at eliminating any appearance of impropriety in the trustee’s selection of professionals.”<sup>280</sup>

Along these lines, the legislative history of § 328(b) indicates that the purpose of permitting the trustee (and his firm) to serve as his own counsel is to reduce costs. The House Report further states that the purpose “is not included to provide the trustee with a bonus by permitting him to receive two fees for the

<sup>275</sup> *In re Sambo’s Rests., Inc.*, 20 B.R. 295, 297 (Bankr. C.D. Cal. 1982) (emphasis added).

<sup>276</sup> *In re Dreibelbis*, No. 14–61483, 2015 WL 3536102, at \*2 (Bankr. N.D. Ohio June 4, 2015).

<sup>277</sup> 11 U.S.C. § 327(d).

<sup>278</sup> *Id.*

<sup>279</sup> *In re CNH, Inc.*, 304 B.R. 177, 180 (Bankr. M.D. Pa. 2004) (citing H.R. 595, 95th Cong., 2d Session, at 92, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6053 (1978)).

<sup>280</sup> *In re Wolfson*, 575 B.R. 522, 524 (Bankr. D. Colo. 2017).

same services . . . . Thus, this subsection requires the court to differentiate between the trustee's services as trustee, and his services as trustee's counsel, and to fix compensation accordingly."<sup>281</sup>

The proper question, therefore, is whether § 327(d)—permitting in-house employment—conflicts with § 327(a)—prohibiting employment of interested persons or those that hold an interest adverse to the estate. This author contends it does. And case law demonstrates that these two sections are at odds. If § 327(a) is aimed at eliminating any appearance of impropriety in the trustee's selection of counsel, including the requirement that counsel must be both disinterested and not hold or represent an interest adverse to the estate, how is § 327(d)'s authorization of in-house employment to be read when juxtaposed with the significant amount of case law showing such a widespread abuse? Section 327(a) is clear that divided loyalties are a concern, yet divided loyalties are inherently endorsed by § 327(d). Indeed, how can the trustee make a truly disinterested and objective decision when both he and his firm stand to gain financially by milking the estate?

Cronyism is at its optimum when the trustee hires his own firm. In addition to eroding creditor confidence, the estate actually suffers. When large fee applications are filed by the trustee's firm, will the trustee really give these applications the same scrutiny he would give to those of an outside firm? The cases discussed thus far prove that trustees are refusing to rein in the lawyers of their firm who appear to be more interested in being overly litigious than maximizing the return to creditors. Another obvious concern is that the trustee might receive less candid and independent advice from inside counsel.<sup>282</sup> Indeed, “[w]ill a partner or associate in the trustee's own firm be comfortable questioning the trustee's strategies and assessments? On the other hand, will the trustee feel free to question his firm's advice?”<sup>283</sup> The answer is likely, “no.” One of the trustee's duties is to monitor all legal fees in the bankruptcy case, including those of the trustee's legal counsel. In fact, the trustee has a statutory duty to object to any fee application where the fees requested are not appropriate.<sup>284</sup> Yet, when the trustee's own law firm is appointed as his counsel, he is clearly interested in obtaining the largest fee recovery on behalf of his firm. This, alone, presents an actual conflict of interest for the trustee.

Furthermore, § 327(d), standing alone, is problematic. It states that the trustee may act as his own lawyer if such employment is in the estate's “best interest.”<sup>285</sup> Quite possibly, appointment of a trustee's own law firm as counsel

<sup>281</sup> H.R. REP. NO. 95-595, at 328–29, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6053; S. REP. NO. 95-989, at 39 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5825, 6285.

<sup>282</sup> *In re Wolfson*, 575 B.R. at 525.

<sup>283</sup> *Id.*

<sup>284</sup> 11 U.S.C. § 704(5) (2018).

<sup>285</sup> *Id.* § 327(d).

is never in the estate's best interest and rarely serves to "reduce costs," as discussed in the House Report associated with § 327(d). Instead, the employment arrangement represents a chance for misuse of estate assets, especially because legal fees are paid by the bankruptcy estate. This, of course, causes an associated reduction in creditor distributions. This is particularly troublesome when the legal fees have been shown to not adequately increase the value of the bankruptcy estate. Moreover, the line between a trustee duty and a legitimate legal expense is particularly blurry when in-house employment and case law has shown time and again that the trustee is "double dipping" by billing certain tasks as an "attorney" when he should be performing the same task as one of the administrative functions of his job as a trustee. As one court stated, "[w]here the trustee or the trustee's law firm is appointed as the trustee's own attorney, there is a substantial temptation for the trustee to charge administrative duties as legal services, and thereby to attempt to obtain double compensation."<sup>286</sup> Consequently, "[o]n marginal matters, at least, the trustee would tend to classify the services as legal rather than managerial."<sup>287</sup>

In short, eliminating § 327(d) would (1) ensure that the requirements of § 327(a) are adequately satisfied when the trustee seeks to employ counsel and (2) curtail the widespread fee abuse and the appearance of impropriety. If the trustee employs outside counsel, he is more likely to monitor legal fees in the bankruptcy case. He is more likely to object to fees that are not appropriate. He is more likely interested in maximizing the value of the estate, rather than obtaining excessive and large fee recoveries on behalf of his law firm. Moreover, outside counsel is much less likely to undertake administrative duties for a trustee and shoulder the risk of disallowance of its fees for these services. In other words, eliminating § 327(d) eradicates the conflict of interest that is inherently present in in-house employment arrangements.

This author recognizes that amendments to the Bankruptcy Code may not be in the near future. Consequently, bankruptcy courts should consider whether it is appropriate to adopt a policy in their jurisdiction of not allowing a trustee to employ himself and his firm as attorney for the estate since it may never be in the estate's best interest because of the inherent impropriety in such an arrangement.

## VI. CONCLUSION

The problems identified herein are significant. While a trustee should have some latitude in selecting legal counsel, when it comes to in-house employment, more parameters and safeguards—other than the vague "best interest" standard—are required to protect the estate from abuse. The duality of the attorney-trustee's role as trustee and as member of the law firm basically

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<sup>286</sup> *In re Butler Indus.*, 101 B.R. 194, 197 (Bankr. C.D. Cal. 1989).

<sup>287</sup> *Id.*

erases the checks and balances necessary to maximize returns to creditors and completely erodes creditor confidence.

For trustees who wish to employ themselves and their firms as counsel, courts should require the trustee to produce a preliminary budget and asset-recovery plan at the inception of employment or as a condition to employment. At a minimum, this rather simple undertaking will allow the bankruptcy court and creditors to fully understand why legal counsel has been employed and then assess the worth of litigation. At the same time, a budget and asset-recovery plan will force the trustee and his counsel to realistically weigh the maximum possible success of any litigation against the costs to be incurred pursuing the litigation.

Another safety device courts should adopt is a requirement that the trustee and his counsel file interim-reports and periodic detailed fee applications supported by time records and narrative statements of service. With these periodic reports and applications, the trustee and his counsel will be forced to discontinue litigation when it becomes apparent that the fees charged will outpace the maximum possible recovery. And if they fail to abandon such fruitless litigation, their fees should not be recoverable.

Lastly, Congress should consider eliminating § 327(d) because of the conflict it creates with § 327(a). And courts, at the very least, should consider disallowing this employment arrangement altogether.

[P]rofessionals engaged in the conduct of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration.<sup>288</sup>

“The conduct of bankruptcy proceedings not only should be right but seem right.”<sup>289</sup> When a trustee—who clearly holds a fiduciary obligation to the debtor's estate and its creditors—hires himself and his firm to represent the estate, he places himself in a position which gives the appearance of impropriety and creates a conflict of interest. Indeed, equitable principles require that a fiduciary only serve one master.<sup>290</sup> This in-house employment arrangement inherently compromises the trustee's primary duty to maximize the value of the bankruptcy estate. By retaining their own law firms to represent them, and then requesting illegitimate legal fees to be paid by the estate, trustees are in clear breach of their fiduciary duties to creditors. This conduct should not be tolerated by courts or acceptable to creditors of the bankruptcy estate.

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<sup>288</sup> *In re Phila. Athletic Club, Inc.*, 20 B.R. 328, 334 (Bankr. E.D. Pa. 1982).

<sup>289</sup> *In re Gem Tire & Serv. Co.*, 117 B.R. 874, 877 (Bankr. S.D. Tex. 1990).

<sup>290</sup> *Id.*

As such, courts (and Congress) should foreclose this behavior by establishing and implementing the safeguards discussed herein, including outright denial of in-house employment requests. If this problem is overlooked or minimized, trustees and their law firms will continue to view the bankruptcy estate as a cash cow and will milk it (and bilk it) for all its worth.