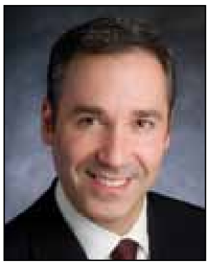
By Jordan A. Kroop and Bradley A. Cosman

Of Bunnies and Moneys: Fixing Trustee Payment under § 326(a)



Jordan A. Kroop
Perkins Coie LLP
Phoenix

Bradley A. Cosman
Perkins Coie LLP
Phoenix

Jordan Kroop is a partner with Perkins Coie LLP's Financial Transactions and Restructuring Group in Phoenix. Bradley Cosman is an associate in the same office.

Thomas Austin, a cattle and sheep rancher who left Victorian England for Australia in the 1850s, is widely regarded as the person responsible for introducing rabbits to Australia. He was a hunting enthusiast with a penchant for shooting small, furry rodents that were not indigenous to the land "down under." He imported two dozen rabbits from England and released them on his ranch, reasoning that "the introduction of a few rabbits could do little harm and might provide a touch of home, in addition to a spot of hunting."[1] Austin's rabbits propagated like … well, like rabbits — so much so that by 1901, the exploding rabbit population in Australia threatened to destroy its farming industry, forcing the government's land department to build what became the longest fence in the world: more than 2,000 miles of fencing to keep the voracious horde of rabbits from advancing any further west into Australia's agricultural heartland.

Austin could not have been familiar with 20th century American sociologist Robert Merton's now-famous "law of unintended consequences," or else he might have reconsidered his "hare"-brained scheme. His solution to the small problem of a rabbit-less homestead had the unintended consequence of jeopardizing Australian agriculture. To this day, Australia has a serious rabbit problem.

A relatively recent chapter 11 case in Phoenix had a rabbit problem of its own, created by the unintended consequences of Congress's drafting of § 326(a) of the Bankruptcy Code while thinking only of chapter 7 trustees. Radical Bunny LLC was an Arizona entity that pooled investments from individuals and personal trusts for the purpose of making loans to another now-infamous Arizona lender called Mortgages Ltd., which, in turn, used the loan proceeds from Radical Bunny to make short-term secured loans to real estate developers. In 2008, as the real estate market collapsed, Mortgages Ltd.'s loan portfolio became deeply distressed, and by June 2008, it was in chapter 11. Four months later, faced with no reasonable possibility of being repaid on its loans to Mortgages Ltd., Radical Bunny itself was in chapter 11.[2] The bankruptcy court appointed a chapter 11 trustee to administer an estate devoid of any cash or liquid assets and containing essentially one illiquid asset: approximately $197 million in alleged secured claims against the Mortgages Ltd. bankruptcy estate.

After substantial bankruptcy court litigation that lasted more than two years, Radical Bunny — through its chapter 11 trustee — and Mortgages Ltd. reached a settlement that was ultimately embodied in a Byzantine chapter 11 plan for Mortgages Ltd. that, among many other things, allowed Radical Bunny's claims and gave the Radical Bunny bankruptcy estate two sources of recovery: (1) an interest in a liquidation trust vested with various Mortgages Ltd. assets and (2) membership interests in a series of loan-specific limited liability companies (LLCs) vested with the lender's interests in particular outstanding loans originally made by Mortgages Ltd. Most of those loans were already distressed, many were themselves the subject of other bankruptcy proceedings and foreclosures, and nearly all required considerable time to realize maximum value for LLC members like Radical Bunny. Although Radical Bunny's recoveries under the Mortgages Ltd. plan were likely worth at least a few million dollars, everyone knew that it would take years to monetize Radical Bunny's interests in those LLCs.

Having negotiated this settlement with the Mortgages Ltd. estate, the Radical Bunny chapter 11 trustee proposed his own simple reorganization plan in March 2010. Radical Bunny's plan provided for a reorganized entity to maintain operations that were strictly limited to managing and ultimately monetizing the illiquid LLC membership interests that Radical Bunny received under the Mortgages Ltd. plan. Since the Radical Bunny estate had no cash or other liquid assets at the time that its chapter 11 trustee's plan was confirmed in May 2010, payment of all administrative expenses, including all the trustee's fees, was delayed more than a year until proceeds from the Mortgages Ltd. loan LLCs began to trickle in.

Once the Mortgages Ltd. estate began distributing cash to reorganized Radical Bunny, Radical Bunny's chapter 11 trustee filed a final fee application. Despite the absence of any material objections to the compensation sought in that application, now-retired Bankruptcy Judge Charles Case identified a peculiar statutory problem: Section

1 "The State Barrier Fence of Western Australia," National Library of Australia, *available at* http://pandora.nla.gov.au/pan/43156/20040709-0000/agspsrv34.agric.wa.gov.au/programs/app/barrier/history.htm.

2 *In re Radical Bunny LLC*, Case No. 2:08-bk-13884-CGC (Bankr. D. Ariz.). Radical Bunny's bankruptcy case was converted to chapter 11 shortly after an involuntary petition had been filed by creditors. The court appointed a chapter 11 trustee in light of several ongoing civil and criminal investigations being conducted by the Securities and Exchange Commission and the state of Arizona against the individuals running Radical Bunny.

326(a) seemed to preclude the court from approving *any* compensation to the chapter 11 trustee because "the Trustee did not distribute money [to the reorganized Radical Bunny] in the traditional sense."[3]

Here is how the problem arises: Sections 330 and 326(a) of the Bankruptcy Code work together to determine the appropriate amount of compensation that should be awarded a trustee. Under § 330, bankruptcy courts are authorized to award "reasonable compensation" to trustees.[4] Once requested fees are deemed reasonable under § 330, § 326(a) imposes a sliding scale of sorts that caps the amount of reasonable compensation at a percentage of "moneys disbursed or turned over in the case by the trustee to parties in interest." In this way, the reasonableness of the trustee's compensation is first determined under § 330 and then "cut down" to the cap calculated under § 326(a).[5]

Since § 326(a) expressly tethers compensation to "moneys disbursed or turned over," what constitutes "moneys" significantly affects a trustee's compensation. If the trustee does not disburse or turn over any moneys, the trustee's fee cap is zero. But does "moneys" simply mean "cash"?

Regarding "moneys" as being synonymous with cash presents little problem, for the most part, in chapter 7 cases because chapter 7 trustees have an express duty to expeditiously liquidate all assets of the estate into cash.[6] Construing "moneys" as being synonymous with cash can, however, create a serious problem for chapter 11 trustees, whose duty is to operate the debtor's business and confirm a reorganization plan.[7] If "moneys" means only cash, chapter 11 trustees who administer estates with prospectively valuable but presently illiquid assets — real estate, causes of action, ownership interests in other entities, etc. — may find themselves entirely uncompensated. Must chapter 11 trustees hastily and recklessly monetize these types of assets, realizing only a small fraction of their potential future value, just so they have something to distribute and, therefore, a means of being compensated for their service under § 326(a)? Wouldn't doing that implicate trustees' fiduciary duties to the estate? By allowing trustee compensation only with reference to "moneys disbursed" in § 326(a), Congress has seemingly created the unintended consequence of offering chapter 11 trustees a Hobson's choice: either (1) recklessly liquidate assets and get paid, or (2) prudently wait to maximize asset value and not get paid. Section 326(a) has created a rabbit problem.

The scope of the term "moneys" as used in § 326(a) has been previously explored in the context of chapter 7 cases and has resulted in a split of authority. An apparent minority of courts has developed a "constructive disbursement" theory, which allows a trustee to receive compensation based on the value of disbursements of property or other consideration, not just distributions of cash. Under this theory, nonliquidated property is deemed to be "moneys" for purposes of § 326(a); this includes property such as securities,[8] realty that is subject to existing liens,[9] a guaranty of contracts[10] and the assumption of an existing mortgage.[11]

Modify § 326(a) to compensate a chapter 11 trustee based on a percentage of the "*value of property* disbursed or turned over," rather than ... "*moneys* disbursed or turned over."

However, a majority of courts, including the Fifth Circuit, still rejects the constructive disbursement theory, some due to a "plain-meaning" analysis.[12] Other courts have rejected the constructive disbursement theory as inconsistent with putative congressional intent regarding § 326(a).[13] Courts rejecting the constructive disbursement theory have done so despite acknowledging the potentially inequitable results for trustees,[14] as well as warnings that excluding distributions of property from § 326(a) would create an incentive for trustees to liquidate assets even though liquidation might not be in the best interests of the estate.[15] These courts simply find themselves constrained by the plain meaning of § 326(a).

There is another apparent problem of statutory construction: The Bankruptcy Code uses "moneys" in only two places, whereas it uses "cash" in several other places. When Congress said "cash," it meant cash, so ostensibly, Congress must have meant something different when it used the word "moneys" instead of "cash." It is a principle of statutory interpretation that different words used in the same statute should be assigned different meanings whenever possible.[16]

Case law on either side of the issue has been largely limited to chapter 7 cases. There has been essentially no reported case law analyzing the application of § 326(a) in chapter 11 — particularly where a plan has been confirmed — where a trustee's role is markedly different and where the unintended consequences of § 326(a) are most pernicious. The stark difference between the roles of chapter 7 trustees and chapter 11 trustees may offer a logical

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3 *In re Radical Bunny LLC*, Case No. 2:08-bk-13884-CGC (Bankr. D. Ariz.), Under Advisement Decision Approving Chapter 11 Trustee's Fee Application, dated July 22, 2011 [Docket No. 1211].

4 As a practical matter and under most case precedent, "reasonable compensation" is typically determined by considering, among other things, the amount of time spent, hourly rates charged, whether the services were necessary or beneficial, complexity of the tasks performed, and customary compensation charged by comparably skilled practitioners in non-bankruptcy cases.

5 *Gill v. Wittenburg (In re Fin. Corp. of Am.)*, 114 B.R. 221, 223 (B.A.P. 9th Cir. 1990).

6 11 U.S.C. § 704(a)(1). As discussed below, this is not to say that the scope of "moneys" in chapter 7 has not been without controversy.

7 11 U.S.C. § 1106(a) (requiring chapter 11 trustee to perform duties in § 704(a), but not § 704(a)(1)).

8 *See In re Toole*, 294 F. 975 (S.D.N.Y. 1920).

9 *See Southwestern Media Inc. v. Rau*, 708 F.2d 419, 423 (9th Cir. 1983) (*dictum*); *In re Stanley*, 120 B.R. 409 (Bankr. E.D. Tex. 1990).

10 *See In re Greenly Energy Holdings Pa. Inc.*, 102 B.R. 400 (E.D. Pa. 1989).

11 *See York Int'l Bldg. Inc. v. Chaney*, 527 F.2d 1061, 1074 n.12 (9th Cir. 1975).

12 *See Pritchard v. United States Trustee (In re England)*, 153, F.3d 323 153 F.3d 232, (5th Cir. 1998) ("[The] plain language of § 326(a) indicates that the statute caps a trustee's compensation based upon only the moneys disbursed, without any allowance for the property disbursed."); *see also In re Barnett*, 133 B.R. 487, 489 (Bankr. N.D. Iowa 1991) (relying on plain language to exclude property disbursements from § 326(a)); *In re New England Fish Co.*, 34 B.R. 899, 901-02 (Bankr. W.D. Wash. 1983) (same); *In re Am. Canadian Invests. Inc.*, 353 B.R. 852 (Bankr. E.D. Va. 2006) (same).

13 *See Staiano v. Cain (In re Lan Assocs. XI LP)*, 192 F.3d 109, 115-21 (3d. Cir. 1999) (value of credit-bid not within scope of "moneys" under § 326(a); based on legislative history of § 326(a), "moneys" is limited to cash equivalents); *In re Am. Canadian Invests. Inc.*, 353 B.R. 852 (Bankr. E.D. Va. 2006) (based on legislative history of § 326(a), "moneys" is limited to cash equivalents).

14 *Lan Assocs.*, 192 F.3d at 121 (concluding that solution to potential undercompensation of trustees resulting from their holding lies with Congress); *England*, 153 F.3d at 237 (same).

15 *England*, 153 F.3d at 236 (noting that § 330 allows bankruptcy court to award lesser amount of compensation when trustee has manipulated estate to increase maximum compensation under § 326(a)).

16 *See, e.g., Cunningham v. Scibana*, 259 F.3d 303, 308 (4th Cir. 2001) ("The use of different terms within related statutes generally implies that different meanings were intended." (quoting 2A Norman J. Singer, *Sutherland's Statutes and Statutory Construction* § 46.06, at 194 (6th ed. 2000))).

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basis for distinguishing chapter 7 case law that rejects the constructive disbursement theory. Judge Case's decision in *Radical Bunny* did precisely that.

Judge Case rejected the argument that "moneys" is not synonymous with "cash" and ruled that the distributions made under the *Radical Bunny* plan were not "moneys" under the plain meaning of the word.[17] The court then turned to the constructive distribution theory,[18] recognizing that "monetary recovery [was] all but impossible" in the *Radical Bunny* case, but also noting that the trustee had nevertheless managed to bring substantial value to the estate through the confirmed *Mortgages Ltd.* plan and the *Radical Bunny* plan. The court acknowledged — but then rejected — a strict application of § 326(a) that would bar the trustee from any compensation. As the court put it, denying the chapter 11 trustee all fees where the trustee had confirmed a plan that brought significant, albeit non-cash, value to the estate would be an "absurd result not intended by the legislative process."[19] This resulted in an unintended consequence: Radical Bunny's rabbit problem.

The bankruptcy court found that Radical Bunny's chapter 11 trustee deserved compensation because the trustee did exactly what § 1106 of the Bankruptcy Code directed him to do: confirm a plan. By awarding the chapter 11 trustee's requested compensation despite the statutory formulation in § 326(a), the *Radical Bunny* decision highlights both the problem and the solution that is associated with use of the term "moneys" in § 326(a).

The problem is that a narrow interpretation of the term "moneys" in § 326(a) unjustly denies compensation to chapter 11 trustees who have successfully administered a valuable — but illiquid — estate. The solution is as easy as it is obvious: Modify § 326(a) to compensate a chapter 11 trustee based on a percentage of the "*value of property* disbursed or turned over," rather than a percentage of "*moneys* disbursed or turned over." This minor statutory amendment would better align a chapter 11 trustee's compensation with a chapter 11 trustee's duties. Just three words would fix the unintended consequences of legislative drafting.

It's the fence that would keep the rabbits out. abi

17 *Id.* at 6 (citing various dictionary and other sources).

18 *Id.* at 7. The bankruptcy court also analyzed other situations beyond constructive disbursement theory in which courts had allowed the payment of fees under § 326(a) even though no money had been disbursed. For example, the bankruptcy court pointed out that trustee fees have been approved in the following instances: (1) where a case has been converted from chapter 11 to chapter 7 before any distributions were made (*see In re Fin. Corp. of Am.*, 114 B.R. 221 (B.A.P. 9th Cir. 1990)), (2) where a case had been converted from chapter 7 to chapter 13 before distributions were made (*see In re Hages*, 252 B.R. 789 (N.D. Cal. 2000)) and (3) on the basis of *quantum meruit. Id.* at 8-10. Although analyzed, the bankruptcy court did not ultimately rely on these situations in its holding.

19 *Radical Bunny* at 5-6.