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7 UNITED STATES BANKRUPTCY COURT
8 EASTERN DISTRICT OF CALIFORNIA
9 FRESNO DIVISION

10 In re) Case No. 09-11871-B-7
11 Covenant Services, Inc.,)
12 Debtor.)
_____)

13
14 **ORDER REGARDING CHAPTER 7 TRUSTEE'S
APPLICATION FOR FEES AND EXPENSES**

15 The chapter 7 trustee in this case, Robert Hawkins, has filed his Trustee's
16 Final Report ("TFR") indicating that the case has been fully administered and is
17 ready to close. With the TFR, the Trustee also filed an *ex parte* application for
18 payment of his fees and expenses. (Doc. No. 110; the "Fee Application"). In the
19 Fee Application, the Trustee requests "compensation" in the amount of \$23,625
20 and reimbursement of expenses in the amount of \$383.09. Based on Local
21 Bankruptcy Rule ("LBR") 2016-2(a), the court cannot approve the Fee
22 Application on an *ex parte* basis. The Fee Application must be noticed and set
23 for hearing pursuant to LBR 9014-1. The Fee Application must also be
24 supported by time records and a narrative statement of the Trustee's services.¹
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27 ¹Pursuant to LBR 2016-2, a noticed hearing is required whenever a chapter 7
28 trustee requests compensation in excess of \$10,000 (b)(1); or requests compensation
which exceeds the amount remaining to pay priority and general unsecured creditors
(b)(2), or the funds available to compensate the trustee are the result of an undisclosed
"carve out" agreement between the trustee and a secured creditor (b)(3). All three of
these factors appear to be present here.

1 **The Carve-Out Agreement.** This chapter 7 case was filed in March 2009
2 and Robert A. Hawkins was appointed as the trustee (the “Trustee”). Prior to the
3 bankruptcy, Covenant Services, Inc. (the “Debtor”), was engaged in the
4 construction business. At the commencement of the bankruptcy, the Debtor was
5 one of several cross-complainants in a civil suit then pending in the Kern County
6 Superior Court. On Schedule B, the Debtor listed its claim in that litigation as an
7 asset described as "CSI vs. GE, Westco, and Powell Industries" (the “GE
8 Litigation”). In question number 4 of its Statement of Financial Affairs, the
9 Debtor further described the nature of this asset as "Wesco Distribution vs.
10 Covenant Services et al, Breach of contract and related cross complaint.”

11 Shortly after the bankruptcy was filed, Insurance Company of the West
12 (“ICW”) appeared through counsel and filed a request for special notice. ICW
13 was the Debtor’s surety and, prior to commencement of this case, had already
14 paid in excess of \$4.5 million to settle claims against the Debtor. Accordingly,
15 ICW asserted an interest in the proceeds of the GE Litigation by right of
16 subrogation. ICW filed a secured claim in October 2009. ICW's claim included
17 attachments (Doc. No. 18 at 2) detailing the basis for its interest in the GE
18 Litigation stating, in paragraph 9, page 5, “[t]he value of the Debtors' estate
19 property that secures [ICW’s] claim is unknown, but it is believed to be of a
20 value substantially less than the amount of [ICW’s] claim as set forth in this
21 Proof of Claim. . . .” In other words, ICW asserted a security interest in all of the
22 proceeds, if any, which might otherwise benefit the bankruptcy estate from
23 successful prosecution of the GE Litigation.

24 After the meeting of creditors in June 2009, the Trustee filed a report of no
25 distribution indicating that there would be no assets for distribution to unsecured
26 creditors. Presumably, the Trustee had confirmed that ICW had a security
27 interest in, or some other perfected right to, the proceeds of the GE Litigation.

1 Three weeks later, in July 2009, the Trustee filed a notice of assets (the “NOA”)
2 requesting that the creditors be instructed to file their proofs of claim. The NOA
3 did not identify what assets the Trustee had located for distribution to unsecured
4 creditors. However, 17 claims, secured, priority unsecured, and general
5 unsecured, totaling \$6,446,118.10, were filed in the case. The largest secured
6 claim was filed by ICW, the Debtor's surety, in the amount of \$5,816,457.31.

7 Thereafter, there was no apparent activity in this case for almost a year,
8 until June 2010, when the Trustee filed an *ex parte* application to employ special
9 counsel under a contingency fee arrangement. (Doc. No. 22.) The Trustee
10 requested employment of special counsel to prosecute the GE Litigation against
11 cross-defendants Westco, GE, and Powell. Nothing in that employment
12 application disclosed the fact that ICW had a security interest in all of the
13 proceeds of the GE Litigation which the Trustee wanted to prosecute. ICW's
14 attorneys were not served with the application to employ special counsel and thus
15 were not given an opportunity to respond. The application was therefore
16 approved without objection.

17 Over a year later, in July 2011, ICW filed a motion for relief from stay
18 (DC No. KAW-1) and a motion to compel abandonment (DC No. KAW-2), both
19 of which related to ICW's interest in, and prosecution of, the GE Litigation.
20 ICW sought permission to prosecute the Debtor's claims in the GE Litigation, in
21 its own name, as assignee and subrogee of the Debtor. ICW contended that it
22 was the “beneficial and equitable owner” of the claims “pursuant to a pre-petition
23 assignment, as well as ICW's equitable subrogation rights as surety.” ICW
24 argued that its security interests fully encumbered the Debtor's interest in the GE
25 Litigation, and that there would be no remaining equity for the benefit of the
26 estate. “It has become evident that should the Chapter 7 Trustee continue to
27 prosecute the litigation, the estate would be working for the benefit of its
28

1 largest secured creditor, which in and of itself makes little sense given the limited
2 resources in this case.” (Doc. No. 33, p.2:26-p.3:1.)

3 The Trustee opposed ICW's effort to take over and prosecute the GE
4 Litigation because he had already retained special counsel to do it for the estate.
5 In reply, ICW focused on the lack of progress in the GE Litigation and argued
6 that it was being damaged by the delay. ICW reiterated its position that the GE
7 Litigation had no value for the unsecured creditors.

8 The two motions (relief from stay and abandonment) were heard together
9 in August 2011. At that hearing, attorney Kirsten Roe Worley (“Worley”)
10 appeared for ICW. Worley asked for a 30-day continuance, stating that ICW was
11 exploring a *solution suggested by the Trustee*. The court inquired why it had
12 taken so long, more than two years, for ICW to assert its interest in the GE
13 Litigation. There appeared to be no dispute regarding ICW's right to the
14 proceeds of the GE Litigation. Based on the alleged “assignment” to ICW, the
15 court questioned whether the GE Litigation was property of the estate. The court
16 also questioned its authority to surcharge ICW’s collateral with special counsel’s
17 40% contingency fee. In response to the court’s questions, the Trustee
18 represented that the parties were *working on a resolution* that he would present at
19 the continued hearing. If they could not resolve the issue, then he would “wipe
20 my hands and be done with it.” Worley apologized for not advising the court of
21 the *possible settlement*, stating that the potential solution only appeared the day
22 before. The court therefore granted the unopposed motion for relief from stay
23 and continued the motion to compel abandonment.

24 At the continued hearing, Worley again appeared for ICW. She
25 represented that there was a *tentative arrangement* between ICW and the Trustee.
26 The Trustee asked the court to drop the matter from calendar so he could file a
27 new motion to approve the purported “agreement” he had worked out with ICW.

1 The Trustee offered no details regarding the terms of that agreement. The court
2 said, it was not clear that the GE Litigation would result in any benefit to the
3 estate, and questioned the parties whether the purported “agreement” would be a
4 Rule 9019 compromise motion. The Trustee and Worley indicated it would not
5 be a Rule 9019 matter, that instead it would be a stipulation between parties to
6 proceed with the GE Litigation. Worley reiterated that ICW was willing to work
7 with the Trustee. The Trustee suggested that the court drop the “abandonment”
8 matter subject to being reset on 15 days notice if further relief was necessary.

9 In June 2012, the parties submitted, and the court approved, a proposed
10 order which partially resolved the matter (Doc. No.71; the “Abandonment
11 Order”). The Abandonment Order provided for the abandonment of the claims
12 and causes of action against Wesco. However, the Trustee retained the cross-
13 claims against GE and Powell, subject to ICW's security interest in any and all
14 proceeds recovered by Trustee.

15 A little over two years later, on September 16, 2014, the Trustee filed a
16 motion for approval of a compromise with GE whereby GE would pay \$407,500
17 to the estate (the “Compromise Motion”). In the Compromise Motion the Trustee
18 represented that, after payment of special counsel’s contingency fee and
19 expenses, the *estate* would net \$200,626.10.²

20 4. The Trustee and the defendant have reached an agreement
21 whereby the defendant will pay to the bankruptcy the sum of
22 \$407,500.00. After payment of attorney fees and costs and
expenses, the estate will net \$200,626.10.

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26 ²In a second declaration the Trustee filed an “updated” distribution showing
27 expenses of \$47,943.59, and a net recovery to client of \$196,556.41. Doc. No. 80,
28 Exhibit A.

1 5. The debtor is a cross-complainant in the above-entitled lawsuit.
2 The negotiations for settlement of the lawsuit have been lengthy
3 and exhaustive, and a compromise has finally been reached. The
4 Trustee has negotiated in good faith for several months and is of the
5 opinion that the compromise for the estate is fair and equitable to
6 all parties.

7 6. The Trustee has accepted the proposed compromise on the
8 advice of special counsel and taking into account the costs of
9 continuing to litigate the matter and the estimated costs of pursuing
10 any recovery.

11 7. The continuance of this matter as an unresolved issue in the
12 estate, being a contested matter, would result in the estate being
13 administered in a substantially longer time, possibly years longer,
14 than is proposed by the compromise.

15 Trustee's Motion for Order Approving Compromise of Controversy, 2:2-15, Doc.
16 No. 74.

17 The Trustee's declaration explains the Compromise Motion as follows:

18 4. I reviewed the cross-complaint for breach of contract and fraud
19 related to the order and delivery of electrical equipment to the
20 debtor and obtained Court approval of employment of special
21 counsel on June 11, 2010 to continue litigation.

22 5. I have reached an agreement with the defendant whereby the
23 defendant will pay to the bankruptcy the sum of \$407,500.00. After
24 payment of attorney fees and costs and expenses, I estimate that the
25 estate will net \$200,626.10. I have relied on advice from my
26 attorney that the settlement is fair and equitable.

27 6. I have participated in lengthy and exhaustive negotiations for
28 settlement of the lawsuit, and a compromise has finally been
reached. I have negotiated in good faith and am of the opinion that
the compromise for the estate is fair and equitable to all parties. I
have accepted the proposed compromise in good faith.

Declaration of Robert Hawkins in Support of Trustee's Motion for Order
Approving Compromise of Controversy, 2:1-11, Doc. No. 76.

Exhibit A, attached to the Points and Authorities filed in support of the
Compromise Motion, was a breakdown of the proposed disbursement of
settlement funds. Attorney's fees to be paid to special counsel at 40% were listed
as \$163,000, plus costs and expenses in the amount of \$47,943.59. The "Net
Recovery to Client" was stated to be \$196,556.41.

1 Because the Compromise Motion was fully noticed and there was no
2 objection, the court granted the motion without oral argument. However, nothing
3 in the motion, notice, or the supporting documents, disclosed the fact that
4 unsecured creditors would receive nothing from the settlement with GE. In other
5 words, the Trustee had negotiated a “deal” with ICW to prosecute the GE
6 Litigation with special counsel, solely for the benefit of himself and ICW. This
7 bankruptcy case, which was now more than five years old, would produce
8 nothing for the general unsecured creditors.

9 The TFR was filed on April 28, 2015. The TFR disclosed, for the first
10 time, the fact that there would be absolutely no distribution to any creditor other
11 than ICW. Although ICW’s secured claim is listed in the Final Report in the
12 amount of \$5,816,457.31, the Trustee proposed to pay ICW only \$161,726.51 on
13 its claim. The TFR also discloses a “carve out” of funds sufficient to pay the
14 Trustee’s fee and costs and those of his special counsel.³ Thus, the secured
15 creditor ICW, the Trustee, and the Trustee's professionals, were the only intended
16 beneficiaries of the GE Litigation.

17 Reading between the lines in the Trustee's narrative report (Doc. No. 110;
18 the “Narrative”), it is now clear that in 2011, in the context of ICW's motions for
19 relief from stay and to compel abandonment, the Trustee and ICW struck a deal
20 for a carve-out to benefit the Trustee. The terms of that agreement were never
21 brought before the court nor disclosed before the court approved the
22 Abandonment Order. In the October 2014 Compromise Motion, the Trustee
23 projected a “net recovery” for distribution in excess of \$200,000. The only way
24 the Trustee could have projected any distribution to the estate was in the context
25 of a prearranged carve-out agreement.

26
27 ³The TFR also reports the payment of postpetition bank service fees and income
28 taxes to the Franchise Tax Board totaling \$7,097.81.

1 **Law Applicable to Carve-Out Agreements.** Carve-out arrangements,
2 such as appears to have been the case here, are presumptively improper and
3 warrant close scrutiny by the court. *In re KVN Corp., Inc.*, 514 B.R. 1, 4 (9th Cir.
4 BAP 2014). Such agreements only occur in cases where a potential asset of the
5 estate is subject to a significant security interest such that, in the absence of such
6 a carve-out, there would be no reason for a trustee to pursue a claim. In *KVN* ,
7 the bankruptcy court denied approval of a “carve-out” agreement to cover the
8 trustee’s administrative expenses. The trustee argued that the Bankruptcy Code
9 does not prohibit such carve-out agreements, and that § 506 permits payment of
10 administrative expenses even in the absence of any distribution to unsecured
11 creditors so long as the secured creditor consents to the carve-out from its
12 collateral. The bankruptcy court disagreed:

13 [T]he role of a chapter 7 trustee is to closely examine the secured
14 creditor's security interest and defeat it, if the trustee can. And, if
15 not, turn the asset over to the secured creditor. It is a slippery slope,
16 to my mind, when the debtor and the secured creditor start making
deals. I do not believe it's the appropriate role of a chapter 7 trustee
to liquidate fully-encumbered assets.

17 *In re KVN Corp., Inc.*, 514 B.R. at 4.

18 On appeal, citing numerous cases, the BAP noted initially that it is
19 “universally recognized that the sale of a fully encumbered asset is generally
20 prohibited.” Noting also that this prohibition is incorporated in the United States
21 Trustee’s official Handbook for Chapter 7 Trustees (the “Handbook”), and citing
22 the Handbook, the court said that the fundamental principle guiding trustees is
23 that the estate shall be administered so that dividends to creditors must be
24 maximized and expedited and that the resolution of a case must not be unduly
25 delayed. *Id.* at 5-6. According to the Handbook, “[i]n asset cases, when the
26 property is fully encumbered and of nominal value to the estate, the trustee must
27 immediately abandon the asset and contact the secured creditor immediately so
28

1 that the secured creditor can . . . protect its own interest in the property.” *Id.* at 6.

2 Thus, the court concluded, “[t]aken together, the above-referenced authorities
3 stand for the proposition that sales of fully encumbered assets are generally
4 improper. In that instance, the trustee's proper function is to abandon the
5 property, not administer it, because the sale would yield no benefit to unsecured
6 creditors.”

7 According to the Handbook, carve-outs for administrative expenses are
8 not *per se* prohibited, however, such arrangements must also result in a
9 “meaningful distribution to creditors,” otherwise the asset must be abandoned.
10 *Id.* at 7.

11 The *KVN* court detailed the factors that are relevant to approval of such
12 carve-out arrangements.

13 Of course, the presumption of impropriety is a rebuttable one. To
14 rebut the presumption, the case law directs the following inquiry:
15 Has the trustee fulfilled his or her basic duties? *Is there a benefit to*
16 *the estate; i.e., prospects for a meaningful distribution to unsecured*
17 *creditors? Have the terms of the carve-out agreement been fully*
18 *disclosed to the bankruptcy court?* If the answer to these questions
19 is in the affirmative, then the presumption of impropriety can be
20 overcome.

21 *Id.* (emphasis added).

22 In conclusion, the BAP vacated the bankruptcy court’s decision and
23 remanded the case for further findings on, *inter alia*, whether the carve-out would
24 result in a meaningful distribution to unsecured creditors.

25 Here, the court can find little or no difference between the “carve-out” sale
26 of a fully encumbered asset (the issue in *KVN*) and the “carve-out” prosecution of
27 a fully encumbered litigation claim (the issue now before the court). The terms
28 of the purported “carve-out” agreement between ICW and the Trustee were never
disclosed to the creditors or to the court. Indeed, the practical effect of the carve-
out agreement did not become apparent until the Trustee filed his TFR showing

1 where the proceeds of the GE Litigation would actually go. That agreement did
2 not result in a “meaningful distribution” to unsecured creditors.⁴

3 The unique nature of the bankruptcy court requires full, candid and
4 complete disclosure of all facts concerning transactions that affect the estate, its
5 assets, liabilities, and administration. This duty does not fall upon the debtor
6 alone but upon all professionals that come before the court. Based thereon,

7 IT IS HEREBY ORDERED that the Trustee’s Fee Application is
8 DENIED without prejudice.

9 IT IS FURTHER ORDERED that the Trustee may resubmit a TFR which
10 proposes to distribute at least as much to unsecured creditors as the Trustee
11 requests for himself. Alternatively, the Trustee shall file a noticed motion for
12 approval of his fees and expenses pursuant to LBR 2016-2(a). In support of that
13 motion, the Trustee must explain why this case was administered with no hope of
14 a “meaningful distribution to unsecured creditors” and show that the request for
15 fees and expenses is reasonable within the meaning of 11 U.S.C. § 330(a)(1)(A).

16 Dated: July 21, 2015

17 /s/ W. Richard Lee
18 W. Richard Lee
United States Bankruptcy Judge

19 _____
20 ⁴The Narrative filed in support of the Fee Application suggests that ICW’s claim
21 to the GE Litigation proceeds was a surprise to the Trustee. It recites the procedural
22 history of the case and the Compromise Motion and suggest that ICW agreed to
23 payment of administrative expenses out of the kindness of its heart:

24 The bonding company thereafter claimed “best of secured creditor”
25 status asserting those rights, assignments, and properly filed liens. The
26 bonding company has recognized the benefit to the estate of the
27 necessary administrative costs in pursuing the action and agreed with the
28 trustee to allow for those costs. Research of the bonding company claim
does support their position that they have rights superior to other
creditors, in addition to the fact that it is the largest creditor in the case.

Application for Payment of Final Fees and/or Expenses, Trustee Narrative Report, 2:8-
13, Doc. No. 110.