

2017 Hon. Steven W. Rhodes Consumer Bankruptcy Conference

Chapter 11 Basics for Debtors' Attorneys

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Chapter 11 Basics for Debtors' Attorneys

Chapter 11 Basics for Debtors' Attorneys: Absolute Priority Rule in Individual Chapter 11 By: Kimberly Ross Clayson

11 U.S.C. §1129(b)(2)(B)(ii) is best known as the Absolute Priority Rule. This rule comes into play if Cram Down is necessary to confirm the Plan. Post BAPCPA there has been a division among courts as to whether this rule applies in the context of a Chapter 11 filed by an individual Debtor. The "broad view" as it has been described has ruled that "§1115 incorporates and supercedes §541." And thus "[w]hen § 1129(b)(2)(B)(ii) references the property 'included by' §1115, it 'refer[s] to all property Section 1115 itself references.' *Dill Oil Co. v. Stephens* (*In re Stephens*), 704 F.3d 1279, 1285, (2013, 10th Cir.). "In contrast, the narrow view holds that §1115 merely adds to—but does not replace—§541's definition of estate property for individual debtors. Section 1115 'includes' in the estate only that property which was not already included by §541. . . . Accordingly, only post-petition property added by §1115 is exempt from the [Absolute Priority Rule]" and the rule "continues to apply to §541's pre-petition property." *Id.*

The Sixth Circuit has concluded that the Absolute Priority Rule still applies and thus has adopted the "narrow view" in the context of the individual debtor in possession despite some changes to the definition of property of the estate. *Ice House Am., LLC v. Cardin,* 751 F.3d 734, (2014, 6th Cir.). Other circuits have ruled that "Congress intended to include the entirety of the bankruptcy estate as property that the individual debtor may retain, thus effectively abrogating the absolute priority rule in Chapter 11 for individual debtors." *Zachary v. Cal. Bank &Trust*, 811 F.3d 1191 (9th Cir. 2016).

This paper discusses (1) the application of the Absolute Priority Rule in the individual Chapter 11 bankruptcy post-BAPCPA based on the Sixth Circuit's ruling in *Ice House* (2) the BAPCPA changes in the code that called into question whether the Absolute Priority Rule still applies in the individual Chapter 11 which has caused a circuit split and (3) the practical implications and strategies for seeking cram down in an individual Chapter 11.

(1) The Absolute Priority Rule as applied to the individual Chapter 11 The Absolute Priority Rule provides:

The holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

11 U.S.C. §1129(a)(14) (Emphasis added)

(a)(14) If the debtor is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, the debtor has paid all amounts payable under such order or such statute for such obligation that first become payable after the date of the filing of the petition.

11 USC §1115 defines property of a Chapter 11 estate.

- (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541-
 - (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and
 - (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first
- (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

The Absolute Priority Rule is relevant where the individual Debtor has proposed terms that will pay creditors less than the full value of creditors' claims when a class of creditors has rejected the Chapter 11 plan. In these circumstances, a "cram-down" becomes necessary to confirm a plan. The debtor in possession who intends to retain property of the estate after confirmation of a plan is considered junior to creditor classes. A cram-down is required where a non-consenting senior class of creditors receives less than the full value of their claim and in such a circumstance requires the debtor not to receive any value under the plan – that is – the Debtor must liquidate all property of the estate to confirm a Plan over the rejecting creditors who receive less than their full claim. In an individual Chapter 11 a debtor in possession is considered to receive more than senior classes of creditors if the debtor in possession retains property of the bankruptcy estate.

Within the 6th Circuit, the case of *Ice House* affirmed that the Absolute Priority Rule still applies to individual debtors in possession post- BAPCPA. *Ice House* concluded that "every unsecured creditor must be paid in full before the debtor can retain 'any property' under a plan." *Id.* at 737 (quoting 11 U.S.C. § 1129(b)(2)(B)(ii)). "Thus, as the bankruptcy court observed (and Cardin reiterates on appeal), an individual debtor in Chapter 11 is hit by a double whammy: he must dedicate at least five years' disposable income to the payment of unsecured creditors, and—unlike a debtor in Chapter 13—is also subject to the absolute-priority rule (and thus cannot retain any pre-petition property) if he does not pay those creditors in full." *Id*.

The Ninth Circuit in *Zachary* assists practitioners in understanding the post BAPCPA changes to the Absolute Priority Rule and delivers a comprehensive explanation of the reasoning among courts who have found the absolute priority rule applies to require individual debtors to relinquish all pre-petition assets.

Zachary thoroughly instructs the means for confirmation of a plan for individual debtor and explains that there are two ways to obtain confirmation: "The first is by satisfying the bankruptcy court that a plan complies with each of the sixteen paragraphs in 11 U.S.C. § 1129(a). Under this path, '[o]f particular note is the requirement of obtaining the consent of each class of creditor as required by paragraph (8) of § 1129(a)." (Quoting *In re Friedman*, 466 B.R. 471 at 480 (B.A.P. 9th Cir. 2012)). And where an individual debtor has failed to obtain consent of each creditor class – the "second path" for a debtor to obtain confirmation requires that the individual debtor satisfy to the bankruptcy court that the plan is "fair and equitable" to each creditor class. *Zachary*. (Citing 11 U.S.C. § 1129(b)(1), (2)). "A debtor may cram down a plan only if it complies with the absolute priority rule in § 1129(b)(2)(B)(ii)." *Id*.

(2) BAPCPA changes to the Absolute Priority Rule that called its application into question

As *Zachary* notes there are three code sections that come into play for instruction regarding the Absolute Priority Rule under the post-BAPCPA Bankruptcy Code:

- (1) Section 541(a) Property of the Estate, which *Zachary* notes was not changed by BAPCPA, "Under this section, the 'property of the estate,' and, therefore, the property subject to the absolute priority rule in chapter 11 cases," is all property owned by the debtor at the commencement of the bankruptcy case. Id. (Citing *Ice House* at 737-38.
- (2) Section 1115 that was added by enactment of BAPCPA "which only applies to individual chapter 11 proceedings, adds to the § 541 'property of the estate' certain property obtained by the debtor 'after the commencement of the case.""
- (3) BAPCPA changes to the Absolute Priority Rule at § 1129(b)(2)(B)(ii): "except that in a case in which the debtor is an individual, the debtor may retain property included in

the estate under section 1115, subject to the requirements of subsection (a)(14) of this section."

As *Zachary* explained "the new clauses in subsection (B)(ii) plainly create an exception to the absolute priority rule that applies only to a chapter 11 case in which the debtor is an individual. But the question is, what is the exception's scope? Or, put another way, what property may an individual chapter 11 debtor retain 'without running afoul of the absolute priority rule?'" *Id.* (Citing *In re Friedman*, 466 B.R. at 487).

In sum, the Sixth Circuit's view is all that was changed about the Absolute Priority Rule in the context of an individual Chapter 11 is that while BAPCPA added property acquired postpetition to the Section 541 definition of property of the estate, property acquired postpetition is the only property that the debtor can retain in the event that cram-down is necessary to gain confirmation of the plan.

In comparison, in the context of a corporation or limited liability company the Absolute Priority Rule restricts the members or shareholders of the debtor in possession from retaining their interest in the company unless they provide new value in exchange for that interest or all creditors will be paid in full under the plan except that senior classes creditors may also consent to allow members or shareholders to retain their interest in the LLC or corporation. The reason for this limitation is that equity security holders are the most junior class of creditors so the retention of their equity interests is equivalent to a payment in full on their interest. If senior classes of creditors are not to be paid in full then this junior most class cannot be paid in full over the objections by senior creditors.

(3) Getting an individual Chapter 11 Plan confirmed – the practical application of cram down and the Absolute Priority Rule

The practical result of the enforcement of the Absolute Priority Rule is that an individual debtor in possession must have consent from each class of creditors in order to confirm a Chapter 11 Plan unless it pays all classes of creditors in full. The reason being is that the courts have ruled that an individual Debtor in Possession's interest in pre-petition property is subordinate to all other classes of claims. The rejection by any class of creditors that does not receive payment in full for their claims in the context of an individual Chapter 11 necessitates that practitioners negotiate with the rejecting creditors to obtain enough votes in favor of a Chapter. Pursuant to 11 U.S.C. §1126(d) acceptance by a class is deemed to exist if the accepting creditors represent 2/3 of the dollar value of the claims as well as simple majority in number among all *voting* creditors. Practitioners should evaluate the mathematics among voting creditors of a class to determine the key creditors necessary to garner an accepting class. Negotiations among creditors will have the most impact on gaining acceptance where practitioners prioritize negotiations among creditors holding the largest claims to get to a two-thirds dollar figure of class acceptance and then negotiations should continue as needed to get a simple majority accepting the Plan.

Short of gaining sufficient acceptance among creditors receiving less than 100 percent of their claims, individual debtors are faced with liquidating property of the estate acquired prepetition. The result is individuals who require a cram-down will need to promote a plan that calls for liquidating all assets that are property of the estate – real estate, business interests, personal effects etc.

Chapter 11 Basics for Debtors' Attorneys: Plan Drafting Basics - Defining Priority Claims and Classes of Creditors

By: Kimberly Ross Clayson

At the start of plan drafting, practitioners should gather all necessary tools for drafting a Chapter 11 Plan of Reorganization and Disclosure Statement. The Bankruptcy Code provides detailed instruction on classification of creditors and information to be included in the plan. The most important secondary resource is provided by each judge. Generally, each judge provides specific instructions on the applicable jurisdiction's bankruptcy court website for drafting a plan that will meet with a particular judge's requirements and expectations in order to obtain preliminary approval of the Chapter 11 Plan.

(1) Description and treatment of claims in the Chapter 11 plan.

Proper description of claims and proper classification of claims is a key piece of drafting the plan and should be clearly articulated and outlined in the manner required by each judge as well as the Bankruptcy Code. 11 U.S.C. 1123(a)(1) provides instruction on classification of creditors within the Chapter 11 Plan and Disclosure Statement. The plan is required to "designate. . . . classes of claims" Claims arising under 507(a)(2) – administrative expenses, 507(a)(3) – post petition expenses in an involuntary Chapter 11, or 507(a)(8) – priority tax claims – and their treatment must also be included in the Chapter 11 Plan but they are not to be designated as classes of claims.

11 U.S.C. §1122(a) instructs how creditors are to be divided into classes and requires that the claims of a particular class be "substantially similar to the other claims or interests of such class." Subsection (b) permits separating classes of similarly situated unsecured creditors "A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative

convenience." A practical example for this may include separating general unsecured creditors by a dollar amount threshold – a plan may justifiably separate smaller claims where installment payments over time would be nominal – i.e. \$1.00 or \$7.50 a month and provide treatment where a lump sum is paid at a given time or the frequency of payments is fewer. In doing so the practitioner should consider providing some justification that supports that the separation of claims as "administratively convenient."

(2) Plan terms for administrative expenses.

Unclassified administrative expenses should include the amount of the claim and proposed treatment. The Office of the United States Trustee generally requires specific language to be included in the plan to address the quarterly fees charged to the bankruptcy estate that provides:

Debtor will pay to the United States Trustee the appropriate sums required pursuant to 28 U.S.C. §1930(a)(6). After confirmation, and until the Case is dismissed or closed by the Court, Debtor and the Reorganized Debtor will pay all post-confirmation fees on all disbursements of the Debtor and the Reorganized debtor, and will follow all procedures of the United States Trustee for reporting and tracking such disbursements.

(3) Plan terms for priority tax claims.

Priority tax claimants including the State of Michigan and the Internal Revenue Service generally require specific language regarding their claims indicating the amount of statutory interest to be paid and providing specific terms in the event of the debtor's default on plan payments. Internal Revenue Service Publication 908 instructs on treatment of priority tax claims and specifies the time within which priority tax claims – which are to be paid "over a period of 5 years from the date of the order for relief issued by the bankruptcy court" which is the petition date in a voluntary Chapter 11. In practice, this means that a plan with an effective date that is 4 months

after the commencement of the case must propose payments of priority tax claims within 56 months and the Chapter 11 plan should be calculated accordingly.

Chapter 11 Basics for Debtors' Attorneys: Educating the client – important advance preparations for individual debtors in possession. BY: Leslie Berg and Kimberly Clayson

Chapter 11 debtors including individuals have substantial additional duties to the bankruptcy estate as compared to the Chapter 13 or Chapter 7 debtor that are important to prepare the client for before filing a Chapter 11 petition in order to ensure a successful and smooth process for Chapter 11. The debtor in possession's responsibilities are necessarily implemented within the first few short days after a petition is filed so advance planning and preparation are critical. Debtors will receive a packet of "Operating Instructions" directly from the Office of the United States Trustee along with a letter regarding the date and time of the Initial Debtor Interview, information required from the Debtor for the Initial Debtor Interview and a questionnaire to be completed by the debtor for the Initial Debtor Interview. This letter should not be the first time the client learns about all that is entailed and required of the Chapter 11 debtor – practitioners should do as much advance client preparation as possible to ensure success in the Chapter 11 process.

Here is a basic summary regarding the Chapter 11 process that is a useful information tool for practitioners to share with clients in the pre-petition planning stages to prepare the Chapter 11 client for the road ahead:

SUMMARY OF CHAPTER 11 PROCESS

Quarterly fees are paid to the United States Trustee every calendar quarter, the amount of fees to pay are based on total amount that you spent during the quarter and range in amount as follows:

TOTAL QUARTERLY DISBURSEMENTS	QUARTERLY FEE
\$0 to \$14,999.99	\$325.00
\$15,000 to \$74,999.99	\$650.00
\$75,000 to \$149,999.99	\$975.00
\$150,000 to \$224,999.99	\$1,625.00
\$225,000 to \$299,999.99	\$1,950.00
\$300,000 to \$999,999.99	\$4,875.00

- 2. Requirements to file: You will need to provide your prior two years of tax returns, information identifying all of your creditors and all of your assets and other records requested to prepare your bankruptcy papers. You will review all documents that will be filed on your behalf and you will have to affirm under oath that the documents are truthful and accurate in order for them to be filed. This means it will be up to you to carefully review all of the forms to ensure that we have correctly and accurately disclosed your assets, liabilities and other financial affairs that must be disclosed to the court.
- 3. <u>Plan Payments:</u> All liabilities that arise prior to the bankruptcy filing date are included in the bankruptcy plan.
- 4. **Financial Reporting:** Every month you will be required to submit a "Monthly Operating Report" showing your exact income and all of your expenses for each month and a balance sheet for your assets and liabilities. Forms are provided by the US Trustee after the case gets filed for this purpose.
- 5. <u>Insurance</u>: You must insure all personal and real property (general liability, theft, fire etc.) in order to proceed in Chapter 11. Any insurance on the property will require you to add "[DEBTOR NAME], Debtor in Possession" as a named insured.
- 6. **Banking:** You will need to close all old personal checking, savings and other bank accounts and open a new bank account and up to 3 accounts with account owner named "[DEBTOR NAME], Debtor in Possession" or "[DEBTOR NAME], DIP" this title will need to be on your account statements and checks if you order checks. Plan to get this done as soon as the case is filed but you will have a few weeks to complete the process. Some banks do not offer DIP services, you will want to be sure that any bank you engage can provide you a debit card for day-to-day purchases so that purchases can be easily tracked for reporting purposes.

- 7. **Payment Timeframe:** You will have up to 5 years from the bankruptcy filing date to pay taxes. All other liabilities can be paid based on the same time frame or a different timeframe which we can discuss as we acquire more knowledge about the property value and your income and expenses.
- 8. <u>Court appearances</u>: You will need to plan to accompany me for approximately 4 court appearances
 - 1) Initial Debtor Interview ("IDI") which takes place within 2 weeks after the case is filed. You and I meet with a case analyst from the United States Trustee office to informally discuss duties in the bankruptcy, talk about what caused the bankruptcy and to discuss banking and insurance during the Chapter 11. Creditors are invited to attend a meeting scheduled immediately after your IDI to form a Creditor's Committee although this is not a typical occurrence in individual Chapter 11s and the creditors must meet certain criteria in order to form a committee. A Creditor's Committee is another layer of oversight in your case if one is formed.
 - 2) Status hearing with the judge to provide a general outline of the case and issues anticipated. This happens within the first few weeks of the bankruptcy
 - 3) Meeting of the Creditors you will be sworn under oath and generally discuss the same things that you discuss at the IDI. The party asking questions is the attorney from the United States Trustee's office. This is usually done a month or so after the bankruptcy is filed. Creditors can also come to the meeting to ask questions.
 - 4) Confirmation hearing at the end of the case to seek the court's order confirming your chapter 11 plan, this will be done about a month after we submit our plan or as soon as we have reached an agreement with the creditors if they object to the plan. We have to submit a plan to seek confirmation within about 3 months of the bankruptcy filing date.
- 9. Other professionals: If you require the assistance of an accountant for monthly reporting or tax filing purposes, I need to know the name of the accountant and firm and terms for services. If you decide to market real property to sell and wish to hire a broker to do that, we must get approval of the terms of the listing agreement. Generally, all professionals you chose to hire while the Chapter 11 is pending must be approved for hiring by the United States Trustee's office, your creditors and the court.
 - 10. <u>Case closing and discharge</u>: After a plan is confirmed by the court and attorney fees and other professional fees are approved by the court, your case will close. The case closing usually occurs 60 days after the date of confirmation. You will proceed

to pay your creditors pursuant the Chapter 11 plan after the case closes. Once the plan is complete, you will need to contact my firm or another attorney to request that your case reopen so you can request a bankruptcy discharge upon completion of the plan. There may be other reasons to request a discharge before you complete the plan payments but those circumstances need to be independently analyzed to determine the possibility of obtaining a discharge before the plan is complete.

LET'S GET THE SHOW ON THE ROAD: "FIRST DAY" MOTIONS IN CHAPTER 11

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LET'S GET THE SHOW ON THE ROAD: "FIRST DAY" MOTIONS IN CHAPTER 111

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In a typical Chapter 11 bankruptcy case, a debtor is likely to file a series of motions on or shortly after the petition date that seeks relief on an expedited, if not emergency, basis.³ These motions, referred to as "first day" motions, are designed to ensure continued operations in the ordinary course of the debtor's business. The motions generally facilitate the payment of certain of the debtor's pre- and post-petition obligations, subject to certain restrictions. They also seek to establish procedures to assist the debtor and other parties in interest as the case progresses from its infancy.

In conjunction with its first day motions, the debtor should file a motion requesting that the court schedule hearings on the first day motions along with a proposed order with blanks for the date and time. The motion need not be lengthy, but it should identify all of the first day motions sought to be heard and any other information required by the local rules or procedures established

These materials are intended to provide an introduction to many, but not all, potential first day motions in a Chapter 11 case. For a fairly comprehensive explanation of first day motions, including certain motions not addressed herein (e.g., critical vendor motions and DIP financing motions), see Debra Grassgreen, et al., First Day Motions: A Guide to the Critical First Days of a Bankruptcy Case (3d ed.) published by the American Bankruptcy Institute.

The authors appreciate the contributions of Jacob N. Witte, intern to Hon. John T. Gregg in the Fall of 2017. None of the authors or the United States Bankruptcy Court for the Western District of Michigan express any opinion regarding the decisions discussed herein. Practitioners are encouraged to review the actual decisions in order to thoroughly understand the issues and holdings.

For example, in a recently filed "mega" case, the debtors filed approximately eighteen first day motions. *See In re Toys "R" Us, Inc.*, Case No. 17-34665 (Bankr. E.D. Va.). In smaller and medium sized Chapter 11 cases, the number of first day motions is likely to be exponentially less.

by a particular judge. *See*, *e.g.*, LBR 9013-1 (Bankr. E.D. Mich.). Such procedures are often available on the court's website.⁴

It is advisable for the debtor to include a factual summary of its business operations and demands thereupon in each first day motion. Each motion should also specifically identify the nature of the relief requested and the legal authority relied upon. The prudent practitioner will arrange for an officer or other representative of the debtor to file a declaration or affidavit that includes detailed factual support for the relief requested in the first day motions, including any request for the use of cash collateral. The declaration is the first opportunity to provide the court and parties in interest with a history of the debtor's business and its financial problems. Therefore, most declarations will explain the type of business in which the debtor is engaged, the number of employees, the principal causes of the debtor's financial troubles, and the debtor's debt and capital structure.

At the first day hearings, counsel for the debtor should be prepared to proffer the testimony of one or more of the debtor's representatives, including the declarant. If the matter is contested, counsel for the debtor should be prepared to elicit direct testimony and address any matters that arise on cross examination.

A. Joint Administration

When two or more related debtor entities file petitions for relief under Chapter 11, the debtors should file a motion for joint administration in order to assist with procedural management of the cases. A motion for joint administration proposes the use of a single docket to reduce the costs of notice while providing other administrative efficiencies. *See In re Appalachian Fuels*,

If possible, the debtor should also consider providing copies of the first day motions to the United States Trustee on a confidential basis several days before filing the petition. By allowing the United States Trustee to review first day motions in advance, the debtor may be able to informally address the concerns of the United States Trustee without a formal objection.

LLC, 493 B.R. 1, 21 (B.A.P. 6th Cir. 2013). Although the Bankruptcy Code provides for joint administration of cases involving spouses, it does not specifically address joint administration in other contexts. See 11 U.S.C. § 302(a). However, Rule 1015(b) of the Federal Rules of Bankruptcy Procedure implements joint administration in cases involving partnerships, corporations and other affiliated entities and individuals. Fed. R. Bankr. P. 1015(b).

A typical motion for joint administration should state (i) the degree to which the affiliated debtors are related; (ii) that costs will be reduced because motions, hearings and orders will affect the debtors jointly; (iii) that the rights of creditors will not be adversely impacted; and (iv) that management of the cases will be more efficient.

At the first day hearings, the debtors should be prepared to explain that joint administration of cases will not prejudice or otherwise adversely impact the rights of creditors.⁵ The debtors may be asked to confirm that notwithstanding joint administration, they will maintain, among other things, separate bank accounts and books and records for each estate. *See In re Toland*, 346 B.R. 444, 449 (Bankr. N.D. Ohio 2006); *see also In re Appalachian Fuels, LLC*, 493 B.R. at 21 (quoting *In re Las Torres Development, LLC*, 413 B.R. 687, 698 (Bankr. S.D. Tex. 2009)). In addition, any request for joint administration should leave unaffected the requirement that creditors file proofs of claim against a specific debtor by identifying the name of the debtor and its case number on the proof of claim.

The Bankruptcy Courts in the Eastern and Western Districts of Michigan have routinely granted motions for joint administration shortly after the petitions are filed. *See*, *e.g.*, *In re Great*

Joint administration should not be confused with the substantive consolidation of bankruptcy estates. Substantive consolidation is appropriate only in instances where the debtors' estates are intermingled to the extent that any "attempt to unscramble them is so substantial as to threaten the realization of any net assets for all of the creditors." See In re Appalachian Fuels, LLC, 493 B.R. at 20-21 (quoting First National Bank of Barnesville v. Rafoth (In re Baker & Getty Financial Services, Inc.), 974 F.2d 712, 720 (6th Cir. 1992)). Substantive consolidation merges estates and treats separate debtors as a single entity with cumulative assets and liabilities. See, e.g., id. at 21. Joint administration does not result in any merging of the debtors' assets and liabilities.

Lakes Comnet, Inc., Case No. 16-00290 (Bankr. W.D. Mich. Jan. 27, 2016); In re Capitol Bancorp. Ltd., Case No. 12-58409 (Bankr. E.D. Mich. Aug. 15, 2012).

B. Employee Wages and Benefits

A motion requesting authority to pay prepetition wages and benefits to a debtor's employees is one of the most critical first day requests for relief. It is intended to maintain employee morale and preserve consistent performance by a trained labor force. Practically speaking, it is hard to imagine how a debtor could succeed post-petition without payment of employee wage and benefit claims.

Because employees' claims for wages and benefits are prepetition claims, a debtor must obtain court approval before satisfying them. Like many first day motions, there is no explicit statutory authority authorizing payment of prepetition wage and benefit claims. Nonetheless, these motions are generally granted. Debtors typically rely on sections 363(b) and 105(a), which allow the debtor to use property of the estate in conjunction with the court's equitable authority. 11 U.S.C. §§ 105(a), 363(b). Because many employees' claims for wages or benefits would be entitled to priority, section 507(a) provides additional authority to satisfy such claims shortly after the petition date. 11 U.S.C. § 507(a)(4) (priority for unsecured claims up to \$12,475 for wages, salaries, commissions); 11 U.S.C. § 507(a)(5) (priority for unsecured claims for contributions to employee benefit plan); *see In re CEI Roofing, Inc.*, 315 B.R. 50, 60-61 (Bankr. N.D. Tex. 2004) (priority status for wage claimants provides authority along with section 105(a) for payment of wages prior to plan confirmation). Accordingly, as the argument goes, only the timing of such payments would be implicated by satisfying wage and benefit claims entitled to priority.

Motions to pay prepetition wages and continue benefits programs often cite to the "doctrine of necessity," or the "necessity of payment doctrine," which allows a debtor to pay certain

prepetition claims where the payment is essential to the continued operations of the debtor. *See*, *e.g.*, *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989). The payment of prepetition wages and benefit obligations satisfies this standard, as timely payment of employee wages and benefits preserves the going concern value of the debtor and furthers the goal of reorganization. *In re Escalera Res. Co.*, 2015 WL 7351396, at *3 (Bankr. D. Colo. Nov. 9, 2015) ("employees are the lifeblood of any operating business").

A wage and benefits motion should summarize the debtor's workforce, including the number of employees the debtor has, the amount of outstanding wages and benefits, the type of benefits offered to employees (*e.g.*, holiday, vacation, personal or sick days, health, dental, disability or life insurance, retirement plan), the debtor's usual pay schedule and next pay date, and any payroll processor used by the debtor and fees related thereto.

As with most first day motions, it is good practice to include citations to cases in the district and elsewhere where similar relief has been granted. *See*, *e.g.*, *In re Michigan Sporting Goods Distributors, Inc.*, Case No. 17-00612 (Bankr. W.D. Mich. Feb. 16, 2017); *In re Lee Steel Corp.*, Case No. 15-45784 (Bankr. E.D. Mich. Apr. 15, 2015).

C. Use of Cash Collateral

A motion for the use of cash collateral is arguably the most important request for relief at the beginning of a Chapter 11 case. *See* 11 U.S.C. § 363(a) (defining cash collateral). In order to use cash and other assets to conduct business and pay employees, a debtor must seek authorization from the court or obtain the secured creditor's consent to use cash collateral. 11 U.S.C. § 363(c)(2). Absent consent of the secured creditor, a debtor must establish that it has provided adequate

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⁶ Practitioners are encouraged to review this well-reasoned decision when preparing a wage and benefits motion.

protection of the secured creditor's interest in the cash collateral. 11 U.S.C. § 363(e); see 11 U.S.C. § 361.

1. Technical and Procedural Requirements

A typical cash collateral motion will set forth the reasons why use of cash collateral is necessary, the entities with an interest in cash collateral, the material terms of the proposed adequate protection for the secured creditor(s), the alleged value of the property subject to secured claims, a proposed budget for the initial period of use of cash collateral, a proposed date for a final hearing, and a proposed order approving the use of cash collateral. *See* Fed. R. Bankr. P. 4001(b)(1)(A)-(B). No detail should be spared. The local rules of the district in which the case has been filed may have additional requirements. *See*, *e.g.*, LBR 4001-2 (Bankr. W.D. Mich.); LBR 4001-2 (Bankr. E.D. Mich.).

The proposed order may be subject to significant revisions based on the court's comments or determinations at the hearing and negotiations with parties in interest prior to and during the hearing. The debtor should make every reasonable effort to resolve any cash collateral dispute in advance of the first day hearings.

Because a first day motion usually seeks relief on an emergency basis, the court may authorize the debtor to use cash collateral only in the amount necessary to avoid immediate and irreparable harm to the estate pending the final hearing. Fed. R. Bankr. P. 4001(b)(2). Nonetheless, the debtor may wish to attach the proposed final budget to the motion in order to facilitate early negotiations with parties in interest. The motion should also be accompanied by an affidavit or declaration of an officer or other representative of the debtor setting forth the facts on which the debtor relies and the amount of cash collateral necessary to avoid immediate and

irreparable harm. *See* LBR 4001-2(b)(6) (Bankr. W.D. Mich.); LBR 4001-2(c)(6) (Bankr. E.D. Mich.).⁷

Parties seeking relief via first day motions should familiarize themselves with the court's procedures for emergency and expedited relief. *See*, *e.g.*, LBR 9013(g)-(h) (Bankr. W.D. Mich.); LBR 9013-1 (Bankr. E.D. Mich.). The first day motion for cash collateral and any order granting an emergency hearing should be served by all means available (*e.g.*, overnight carrier, electronic mail <u>and</u> facsimile) upon the twenty largest unsecured creditors, the United States Trustee, all secured creditors with an interest in the debtor's cash collateral, and any other entity the court directs. Fed. R. Bankr. P. 4001(b)(1)(C), (b)(3). The final hearing may not be held sooner than fourteen (14) days after service of the motion. Fed. R. Bankr. P. 4001(b)(3).

2. Burdens of Proof and Typical Forms of Adequate Protection

As previously mentioned, a debtor must, absent consent of the secured creditor, establish at the first day hearing that the secured creditor's interest in cash collateral has been adequately protected. 11 U.S.C. § 363(c)(2), (e). The debtor bears the burden of proof as to adequate protection. 11 U.S.C. § 363(p)(1). Once a debtor has established a prima facie case that the secured creditor is adequately protected, the objecting party must present sufficient evidence to controvert the debtor's evidence. *In re Village Green I, GP*, 435 B.R. 525, 531 (Bankr. W.D. Tenn. 2010) (citations omitted). However, an entity asserting an interest in cash collateral bears the burden of proof as to the validity, priority, and extent of its interest. 11 U.S.C. § 363(p)(2).

Importantly, the cash collateral sought to be used must be property of the debtor's estate.

11 U.S.C. § 363(c)(1). If the debtor does not have a legal or equitable interest in the property as

Such facts are often included in the declaration mentioned in the introduction to these materials. *See supra* at pp. 1-2. If a comprehensive first day declaration is not filed, the prudent practitioner should at the very least arrange for a declaration regarding cash collateral.

of the commencement of the bankruptcy case, the property may not be used as cash collateral or as a funding source for an eventual reorganization. *See In re Kingsport Ventures, L.P.*, 251 B.R. 841, 845-46 (Bankr. E.D. Tenn. 2000). This is especially problematic for single-asset real estate debtors whose secured creditor has obtained an assignment of rents. *See*, *e.g.*, *Town Center Flats, LLC v. ECP Commercial II LLC (In re Town Center Flats, LLC)*, 855 F.3d 721, 727 (6th Cir. 2017) (perfected assignment of rents under Michigan law removed property from estate and potential use by debtor as cash collateral); *see also In re Valley Media, Inc.*, 279 B.R. 105, 123-24 (Bankr. D. Del. 2002) (where consignment is true consignment outside scope of Article 9, consigned goods and proceeds thereof not property of estate).

The purpose of adequate protection is to protect the secured creditor from any diminution in the value of its collateral during the pendency of the bankruptcy case. *See In re Kain*, 86 B.R. 506, 513 (Bankr. W.D. Mich. 1988). The appropriate form of adequate protection will vary depending on the facts and circumstances of each case, but often includes replacement liens and periodic cash payments. 11 U.S.C. § 361(1), (2). Periodic cash payments are typically in an amount commensurate with the depreciation of collateral during the case. *See*, *e.g.*, *United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 370 (1988); *Marpam Truck & Trailer Co. v. Commercial Trailer Co. (In re TennOhio Transp. Co.)*, 247 B.R. 715, 721 (Bankr. S.D. Ohio 2000). Replacement liens are generally granted only to the extent of the secured creditor's prepetition liens, but may be granted as to property acquired post-petition in certain circumstances. *See*, *e.g.*, *In re LTV Steel Co., Inc.*, 274 B.R. 278, 286 (Bankr. N.D. Ohio 2001).

The court may also authorize relief intended to result in the secured creditor's realization of the "indubitable equivalent" of its interest in the property, which operates as a catch-all provision providing the court with flexibility to fashion adequate protection beyond replacement

liens or periodic cash payments. 11 U.S.C. § 361(3); *In re Swedeland Dev. Grp., Inc.*, 16 F.3d 552, 564 (3d Cir. 1994). Secured creditors may request other protections in exchange for the debtor's use of cash collateral. Some common examples are superpriority administrative expenses under section 507(b), waivers of the debtor's rights under section 506(c), and waivers of the debtor's rights to challenge the secured creditor's liens.

A debtor may assert that the secured creditor has an equity cushion that satisfies the requirement of adequate protection. See Sharon Steel Corp. v. Citibank, N.A. (In re Sharon Steel Corp.), 159 B.R. 165, 169 (Bankr. W.D. Pa. 1993) (existence of equity cushion alone can constitute adequate protection, but not where cushion insufficient in size or likely to erode). If an equity cushion alone is offered as adequate protection, many courts have required the equity cushion to be approximately twenty percent. See, e.g., In re Dynaco Corp., 162 B.R. 389, 398 (Bankr. D.N.H. 1993) (17% adequate); In re McKillips, 81 B.R. 454, 458 (Bankr. N.D. Ill. 1989); Matter of Ritz Theaters, Inc., 68 B.R. 256 (Bankr. M.D. Fla. 1986) (38% adequate); In re Dunes Casino Hotel, 69 B.R. 784 (Bankr. D.N.J. 1986) (30% adequate); cf. Ukranian Sav. and Loan Ass'n v. The Trident Corp., 22 B.R. 491 (E.D. Pa. 1982) (10% inadequate); In re McGowan, 6 B.R. 241 (Bankr. E.D. Pa. 1980) (10% inadequate); In re Liona Corp., N.V., 68 B.R. 761 (Bankr. E.D. Pa. 1987) (8.9% inadequate); In re Jug End in the Berkshires, Inc., 46 B.R. 892 (Bankr. D. Mass. 1985) (8.5% insufficient); In re Castle Ranch Ramona, Inc., 3 B.R. 45 (Bankr. S.D. Cal. 1980) (8.6% inadequate); In re LeMay, 18 B.R. 659 (Bankr. D. Mass. 1982) (7% inadequate).

3. Standards for Approval of First Day Cash Collateral Motions

In deciding whether to approve the use of cash collateral, the court must strike a balance between the conflicting interests of the debtor and its secured creditors. *In re Stein*, 19 B.R. 458, 459 (Bankr. E.D. Pa. 1982). The determination of whether a secured creditor's interest is

adequately protected is not an exact science, but rather requires the court to balance relevant factors such as the value of the collateral, whether the collateral is likely to depreciate, and the debtor's prospects for a successful reorganization. *See In re Shivshankar P'ship LLC*, 517 B.R. 812, 817 (Bankr. E.D. Tenn. 2014) (citations omitted); *In re Constable Plaza Assocs.*, 125 B.R. 98, 105 (Bankr. S.D.N.Y. 1991).

If the secured creditor is an insider or affiliate of the debtor, the court should scrutinize the proposed adequate protection offered by the debtor in order to prevent overreaching by the insider. *In re Lafayette Hotel P'ship*, 227 B.R. 445, 454 (S.D.N.Y. 1998) (citing *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 392 (10th Cir. 1979)) ("[S]ince there is an incentive and opportunity to take advantage, dominant shareholders' and other insiders' loans in a bankruptcy must be subject to rigorous scrutiny."). However, absent evidence of inequitable conduct such as fraud, illegality, breach of fiduciary duties, undercapitalization, or use of the debtor as an instrumentality or alter ego, an insider is entitled to the same adequate protection as a non-insider. *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 131 (5th Cir. 1993)); *see In re Lafayette Hotel P'ship*, 227 B.R. at 454 (citing *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d at 392).

The United States Trustee (and the court) may take a more active role at any hearing on the interim use of cash collateral because of the emergency nature of the request, the limited notice provided, and the fact that the debtor may have to enter into a "hard bargain" with its secured creditor(s) at the commencement of a case. *In re Farmland Indus., Inc.*, 294 B.R. 855, 885-86 (Bankr. W.D. Mo. 2003) (citing *In re Ellingsen MacLean Oil Co., Inc.*, 65 B.R. 358, 365 (W.D. Mich. 1986)). The United States Trustee (and the court) may scrutinize the proposed terms for the use of cash collateral in order to ensure that a debtor with limited bargaining power has not given

away significant rights before creditors have had an opportunity to review the relief requested and formulate any objections thereto. *See In re The Colad Grp., Inc.*, 324 B.R. 208, 219 (Bankr. W.D.N.Y. 2005) (noting court's unwillingness to approve interim financing order with prepetition lender with overreaching terms prior to appointment of committee). Particularly with respect to waivers of the debtor's (and the estate's) rights to pursue causes of action against the secured creditor, the court is likely to carefully examine whether the official committee of unsecured creditors, upon appointment, will have sufficient time to investigate.

D. Cash Management System

As part of its first day motions, a debtor will often seek approval to continue to use the debtor's prepetition cash management system. Certain guidelines from the United States Trustee require that the debtor close its existing books and records and open new books post-petition. *See* 28 U.S.C. § 586(a)(3) (UST shall supervise and review administration of cases in accordance with procedural guidelines). The debtor must also close its existing bank accounts and open new debtor-in-possession accounts. *Id.* The purpose of these requirements is to assist the debtor and other parties in interest in clearly delineating between prepetition and post-petition transactions.

In larger cases, these requirements can be cumbersome and cost-prohibitive, particularly where the debtor is a complex entity. Therefore, a debtor will often request permission to continue using their existing cash management systems. A debtor will also request permission to transfer funds between the debtor and its non-debtor affiliates. *See also In re Charter Behavioral Health Sys.*, *LLC*, 292 B.R. 36, 41 (Bankr. D. Del. 2003) (cash management motions procedural in nature and do not substantively consolidate assets of multiple debtors and/or their affiliates).

A cash management motion is intended to preserve the status quo after the debtor's filing and prevent unnecessary distractions and disruptions in business. *Collins & Aikman Corp. v. Valeo*

(In re Collins & Aikman Corp.), 401 B.R. 900, 905 (Bankr. E.D. Mich. 2009) (debtors argued in support of cash management motion that disruption of cash management system would impair debtor's ability to preserve going concern value and achieve a reorganization). Typically a debtor will request authority to continue using their existing bank accounts, cash management systems, and business forms such as checks, deposit forms or purchase orders.

The statutory authority for the continued use of cash management systems is not explicit, but debtors typically rely on section 105(a), the source for the bankruptcy court's equitable authority to issue any order necessary or appropriate to carry out the provisions of the Bankruptcy Code, in conjunction with section 363(c)(1), which permits a debtor to enter into transactions and use property of the estate in the ordinary course of its business. 11 U.S.C. §§ 105(a), 363(c)(1); see 11 U.S.C. § 345(b) (setting forth requirements for bank accounts); see The Charter Co. v. Prudential Ins. Co. of Am. (In re The Charter Co.), 778 F.2d 617, 622 (11th Cir. 1985) (order authorizing debtor to utilize routine cash management system was consistent with section 363(c)(1)). There are few, if any, reported decisions directly on point. However, some decisions offer guidance by discussing the effects of cash management orders entered earlier in the case. See, e.g., In re Charter Behavioral Health Sys., LLC, 292 B.R. at 41 (noting approved cash management order did not determine whether operating debtors would have liability if main debtor paid their expenses in decision regarding UST quarterly fees); In re Collins & Aikman Corp., 401 B.R. at 902-903 (noting effect of order granting motion for continued use of cash management system in decision regarding preferential and fraudulent transfers).

A cash management motion in a large Chapter 11 case will typically provide the court with an overview of the debtor's existing cash management system, including the length of time it has been used by the debtor, its similarity to those used by other businesses in the debtor's industry,

and any transfer between affiliates or debtors that occurs in the ordinary course of the debtor's operations. If the cash management system is particularly complex, the debtor should include an organizational chart in the motion. In addition, the motion should explain why granting the relief requested will result in significant time and cost savings to the estate, such as by noting the number of accounts that would be required to be closed and reopened and checks that would be required to cancelled, destroyed and reissued. Finally, the motion should describe the debtor's efforts to ensure that pre- and post-petition transactions and transfers between the debtor's affiliates are accurately recorded. *See In re Charter Behavioral Health Sys., LLC*, 292 B.R. at 41 (noting that cash management orders entered only after debtor represents that it will be able to track each debtor's receipts notwithstanding use of centralized cash management system).

In the motion, the debtor should cite to other cases in the district and elsewhere in which similar relief has been granted. *See*, *e.g.*, *In re Great Lakes Comnet, Inc.*, Case No. 16-00290 (Bankr. W.D. Mich. Jan. 28, 2016); *In re Energy Conversion Devices, Inc.*, Case No. 12-43166 (Bankr. E.D. Mich. Mar. 30, 2012).

E. Adequate Assurance of Payment for Utilities

Nearly all debtors require utilities such as electricity, phone, water, sewer and other services to continue their business as a going concern. Therefore, upon commencing its Chapter 11 case, a debtor should consider filing a motion that proposes the adoption of procedures for providing adequate assurance to utilities. Section 366 provides the framework for a debtor to obtain utility services post-petition while protecting the interests of utility companies. 11 U.S.C. § 366. It was intended to protect debtors from an abrupt cutoff of services after a petition is filed by prohibiting a utility from altering, refusing, or discontinuing service or discriminating against a debtor based solely on the filing of the case or the debtor's non-payment of prepetition utility

obligations. 11 U.S.C. § 366(a); *In re Syroco Inc.*, 374 B.R. 60, 61 (Bankr. D. P.R. 2007). A utility may, however, alter, refuse or discontinue service within thirty (30) days of the petition date if the debtor fails to provide adequate assurance of payment for post-petition services. 11 U.S.C. § 366(c)(2).

1. Typical Contents of Utility Motions

Because section 366(b) places the burden of providing adequate assurance upon the debtor, a first day motion is essential to establish procedures for determining whether the proposed form of assurance is adequate. A typical utility motion where a debtor is current on its prepetition utility obligations will request that the court deem utilities adequately assured by the debtor's post-petition liquidity situation and the utilities' rights to seek administrative expenses for post-petition services under section 503(b). A debtor may also seek to establish segregated accounts to act as a deposit or provide other forms of assurance depending on the circumstances. *See In re Circuit City Stores, Inc.*, 2009 WL 484553, at *2 (Bankr. E.D. Va. Jan. 14, 2009).

A utilities motion will often seek to establish procedures for determining the appropriate amount of adequate assurance for utilities who timely object to the debtor's initial offer. Such procedures may establish a time period during which parties will attempt to negotiate the amount of adequate assurance. If negotiations are unsuccessful, procedures typically provide that the court will determine the appropriate amount of adequate assurance under section 366(b). These procedures are critical to debtors in the early stages of their Chapter 11 cases, because they provide a structure to address potentially numerous requests for adequate assurance. *See In re Circuit City Stores, Inc.*, 2009 WL 484553, at *5 (noting that language of section 366 expressly authorizes court to adopt adequate assurance procedures requested by debtors). Absent such procedures,

utilities could arguably make unreasonable requests at the last minute to force a debtor to acquiesce or face a cessation of services. *Id.* at *6.

A utilities motion should be served on the debtor's utility providers by the best available means, as well as upon the United States Trustee, any secured creditors with an interest in cash collateral, the twenty largest unsecured creditors, and any other party that the court might direct.⁸ The interim order must also be served by the debtor on any utilities that provide services to the debtor. *See In re Circuit City Stores, Inc.*, 2009 WL 484553, at *1 (noting that court required notice of entry of interim order to be served upon all of debtors' utilities with opportunity to object).

2. Standards for Determining "Adequate Assurance"

The form of adequate assurance of payment offered by the debtor must be "satisfactory" to the utility. 11 U.S.C. § 366(c)(2). However, the court ultimately has the power to determine what assurance is adequate upon the request of a party in interest. 11 U.S.C. § 366(c)(3)(A) (court may order modification of amount of adequate assurance on request of party in interest). The debtor is not required to pay the amount that is unilaterally satisfactory to the utility prior to obtaining a determination from the court as to a modified amount. *Bedford Town Condo. v. Wash. Suburban Sanitary Comm'n (In re Bedford Town Condo.)*, 427 B.R. 380, 384-85 (Bankr. D. Md. 2010) (noting widespread rejection of interpretation of section 366 requiring debtor to pay assurance demand prior to modification by court); *but see In re Lucre, Inc.*, 333 B.R. 151, 154

A court will likely be reluctant to enter an order adopting procedures on a final basis as part of the first day hearings where the debtor is unable to assure the court that the utilities have been properly served. For example, service on a utility's billing department at a P.O. Box is unlikely to satisfy the court.

(Bankr. W.D. Mich. 2005) (debtor may not request modification of assurance payment until it first pays what the utility demands).⁹

In making a determination as to the appropriate amount of adequate assurance, the court may not consider any absence of security prepetition, whether the debtor made timely payments for utility services prepetition, or the availability of an administrative expense. 11 U.S.C. § 366(c)(3)(B)(i)-(iii); see also In re Bedford Town Condo., 427 B.R. at 385 n.4 (section 366(c)(3)(B)(ii) limits court's consideration of debtor's timely payments, but does not prevent consideration of untimely payments); In re Circuit City Stores, Inc., 2009 WL 484553, at *4 n.14 (court may not consider administrative expense availability alone, but may consider such availability in conjunction with other circumstances such as deposit, the speed with which utility may obtain relief in event assurance fails, and debtors' payment history). The amount of assurance that will be deemed "adequate" is determined by examining the totality of the circumstances. The inquiry requires a court to consider whether the utility company will be subjected to an unreasonable risk of non-payment for post-petition services. In re Adelphia Bus. Solutions, Inc., 280 B.R. 63, 80 (Bankr. S.D.N.Y. 2002). The debtor, however, is not required to provide an absolute guarantee of its ability to pay. *Id.* (citations omitted). In addition, the court should not require a level of adequate assurance beyond that which the utility actually needs. Va. Elec. & Power Co. v. Caldor, Inc.-N.Y., 117 F.3d 646, 650 (2d Cir. 1997) (citation omitted); see Alabama Power Co. v. Clean Earth Ky., LLC (In re Clean Earth Ky., LLC), 312 Fed. Appx. 718, 718 (6th Cir. 2008) (noting that bankruptcy court "split the difference" between utility's demand for prepayment for two months service and debtor's offer of one month prepayment).

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The *Lucre* decision is widely recognized to be an outlier, and one that is not necessarily followed even within the district.

Adequate assurance may take the form of a cash deposit, letter of credit, certificate of deposit, surety bond, a prepayment of utility consumption, or another form of security mutually agreed upon by the utility and debtor. 11 U.S.C. § 366(c)(1)(A)(i)-(vi). Some examples of "other forms" of security proposed by debtors have included a special assessment by a condominium association against its tenants for utility costs or a segregated account for the benefit of all utilities rather than a deposit directly with a specific utility. *See*, *e.g.*, *In re Bedford Town Condo.*, 427 B.R. at 386; *In re Crystal Cathedral Ministries*, 454 B.R. 124, 130-31 (C.D. Cal. 2011). The court retains the discretion to require no deposit or other security depending on the debtor's liquidity and other assets, the extent of liens that would be paid ahead of administrative expenses, and certain conditions identified in the utility order. *In re Adelphia Bus. Solutions, Inc.*, 280 B.R. at 86-88.

F. Customer Programs

If a debtor intends to operate its business post-petition, the debtor should file a motion to continue with its prepetition customer programs, including frequent flyer miles, warranties, loyalty points, layaway sales, return, refund or exchange programs, promotional offers, or giftcards. By continuing these programs, a debtor will promote customer satisfaction, loyalty and goodwill, retain longstanding customers (and ideally generate new ones), maintain competitiveness in the industry, and prevent any disruption that would result from an abrupt cessation of such programs. Ordinarily, a customer's entitlements and benefits under such programs would constitute prepetition claims that could not necessarily be satisfied in full. Court approval to continue these programs is therefore essential.

As authority for this relief, debtors often cite to section 1107(a), the debtor's powers as a debtor in possession, section 1108, which permits the debtor to operate its business, and section

363(b), which, upon court approval, allows a debtor to use property of the estate outside the ordinary course of business. 11 U.S.C. §§ 363(b), 1107(a), 1108; see also 11 U.S.C. § 105(a). In addition, with respect to programs where customers have submitted a deposit of some kind by purchasing a giftcard, layaway merchandise, or prepaid ticket, the debtor may also assert that such claims would be entitled to priority under section 507(a)(7) as consumer deposits. Accordingly, the debtor would arguably be required to eventually satisfy these claims pursuant to a confirmed plan or other distribution scheme. See 11 U.S.C. § 507(a)(7).

In a motion to continue customer programs, a debtor is likely to rely on the "doctrine of necessity," which allows the court to authorize a debtor to pay certain prepetition claims where the payment is essential to the continued operations of the debtor. *In re Ionosphere Clubs, Inc.*, 98 B.R. at 175. This doctrine allows the debtor to pay critical prepetition claims early in the case even though payment of such claims is not expressly authorized by the Bankruptcy Code. *See In re Columbia Gas Sys., Inc.*, 136 B.R. 930, 939 (Bankr. D. Del. 1992).

Any motion to continue customer programs should specifically identify the types of programs in which the debtor participates, explain how those programs drive customer loyalty, estimate the costs of maintaining the programs based on historical averages, and indicate whether the debtors intend to modify the programs post-petition (*e.g.*, suspend future returns or exchanges, but honor prepetition purchases). *See also* 11 U.S.C. § 363(b)(1) (may not sell or lease personally identifiable information absent satisfaction of one of two conditions). The motion should be served on the same parties as other first day motions (*e.g.*, twenty largest unsecured creditors, the United States Trustee, secured creditors). Depending on the relief requested and the extent to which the programs will be altered from their prepetition status, the court may require service on additional parties such as the United States Attorney, state attorneys general or consumer protection agencies.

In the motion, the debtor should cite to cases within the district and elsewhere where similar relief has been granted. *See*, *e.g.*, *Michigan Sporting Goods Distributors*, *Inc.*, Case No. 17-00712 (Bankr. W.D. Mich. Feb. 16, 2017); *In re Collins & Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich. May 17, 2005).

G. Maintenance of Insurance

A Chapter 11 debtor will often file a motion requesting approval to continue participation in its existing insurance policies and pay any prepetition obligations related to such policies. The need for such a motion is self-evident, as insurance protects assets of the estate and provides protection against potential post-petition liabilities.

Debtors typically rely on section 363(c)(1), section 105(a) and the "doctrine of necessity" as authority for the relief requested in an insurance motion. 11 U.S.C. §§ 105(a), 363(c)(1); see Dai-Ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.), 242 B.R. 147, 153 (D. Del. 1999); In re Ionosphere Clubs, Inc., 98 B.R. at 175. Even though a debtor may believe that payment of certain insurance obligations is an ordinary course obligation not requiring court approval, it is nonetheless advisable for a debtor to seek approval in an abundance of caution. See 11 U.S.C. § 363(b).

In any insurance motion, a debtor will typically contend that its failure to pay its prepetition insurance obligations could result in cancellation or interruption of coverage, posing risk of liability for the estate. A debtor will also posit that obtaining new policies would entail additional costs that can be avoided if the debtor is authorized to continue its existing insurance. An insurance motion should include a list of the debtor's current insurance coverage, the policy limits, policy identification numbers, the annual premiums, and estimates of prepetition amounts owed.

Because the failure to maintain insurance coverage where it poses a risk to the estate or the public can constitute cause to dismiss or convert a debtor's case, motions seeking such relief are rarely in dispute. *See* 11 U.S.C. § 1112(b)(4)(C). Moreover, maintenance of insurance by the debtor is often mandated by state law and is required by the United States Trustee in its operating guidelines. *See* 28 U.S.C. § 586(a); United States Trustee Guidelines at § 3-3.2.3 (debtor must maintain appropriate insurance coverage); M.C.L. § 418.111 (employer must maintain worker's compensation insurance coverage); *see also* 28 U.S.C. § 959(b).

As with most first day motions, it is good practice to include citations to cases in the district and elsewhere where similar relief has been granted. *See*, *e.g.*, *In re Family Christian Stores, Inc.*, Case No. 15-00643 (Bankr. W.D. Mich. Mar. 26, 2015); *In re Plastech Engineered Prods.*, *Inc.*, Case No. 08-42417 (Bankr. E.D. Mich. Feb. 14, 2008).

H. Sales and Use Taxes

Because a debtor is likely to have pre-petition liability for state and local sales, use and franchise taxes as of the petition date, the debtor should file a motion requesting authority to pay these obligations post-petition. Such relief is designed to prevent any disruption of the debtor's business operations by facilitating the payment of tax obligations in the ordinary course of business.

While no express authority exists within the Bankruptcy Code authorizing the payment of sales and use taxes, courts often authorize payment when taxes are held in trust by the debtor (e.g., withholding taxes). Because a debtor does not possess an equitable interest in trust fund taxes, property of the estate is arguably not implicated. See 11 U.S.C. § 541(d). Such trust fund taxes include those withheld from the wages of the debtor's employees and sales taxes collected by sellers from customers. See DuCharmes & Co., Inc. v. United States (In re DuCharmes & Co.),

852 F.2d 194, 194-96 (6th Cir. 1988); *Shank v. Wash. State Dept. of Rev. (In re Shank)*, 792 F.2d 829, 822 (9th Cir. 1986); *see also Beiger v. I.R.S.*, 496 U.S. 53, 59 (1990). As another basis, a debtor may assert that the taxing authorities hold priority claims and, therefore, payment early in the case will not alter the priority scheme under the Bankruptcy Code. *See* 11 U.S.C. §§ 105(a), 363(c), 507(a)(8). Rather, only the timing of the payment will be affected.

In any sales and use tax motion, it is advisable for the debtor to explain that (i) non-payment of these taxes will interfere with the operation of the debtor's business and result in immediate and irreparable harm, and (ii) the payment of such taxes will not prejudice creditors. *See* Fed. R. Bankr. P. 6003.

The Bankruptcy Courts in the Eastern and Western Districts of Michigan have routinely granted the relief requested in sales and use tax motions. *See*, *e.g.*, *In re Michigan Sporting Goods Distributors*, *Inc.*, Case No. 17-00612 (Bankr. W.D. Mich.); *In re Plastech Engineered Products*, *Inc.*, Case No. 08-42417 (Bankr. E.D. Mich. Feb. 14, 2008).

I. Appointment of Professionals

It is extremely important for a debtor (and its professionals) to promptly, if not immediately, file retention applications. *See* 11 U.S.C. §§ 327-328. In the event that its retention is not authorized as of a certain date, a professional runs the risk of forfeiting a portion of its fees, including those related to first day motions and hearings.

1. Who is a "Professional" That Must Seek Appointment Under Section 327?

Section 327 of the Bankruptcy Code authorizes a trustee or debtor-in-possession, with court approval, to employ attorneys, accountants, appraisers, auctioneers, or other professional persons to carry out the debtor's duties. 11 U.S.C. § 327(a). Professionals other than those specified in section 327(a) may be required to be retained subject to court approval if the individual performs

tasks involving the exercise of judgment or special expertise and skill. See In re Seven Counties Servs., Inc., 496 B.R. 852, 854-55 (Bankr. W.D. Ky. 2013). However, some courts have limited "professionals" requiring retention under section 327 to those who perform an integral role in the day-to-day administration of the bankruptcy case by, for instance, assisting the debtor with obtaining financing, addressing claims, marketing assets, or formulating a plan. See, e.g., In re Seven Counties Servs., Inc., 496 B.R. at 855; In re Napoleon, 233 B.R. 910, 913 (Bankr. D. N.J. 1999). Consequently, individuals such as expert witnesses, lobbyists, or political consultants that might otherwise be qualified as professionals due to their expertise and use of judgment are not necessarily required to be retained under section 327. Arguably, they do not play an integral role in the bankruptcy case if they do not assist the debtor with performing its duties under section 1107. In re Napoleon, 233 B.R. at 913; In re Seven Counties Serv., at 856-57. Nonetheless, the debtor may wish to seek authorization to continue to employ and pay ordinary course professionals out of an abundance of caution.

Retention under section 327 is a prerequisite to compensation. *See Lamie v. United States* Trustee, 540 U.S. 526, 538-39 (2004) (professional must be employed under section 327 in order to receive compensation under section 330(a)). Therefore, when in doubt about whether section 327 is applicable to a particular type of professional, the prudent professional should file a retention application out of an abundance of caution. *In re Renaissance Residential of Countryside, LLC*, 423 B.R. 848, 859 (Bankr. N.D. Ill. 2010).

2. Standards for Disinterestedness of Professionals to be Employed Under Section 327

Any professional sought to be retained is subject to strict standards. The professional cannot hold or represent an interest adverse to the estate. The professional must also be a

"disinterested person." 11 U.S.C. § 327(a); Morgenstern v. Eagle Picher Indus., Inc. (In re Eagle Picher Indus., Inc.), 999 F.2d 969, 971 (6th Cir. 1993).

A disinterested person is defined as a person that is not a creditor, equity security holder, or insider of the debtor, was not an officer, director, or employee of the debtor within two years of the petition date, and does not have materially adverse interest to the interest of the estate or any class of creditors or equity security holders due to a direct or indirect relationship or for any other reason. 11 U.S.C. §§ 101(14)(A)-(C).

For attorneys who are employed for a specific purpose such as with respect to a particular litigation matter or environmental issues, the requirements are somewhat relaxed. Section 327(e) allows retention of an attorney who might otherwise be disqualified due to a conflict. 11 U.S.C. § 327(e). Likewise, a person may not be disqualified from employment under section 327(a) *solely* because the person was employed by or represented the debtor prior to the commencement of the case. 11 U.S.C. § 1107(b); *see also In re Federated Dep't Stores, Inc.*, 44 F.3d 1310, 1318 (6th Cir. 1995) (section 1107(b) is narrow exception that is not applicable where professional is disqualified for another reason listed in definition of "disinterested person").

When deciding whether a person is "disinterested" and thus qualified for employment under section 327, a court is required to consider not only actual conflicts of interest, but also potential conflicts or even the appearance of conflicts. *Halbert v. Yousif*, 225 B.R. 336, 345-46 (E.D. Mich. 1998). The purpose of this requirement is to ensure that debtor's counsel, who is required to maximize recovery for the debtor's estate, does not have his or her judgment impaired by a conflict of interest. *See id.* (citing *In re Interwest Bus. Equip., Inc.*, 23 F.3d 311, 316 (10th Cir. 1994)).

An adverse interest can be either (i) personal by virtue of a professional's possession of a predisposition under circumstances that might indicate a bias against the estate, or (ii) economic by virtue of a professional's holding of an interest that might lessen the value of the estate or result in a dispute in which the estate is a rival claimant. *In re James F. Humphreys & Assocs., L.C.*, 547 B.R. 190, 194 (Bankr. S.D. W. Va. 2016) (citations omitted). Some examples of disqualifying conflicts are receipt of a preferential transfer, receipt of a fee guaranty from an insider, former participation as a board member of the debtor, or holding a prepetition claim for work that remains unpaid as of the petition date. *In re Pillowtex, Inc.*, 304 F.3d 246, 252-53 (3d Cir. 2002) (firm sought preferential payment of fees to avoid status as creditor); *Halbert v. Yousif*, 225 B.R. at 346 (preferential transfer); *In re Young Mens Christian Ass'n of Marquette Cnty.*, 570 B.R. 64, 68-69 (Bankr. W.D. Mich. 2017) (former board member); *In re Metro. Envtl., Inc.*, 293 B.R. 871, 885-86 (Bankr. N.D. Ohio 2003) (insider fee guaranty).

Rule 2014(b) of the Federal Rules of Bankruptcy Procedure provides that if a law firm or accounting firm (or an individual attorney or accountant within a firm) is employed, regular associates of the firm may work on the case without further order of the court. Fed. R. Bankr. P. 2014(b). If a professional within a firm is not "disinterested," the court must determine whether that conflict should be imputed upon the entire firm. *In re Essential Therapeutics, Inc.*, 295 B.R. 203, 208-209 (Bankr. D. Del. 2003). Some courts have held that automatic disqualification of the firm is required under such circumstances, while other courts have engaged in a fact intensive determination. *Compare In re Essential Therapeutics, Inc.*, 295 B.R. at 208-210 (noting split of authority and concluding firm should automatically be disqualified) *with In re Young Mens Christian Ass'n of Marquette Cnty.*, 570 B.R. at 68-69 (court will not automatically disqualify firm but should conduct fact intensive analysis).

3. Technical Requirements for Employment Applications

A typical retention application includes a detailed description of the services to be performed by the professional and an explanation of how the services are beneficial to the estate. *See* Fed. R. Bankr. P. 2014(a). The application should also disclose any terms of compensation, as well as the other terms of the engagement. *Id.* The retention agreement should be attached to the application as an exhibit. Where there are multiple professionals involved in the case, the application should explain how the professionals intend to avoid duplication of services. *See In re Licking River Mining, LLC*, 2015 WL 5601284, at *12 (Bankr. E.D. Ky. Sept. 22, 2015).

Finally, attached to the application should be a verified statement of disinterestedness explaining how the professional determined that he or she does not hold any interests adverse to the debtor and is disinterested. Fed. R. Bankr. P. 2014(a); LBR 2014-1(a) (Bankr. E.D. Mich.). This statement should specifically disclose all of the connections of the professionals and his or her associates with the debtor, creditors, or other parties in interest, along with their respective attorneys and professionals. Fed. R. Bankr. P. 2014(a). The disclosure should be promptly supplemented after learning of any additional material information such as an actual or potential conflict of interest. *In re Granite Partners, L.P.*, 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) (although Fed. R. Bankr. P. 2014 does not require supplemental disclosure, section 327(a) implies a duty of continuing disclosure to ensure integrity of bankruptcy system) (collecting cases).

Practices vary as to whether employment applications are filed as first day motions. *See*, *e.g.*, Fed. R. Bankr. P. 2014(a) (service on UST); LBR 2014(b), (c) (Bankr. W.D. Mich.) (permitting emergency approval of employment with certification of United States Trustee but otherwise providing United States Trustee with 28 days to object); LBR 2014-1(b), (e) (Bankr. E.D. Mich.) (application may be approved upon statement of concurrence by United States Trustee

or professional may utilize notice and opportunity procedures).¹⁰ Although the application is arguably not required to be served on creditors and other parties in interest, the savvy practitioner will serve the application on the matrix, as it may provide an estoppel-type argument in the event a previously noticed party later challenges the professional's disinterestedness after the application has been approved.

Importantly, the debtor should request that the order approve the retention as of the petition date, lest the professional find that his or her fees are not approved for the period prior to the entry of the order. However, as noted above, if the filing of the application is significantly delayed, some courts have permitted *nunc pro tunc* relief upon a showing of exceptional circumstances or excusable neglect. *See In re Arkansas Co., Inc.*, 798 F.2d 645 (3d Cir. 1986); *In re McKenzie*, 449 B.R. 306, 319-20 (Bankr. E.D. Tenn. 2011) (collecting cases).

The application and proposed order should require the professional to apply for compensation and comply with any applicable fee procedures orders entered in the case. *See also* 11 U.S.C. §§ 328, 330-331. In addition, the United States Trustee may request that the professional include a provision requiring compliance with the United States Trustee's fee guidelines in large Chapter 11 cases.

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¹⁰ It is generally sound practice to file a retention application as soon as possible.

UNITED STATES BANKRUPTCY COURT WESTERN DISTRICT OF MICHIGAN

In re:	Case No. GK 16-03083-jtg
GONZALEZ GROUP JONESVILLE, LLC,	Chapter 11
Debtor(s).	Honorable John T. Gregg

DEFINITIVE ORDER

The above-captioned debtor(s) (the "Debtor") have filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101, *et seq.* Accordingly, the court has decided to enter this Order with respect to the operation of the Debtor's business without the need for a hearing.

NOW, THEREFORE, IT IS HEREBY ORDERED THAT:

- 1. <u>Operation</u>. Pursuant to 11 U.S.C. §§ 363 and 1108, the Debtor, as a "debtor in possession," is authorized to remain in possession of its assets and to continue operations in the ordinary course of business until further order of the court.
- 2. <u>Use of Cash Collateral</u>. The Debtor shall not use cash collateral as defined in 11 U.S.C. § 363 absent the consent of each entity with an interest in the cash collateral, or authorization pursuant to an order of the court. Any request for an order authorizing the Debtor to use cash collateral must comply with Fed. R. Bankr. P. 4001(d). *See* LBR 4001-2. Nothing contained in this Order, however, shall be deemed or construed to authorize the use of cash collateral.
- 3. <u>Payment of Pre-Petition Debts Prohibited</u>. The Debtor shall not pay debts incurred prior to the filing of the petition, including taxes, unless such payments are authorized by the court.
- 4. <u>Professional Fees and Expenses</u>. No fees or expenses shall be paid to any attorney, appraiser, accountant, auctioneer, or other professional person retained under 11 U.S.C. §§ 327 and 1103 unless authorized by order of the court.
- 5. <u>Purchases and Sales</u>. The Debtor may buy and sell merchandise, supplies, and property in the ordinary course of business, provided that any such purchases and sales are necessary and essential for its operation. All purchases or sales shall be for cash or for credit not to exceed terms of thirty (30) days. All transactions not in the ordinary course of business require specific authorization by the court.

6. <u>Bookkeeping</u>. As of the date of entry of the order for relief, the Debtor shall close its existing books and open new books, maintaining a full and accurate accounting with respect to receipts, disbursements, purchases, accounts receivable, and accounts payable.

7. Authorized Bank Accounts.

- (a) The Debtor shall close all bank accounts existing as of the petition date and open new accounts in the name of the debtor in possession at a financial institution approved by the United States Trustee. All cash assets of the Debtor shall be transferred to and held in authorized debtor in possession accounts. The Debtor shall maintain a segregated tax escrow account for the payment of taxes.
- (b) The Debtor's checks shall bear the term "debtor-in-possession" and the Debtor's case number.
- (c) Financial institutions which open accounts for any debtor in possession shall comply with 11 U.S.C. § 345(b).

8. Tax Escrow Requirements.

- (a) Within 30 days of the entry of this Order, the Debtor shall file all tax returns which were delinquent as of the date of filing of this case. The Debtor shall pay all federal, state, and local tax liabilities incurred after the filing of the case, including property taxes, as they become due, and shall file all reports, returns, or other documents required to be filed on the dates due. Prepetition taxes shall not be paid unless payment is authorized by the court. The Debtor shall pay federal taxes using depository receipts and shall file returns as required by Internal Revenue Service regulations.
- (b) Pending payment of taxes, the Debtor shall deposit all funds necessary to pay its taxes, whether federal, state, or local, in its segregated tax escrow account, including any taxes which applicable law requires the Debtor to collect from third persons and to remit to the taxing authority (*e.g.*, funds due the Internal Revenue Service under 26 U.S.C. §§ 3102, 3402(a), 3111, and 3301). All taxes of any description should be paid from the tax escrow account.
- 9. <u>United States Trustee</u>. The Debtor shall furnish to the United States Trustee such reports and information as the United States Trustee may reasonably require to supervise the administration of the estate. Such reports shall be signed by an authorized representative of the Debtor who shall acknowledge and attest to the accuracy of such reports. The originals of such reports and information shall be filed with the Clerk of the Court. Copies shall be served upon the Office of the United States Trustee, The Ledyard Building, 2nd Floor, 125 Ottawa NW, Suite 202R, Grand Rapids, MI 49503, and upon the chair and attorneys for any committees that may have been appointed in this case.

10. <u>Salaries and Draws</u>. Within fourteen (14) days of the petition date, the Debtor shall file with the Clerk of the Court a schedule of proposed salaries to be paid to employees and draws to be paid to equity interest holders. A copy of such schedule shall be served upon the United States Trustee, and the chair and attorneys of any committee appointed in this case. Upon the expiration of fourteen (14) days from the petition date and absent the filing of any written objection by a party in interest, the proposed salaries and draws are approved and may be paid unless and until this court orders otherwise. No changes may be made in such salaries and draws unless an amended schedule, subject to the same notice and objection procedures as the original schedule, is filed.

11. Required Insurance.

- (a) The Debtor shall maintain adequate insurance coverage on all assets of the estate and shall maintain insurance for the protection of its employees and customers.
- (b) The Debtor shall not use uninsured assets of the estate in the operation of its business without the permission of this court, nor shall the Debtor continue business operations without adequate insurance coverage.
- (c) The Debtor shall file a schedule of insurance coverage within fourteen (14) days of the petition date.
- 12. <u>Special Provisions for Corporate Debtors</u>. In the event that the Debtor is a corporation, all present and future officers, directors, and controlling shareholders of the Debtor are personally responsible for ensuring that the Debtor complies with this Order, as well as all future orders of this court. Any change in officers or directors shall be reported in writing by filing a notice on the docket in this case and serving the same on the United States Trustee within fourteen (14) days of such change.
- 13. <u>Plan Date</u>. The Debtor should be prepared to provide a reasonable date for the filing of a plan of reorganization and disclosure statement at the United States Trustee's request at any initial conference or meeting of creditors pursuant to 11 U.S.C. § 341.
- 14. <u>Amendments</u>. This Order is subject to modification by the court upon its own initiative or upon the motion of any party in interest.
- 15. <u>Service</u>. This Order shall promptly be served in person or via first class United States mail upon the following by the Clerk of the Court:
 - (a) the Debtor;
 - (b) the attorney for the Debtor:
 - (c) the Internal Revenue Service;
 - (d) Michigan Department of Treasury;
 - (e) Michigan Employment Security Commission;
 - (f) United States Trustee;

Case:16-03083-jtg Doc #:6 Filed: 06/07/16 Page 4 of 4

- (g) the twenty largest creditors as described pursuant to Fed. R. Bankr. P. 1007-I(d); and
- (h) all other persons requesting notice in this case to date.

This Order shall promptly be served in person or via first class United States mail upon the following by the Debtor:

- (a) each bank holding an authorized account of the Debtor;
- (b) the chair of any committee appointed in the case;
- (c) the attorneys for any committees appointed in the case; and
- (d) all present officers, directors, and controlling entities of the Debtor, if any, and upon their successors upon notification of their appointment.

The Debtor shall file a proof of service regarding service to these parties.

[END OF ORDER]

Signed: June 7, 2016





OFFICE OF THE UNITED STATES TRUSTEE OPERATING INSTRUCTIONS AND REPORTING REQUIREMENTS FOR CHAPTER 11 CASES

LINK TO OPERATING INSTRUCTIONS:

https://www.justice.gov/sites/default/files/ust-regions/legacy/2011/07/13/oirr_0.pdf

Executive Order 12866

These guidelines have been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. The Director, Executive Office for United States Trustees, has determined that these guidelines are not a "significant regulatory action" under Executive Order 12866 section 3(f), Regulatory Planning and Review. These guidelines pertain to the internal management of the Department and as such are not subject to central Office of Management and Budget review pursuant to section 6 of Executive Order 12866. Accordingly, these guidelines have not been reviewed by the Office of Management and Budget pursuant to Executive Order 12866.

Regulatory Flexibility Act

The Director, Executive Office for United States Trustees, in accordance with the Regulatory Flexibility Act (5 U.S.C. § 605(b)), has reviewed these guidelines and by approving them certifies that these guidelines will not have a significant economic impact on a substantial number of small entities.

List of Subjects in 28 CFR Part 58

Bankruptcy, Trusts, and Trustees. For the reasons set forth in the preamble, the Department of Justice proposes to amend 28 CFR part 58 as follows:

PART 58—REGULATIONS RELATING TO THE BANKRUPTCY REFORM ACTS OF 1978 AND 1994

- 1. The heading of Part 58 is revised to read as set forth above.
- 2. The authority citation for Part 58 continues to read as follows:

Authority: 28 U.S.C. 509, 510, 586(e),

3. Appendix A is added to Part 58 to read as follows:

Appendix A to Part 58-Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed Under 11 U.S.C. 330

(a) General Information. (1) The Bankruptcy Reform Act of 1994 amended the responsibilities of the United States Trustees under 28 U.S.C. 586(a)(3)(A) to provide that, whenever they deem appropriate, United States Trustees will review applications for compensation and reimbursement of expenses under section 330 of the Bankruptcy Code, 11 U.S.C. 101, et seq. ("Code"), in accordance with procedural guidelines ("Guidelines") adopted by the Executive Office for United States Trustees ("Executive Office"). The following Guidelines have been adopted by the Executive Office and are to be uniformly

applied by the United States Trustees except when circumstances warrant different treatment.

(2) The United States Trustees shall use these Guidelines in all cases commenced on or after October 22, 1994.

(3) The Guidelines are not intended to supersede local rules of court, but should be read as complementing the procedures set forth in local rules.

(4) Nothing in the Guidelines should be construed:

(i) To limit the United States Trustee's discretion to request additional information necessary for the review of a particular application or type of application or to refer any information provided to the United States Trustee to any investigatory or prosecutorial authority of the United States

(ii) To limit the United States Trustee's discretion to determine whether to file comments or objections to applications; or

(iii) To create any private right of action on the part of any person enforceable in litigation with the United States Trustee or the United States.

(5) Recognizing that the final authority to award compensation and reimbursement under section 330 of the Code is vested in the Court, the Guidelines focus on the disclosure of information relevant to a proper award under the law. In evaluating fees for professional services, it is relevant to consider various factors including the following: the time spent; the rates charged; whether the services were necessary to the administration of, or beneficial towards the completion of, the case at the time they were rendered; whether services were performed within a reasonable time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and whether compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in non-bankruptcy cases. The Guidelines thus reflect standards and procedures articulated in section 330 of the Code and Rule 2016 of the Federal Rules of Bankruptcy Procedure for awarding compensation to trustees and to professionals employed under section 327 or 103. Applications that contain the information requested in these Guidelines will facilitate review by the Court, the parties, and the United States Trustee.

(6) Fee applications submitted by trustees are subject to the same standard of review as are applications of other professionals and will be evaluated according to the principles articulated in these Guidelines. Each United States Trustee should establish whether and to what extent trustees can deviate from the format specified in these Guidelines without substantially affecting the ability of the United States Trustee to review and comm on their fee applications in a manner consistent with the requirements of the law.

(b) Contents of Applications for Compensation and Reimbursement of Expenses. All applications should include sufficient detail to demonstrate compliance with the standards set forth in 11 U.S.C. § 330. The fee application should also contain sufficient information about the case and the applicant so that the Court, the

creditors, and the United States Trustee can review it without searching for relevant information in other documents. The following will facilitate review of the

application.
(1) Information about the Applicant and the Application. The following information should be provided in every fee application:

(i) Date the bankruptcy petition was filed, date of the order approving employment, identity of the party represented, date services commenced, and whether the applicant is seeking compensation under a provision of the Bankruptcy Code other than section 330,

(ii) Terms and conditions of employment and compensation, source of compensation, existence and terms controlling use of a retainer, and any budgetary or other limitations on fees.

(iii) Names and hourly rates of all applicant's professionals and paraprofessionals who billed time, explanation of any changes in hourly rates from those previously charged, and statement of whether the compensation is based on the customary compensation charged by comparably skilled practitioners in cases other than cases under title 11.

(iv) Whether the application is interim or final, and the dates of previous orders on interim compensation or reimbursement of expenses along with the amounts requested and the amounts allowed or disallowed. amounts of all previous payments, and amount of any allowed fees and expenses remaining unpaid.
(v) Whether the person on whose behalf

the applicant is employed has been given the opportunity to review the application and whether that person has approved the requested amount.

(vi) When an application is filed less than 120 days after the order for relief or after a prior application to the Court, the date and terms of the order allowing leave to file at shortened intervals.

(vii) Time period of the services or

rpenses covered by the application.
(2) Case Status. The following information should be provided to the extent that it is known to or can be reasonably ascertained by

(i) In a chapter 7 case, a summary of the administration of the case including all moneys received and disbursed in the case, when the case is expected to close, and, if applicant is seeking an interim award, whether it is feasible to make an interim distribution to creditors without prejudicing the rights of any creditor holding a claim of

equal or higher priority.

(ii) In a chapter 11 case, whether a plan and disclosure statement have been filed and, if not yet filed, when the plan and disclosure statement are expected to be filed; whether all quarterly fees have been paid to the United States Trustee; and whether all monthly operating reports have been filed.

(iii) In every case, the amount of cash on hand or on deposit, the amount and nature of accrued unpaid administrative expenses and the amount of unencumbered funds in

(iv) Any material changes in the status of the case that occur after the filing of the fee application should be raised, orally or in

writing, at the hearing on the application or, if a hearing is not required, prior to the expiration of the time period for objection.

(3) Summary Sheet. All applications should contain a summary or cover sheet that provides a synopsis of the following information:

(i) Total compensation and expense requested and any amount(s) previously

requested;
(ii) Total compensation and expenses

previously awarded by the court;
(iii) Name and applicable billing rate for each person who billed time during the period, and date of bar admission for each attorney;

(iv) Total hours billed and total amount of

(iv) Total hours butted and total amount of billing for each person who billed time during billing period; and (v) Computation of blended hourly rate for persons who billed time during period, excluding paralegal or other paraprofessional

(4) Project Billing Format. (f) To facilitate effective review of the application, all time and service entries should be arranged by project categories. The project categories set forth in Exhibit A should be used to the extent applicable. A separate project category should be used for administrative matters and, if payment is requested, for fee

application preparation.

(ii) The United States Trustee has discretion to determine that the project billing format is not necessary in a particular case or in a particular class of cases. Applicants should be encouraged to consult with the United States Trustee if there is a question as to the need for project billing in any particular case.

(iii) Each project category should contain a narrative summary of the following information:

(A) a description of the project, its necessity and benefit to the estate, and the status of the project including all pending litigation for which compensation and reimbursement are requested;

(B) identification of each person providing

services on the project; and
(C) a statement of the number of hours spent and the amount of compensation requested for each professional and paraprofessional on the project.

(iv) Time and service entries are to be reported in chronological order under the appropriate project category.

(v) Time entries should be kept

contemporaneously with the services rendered in time periods of tenths of an hour Services should be noted in detail and not combined or "lumped" together, with each service showing a separate time entry; however, tasks performed in a project which total a de minimis amount of time can be combined or lumped together if they do not exceed .5 hours on a daily aggregate. Time entries for telephone calls, letters, and other communications should give sufficient detail to identify the parties to and the nature of the communication. Time entries for court hearings and conferences should identify the subject of the hearing or conference. If more than one professional from the applicant firm attends a hearing or conference, the applicant should explain the need for multiple

(5) Reimbursement for Actual, Necessary Expenses. Any expense for which reimbursement is sought must be actual and necessary and supported by documentation as appropriate. Factors relevant to a determination that the expense is proper included by fall units. include the following:

 (i) Whether the expense is reasonable and economical. For example, first class and other luxurious travel mode or accommodations will normally be objectionable.

(ii) Whether the requested expenses are customarily charged to non-bankruptcy

clients of the applicant.

(iii) Whether applicant has provided a detailed itemization of all expenses including the date incurred, description of expense (e.g., type of travel, type of fare, rate, destination), method of computation, and, where relevant, name of the person incurring the expense and purpose of the expense. Itemized expenses should be identified by their nature (e.g., long distance telephone, copy costs, messengers, computer research, airline travel, etc.) and by the month incurred. Unusual items require more detailed explanations and should be allocated, where practicable, to specific

(iv) Whether applicant has prorated expenses where appropriate between the estate and other cases (e.g., travel expenses applicable to more than one case) and has adequately explained the basis for any such proration.

(v) Whether expenses incurred by the applicant to third parties are limited to the actual amounts billed to, or paid by, the

applicant on behalf of the estate.

(vi) Whether applicant can demonstrate that the amount requested for expenses incurred in-house reflect the actual cost of such expenses to the applicant. The United States Trustee may establish an objection ceiling for any in-house expenses that are routinely incurred and for which the actual cost cannot easily be determined by most professionals (e.g., photocopies, facsimile charges, and mileage).

(vii) Whether the expenses appear to be in the nature nonreimbursable overhead.

Overhead consists of all continuous administrative or general costs incident to the operation of the applicant's office and not particularly attributable to an individual client or case. Overhead includes, but is not limited to, word processing, proofreading, secretarial and other clerical services, rent, utilities, office equipment and furnishings, insurance, taxes, local telephones and monthly car phone charges, lighting, heating and cooling, and library and publication

(viii) Whether applicant has adhered to allowable rates for expenses as fixed by local rule or order of the Court.

Exhibit A-Project Categories

Here is a list of <u>suggested</u> project categories for <u>use in most bankruptcy</u> cases. Only one category should be used for a given activity. Professionals should make their best effort to be consistent in their use of categories,

whether within a particular firm or by different firms working on the same case. It would be appropriate for all professionals to discuss the categories in advance and agree generally on how activities will be categorized. This list is not exclusive. The application may contain additional categories as the case requires. They are generally more applicable to attorneys in chapter 7 and chapter 11, but may be used by all professionals as appropriate.

Asset Analysis and Recovery: Identification and review of potential assets including causes of action and non-litigation recoveries.

Asset Disposition: Sales, leases (§ 365 matters), abandonment and related transaction work.

Business Operations: Issues related to debtor-in-possession operating in chapter 11 such as employee, vendor, tenant issues and other similar problems.

Case Administration: Coordination and compliance activities, including preparation of statement of financial affairs; schedules; list of contracts; United States Trustee interim statements and operating reports; contacts with the United States Trustee; general creditor inquiries.

Claims Administration and Objections:

Specific claim inquiries; bar date motions; analyses, objections and allowances of

Employee Benefits/Pensions: Review issues such as severance, retention, 401K coverage and continuance of pension plan.

Fee/Employment Applicants: Preparation of employment and fee applications for self or others; motions to establish interim procedures.

Fee/Employment Objections: Review of and objections to the employment and fee applications of others.

Financing: Matters under §§ 361, 363 and 364 including cash collateral and secured claims; loan document analysis.

Litigation: There should be a separate category established for each matter (e.g.,

XYZ Litigation).

Meetings of Creditors: Preparing for and attending the conference of creditors, the § 341(a) meeting and other creditors committee meetings.

Plan and Disclosure Statement: Formulation, presentation and confirmation; compliance with the plan confirmation order, related orders and rules; disbursement and case closing activities, except those related to the allowance and objections to allowance of

Relief From Stay Proceedings: Matters relating to termination or continuation of

automatic stay under § 362.

The following categories are generally more applicable to accountants and financial advisors, but may be used by all

professionals as appropriate.

Accounting/Auditing: Activities related to maintaining and auditing books of account, preparation of financial statements and account analysis.

Business Analysis: Preparation and review of company business plan; development and review of strategies; preparation and review of cash flow forecasts and feasibility studies.



24892 Federal Register / Vol. 61, No. 97 / Friday, May 17, 1996 / Rules and Regulations

Corporate Finance: Review financial aspects of potential mergers, acquisitions and

disposition of company or subsidiaries.

Data Analysis: Management information systems review, installation and analysis, construction, maintenance and reporting of significant case financial data, lease rejection, claims, etc.

Litigation Consulting: Providing consulting and expert witness services relating to various bankruptcy matters such as insolvency, feasibility, avoiding actions,

forensic accounting, etc.

Reconstruction Accounting: Reconstructing books and records from past transactions and

bringing accounting current.

Tax Issues: Analysis of tax issues and preparation of state and federal tax returns.

Valuation: Appraise or review appraisals of

Dated: April 25, 1996. Joseph Patchan, Director.

[FR Doc. 96-11799 Filed 5-16-96; 8:45 am] BILLING CODE 4410-01-M

DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 165

[COTP Los Angeles-Long Beach, CA 96-

RIN 2115-AA97

Safety Zone; Long Beach Harbor, CA

AGENCY: Coast Guard, DOT. ACTION: Final rule with request for comments.

SUMMARY: The Coast Guard is establishing a temporary safety zone in the navigable waters of the United States in the vicinity of the South East side of Pier "J" in the Long Beach Outer Harbor, California. The event requiring the establishment of this safety zone is the Pier "J" breakwater construction project. Duration of this project is estimated to be 11 months. A safety zone is necessary to safeguard recreational and commercial craft from the dangers of the construction project and to prevent interference with the vessels engaged in these operations. The safety zone includes all waters within the boundaries defined by the line connecting the following coordinates:

Latitude /	Longitude
33° 44,5′N.	118° 11.2′W.
33° 44,5′N.	118° 10.9′W.
33° 44.3′N.	118° 10.8W.
33° 44.0′N.	118° 10.8′W.
33° 44 0'N	118° 11 17W

Entry into, transit through, or anchoring within the safety zone by vessels or persons other than those engaged in the construction project, or vessels servicing the Maersk terminal is prohibited unless authorized by the Captain of the Port.

DATES: Effective Date: This rule is effective at 12:01 a.m. PDT on April, 24, 1996 and will remain in effect until 12:01 a.m. PST on March 31, 1997, unless cancelled earlier by the Captain of the Port Los Angeles-Long Beach, Ca.

Comments: Comments on this regulation must be received by June 17,

ADDRESSES: Comments should be mailed to Commanding Officer, Coast Guard Marine Safety Office, 165 N. Pico Avenue, Long Beach, Ca 90802. Comments received will be available for inspection and copying within the Port Safety Division at MSO Los Angeles-Long Beach. Normal office hours are between 8 a.m. and 4 p.m., Monday through Friday, except federal holidays.

FOR FURTHER INFORMATION CONTACT: Chief Petty Officer Daniel J. Walsh, Port Safety and Security Division Marine Safety Office Los Angeles-Long Beach, (310) 980-4454.

SUPPLEMENTARY INFORMATION: In accordance with 5 U.S.C. 553, a notice of proposed rulemaking was not published for this regulation and good cause exists for making it effective in less than 30 days after Federal Register publication. Following normal rulemaking procedures could not be done in a timely fashion in that the Coast Guard was not approached concerning the necessity for implementation of a safety zone until late in the planning process. The actual stipulations of the safety zone were not finalized until a date fewer than 30 days prior to the start of the project.

Although this regulation is published as a final rule without prior notice, an opportunity for public comment is nevertheless desirable to ensure the regulation is both reasonable and workable. Accordingly, persons wishing to comment may do so by submitting written comments to the office listed under ADDRESSES in this preamble. Those providing comments should identify the docket number (COTP Los Angeles-Long Beach, CA; 96-008) for the regulation and also include their name, address, and reason(s) for each comment presented. Persons wanting acknowledge of receipt of comments should enclose a stamped, selfaddressed postcard or envelope.

Based upon the comments received. the scope of the regulation may be changed.

Discussion of Regulation

The project to construct a breakwater around the Pier "J" Maersk terminal entrance has already been initiated. A safety zone is necessary to safeguard recreational and commercial craft from the dangers of the construction project and to prevent interference with vessels engaged in these operations. This safety zone will be enforced by U.S. Coast Guard personnel. The Coast Guard Auxiliary and the Long Beach Lifeguards will assist in the enforcement of the safety zone. Persons and vessels are prohibited from entering into, transiting through, or anchoring within the safety zone unless authorized by the Captain of the Port of his designated representative.

Regulatory Evaluation

This rule is not a significant regulatory action under section 3(f) of Executive Order 12866 and does not require an assessment of potential costs and benefits under section 6(a)(3) of that order. It has been exempted from review by the Office of Management and Budget under that order. It is not significant under the regulatory policies and procedures of the Department of Transportation (44 FR 11040; February 26, 1979). The Coast Guard expects the economic impact of this regulation to be so minimal that a full Regulatory Evaluation under paragraph 10(e) of the regulatory policies and procedures of the Department of Transportation is unnecessary. The safety zone does not extend into the vessel traffic lanes. It will have little or no impact on commercial vessels transiting through the harbor.

Small Entities

Under the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the Coast Guard must consider whether this regulation will have a significant economic impact on a substantial number of small entities. "Small entities" include independently owned and operated small businesses that are not dominant in their field and that otherwise qualify as "small business concerns" under Section 3 of the Small Business Act (15 U.S.C. 632). As discussed in the "Regulatory Evaluation" section because it expects the impact of this regulation to be minimal, the Coast Guard certifies under 5 U.S.C. 605(b) that this regulation will not have a significant economic impact on a substantial number of small entities.

Collection of Information

This regulation contains no collection of information requirements under the

THE BETTER PRACTICE IS ...

EMPLOYMENT AND FEE APPLICATIONS FOR DEBTOR'S COUNSEL IN CHAPTER 11 CASES

Leslie Berg
Trial Attorney¹
Office of the U.S. Trustee, Detroit, Michigan
November, 2017

- I. Employment Under the Bankruptcy Code Key Sections of the Bankruptcy Code, Fed. R. Bankr. P., and LBR for the E.D. Michigan
 - A. §327(a) applies to attorneys, accountants, appraisers and "other professionals"
 - B. Must be "disinterested" and not hold or represent any "interest adverse to the estate."

Disinterested definition – 11 USC §101(14):

- (A) is not a creditor, an equity security holder, or an insider;
- (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
- (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.
- C. FRBP 2014 Affidavit of disinterestedness What should it say?
 - 1. Must disclose *all connections* err on the side of inclusion;
 - 2. "Connections" include family relationships 11 USC §101(45);
 - 3. Attorneys and accountants of Debtor, creditors, parties in interest, and U.S. Trustee or anyone employed by the Office of the U.S. Trustee;
 - 4. May state applicant's opinion that based on investigation of all connections that applicant is disinterested, but that is not binding;
 - 5. Specifically state what was done to check for conflicts and adverse interests;
 - 6. What qualifies Applicant to serve as counsel?
 - a. Set forth experience and qualifications and why Debtor chose this attorney or firm;
 - b. State what services are to be performed;
 - c. Application must be signed by Debtor.

¹ The views expressed by the author and member of the panel on Chapter 11 Practice at the November 10, 2017 ABI Consumer Bankruptcy Seminar at Detroit, Michigan are those of the author/ panel member and do not necessarily represent the views or official policies of the Office of the United States Trustee.

- 7. Follow the language in **FRBP 2014** in the Affidavit of Disinterestedness.
 - a) State that applicant believes she is disinterested and neither has nor represents no interest adverse to the interests of the estate or any class of creditors or equity. Note that adverse interest qualification is as to the estate and any class of creditors or equity in the debtor, not the debtor individually!)
 - b) List any and all connections to debtor (do you or someone in your firm represent the principal in any matter? Any of the principal's relatives? See LBR 2014-1(a). Does anyone in your office have any connections?
 - c) Connections to whom? Debtor, creditors, any other party in interest, their respective attorneys, accountants, the U.S. Trustee or any person employed in the Office of the U.S. Trustee (FRBP 2014.)
 - d) Ongoing duty to disclose.
 - e) Failure to disclose relevant connections is basis for disallowance of fees or disqualification.
- **D.** §327(e) special counsel for "specified special purpose," must not have any interest adverse to the debtor or the estate with respect to the matter on which special counsel is to be employed.
 - 1. Determine "adverse interest" on the matter for which special counsel is retained;
 - 2. Delineate scope of services (no general bankruptcy work for special counsel);
 - 3. Limited to attorneys who have previously represented the debtor.
- **E.** Body of the application:
 - 1. State what employment is being sought and under what sections of the Code;
 - 2. Jurisdiction and venue provisions;
 - 3. Background (when case was filed, that debtor is operating as DIP under §§1107 and 1108, that committee has or has not been formed; that debtor sought applicant to represent it in the bankruptcy.)
 - 4. Basis for relief (§327, FRBP 2014);
 - 5. When services were commenced;
 - 6. Necessity for debtor to have counsel;
 - 7. Services to be rendered (filing the case, preparing schedules, advising debtor of obligations and duties under the Bankruptcy Code, carrying out debtor's duties by filing motions, objections and other pleadings, appearing before the court in all matters in the case, assisting in the administration of the case, communicating with US Trustee and creditors as necessary, preparing plan and disclosure statement and all other matter incident to obtaining confirmation, case closing, and assisting the debtor as necessary in the sale of any property outside the ordinary course of business);
 - 8. Disinterestedness (referencing attached affidavit or verified statement);
 - 9. Qualifications of counsel to undertake the representation;

- a. If a lawyer believes that he should handle a debtor's or DIP's representation but may only do so competently in association with a lawyer with more bankruptcy expertise, he should associate such counsel on the case. [DR 6-101(A)(1); Model Rule 1.1, see Part II, infra. In re Byman Furniture & Interiors, Inc., 14 BR 230 (BC SD Tex, 1981).] If counsel expects payment from the estate as an administrative claim, however, a fee sharing agreement is a mistake. Rather, both counsel should request court appointment and be prepared to accept payment only of such fees as the court allows. 1987 Ann. Surv. of Bankr.Law 3 Ethical Guidelines for Representing Debtors and Debtors-In-Possession Norton Annual Survey of Bankruptcy Law, 1987 Edition, Susan M. Freeman, Author;
- 10. Terms of employment (retainer, hourly billing, current rates, notice to be given to court and U.S. Trustee if rates go up, that no premium is being charged by applicant in this case, whether counsel will seek payment into trust account on a monthly basis, acknowledgement that all fees and reimbursement of expenses are subject to court approval);
- 11. Identify any pre-petition payments to applicant by debtor or any other party on behalf of debtor and what they were for, including retainer and amount remaining in applicant's trust account.

F. Attachments to Application

- 1. [Proposed] Order
- 2. Affidavit of Disinterestedness
- 3. Statement of U.S. Trustee's Consent (E.D. Mich. only, see LBR 2014-1(b))
- 4. Optional FRBP 2016(b) Statement of Compensation
- **G.** Co-counsel arrangements
- H. Nunc pro tunc employment. In re Georgetown of Kettering, Ltd., 750 F.2d 536 (6th Cir. 1984)
- I. FRBP 6003
- J. Retention Cases of Interest
 - 1. In re Champagne Servs., LLC, 560 B.R. 196 (Bankr. E.D. Va. 2016)
 - 2. In re Jore Corp., 298 B.R. 703 (Bankr. D. Mont. 2003)
 - 3. *In re Pillowtex, Inc*. 304 F. 3d 246 (3rd Cir. 2002)
 - 4. In re Project Orange Assocs.,LLC, 431 B.R. 363 (Bankr. S.D.N.Y. 2010)
 - 5. HardRock HDD, Inc. 17-46425 Doc 63 (E.D. Mich. Judge Shefferly)
 - Young Mens Christian Association of Marquette County, 17-90131 Doc. 53 (W.D. Mich. Judge Dales)

- 7. In re WM Distribution, Inc., 2017 WL2688233, 64 B.Ct.Dec.79 (Bankr. D. New Mexico.)
- II. Fee Applications Key Sections of the Bankruptcy Code, Fed. R. Bankr. P. and L.B.R. E.D. Michigan
 - **A.** §330 allows reasonable compensation for *actual and necessary* services, and reimbursement for *actual and necessary* costs
 - 1. Reasonableness factors:
 - a) time spent;
 - b) rates charged;
- c) whether services were necessary to the administration of, or beneficial at the time rendered toward the completion of, the case;
- d) whether services were performed within a reasonable amount of time commensurate with the complexity, importance and nature of the problem, issue or task addressed;
- e) whether person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and
- f) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under the Bankruptcy Code.
- i. No compensation for unnecessary duplication of services or services that were not reasonably likely to benefit the estate or were not necessary to the administration of the case.
- ii. Compensation allowed for preparation of fee application commensurate with difficulty of application.
- iii. Can apply only once every 120 days subject to court order providing otherwise.

See LBR 2016-3 - Interim Fee Procedures.

- B. FRBP 2016(a) General requirements of a fee application
 - 1. Detailed statement of services rendered, time spent and expenses incurred, and amounts requested.
 - Statement of payments made to applicant in connection with the case and promised to be paid, source of such payments, whether the compensation has been shared and whether there is an agreement for the sharing of compensation in the case and the terms of any such agreement. Fee sharing is not permitted under the Bankruptcy Code. 11 U.S.C. §504.

Fees paid from a bankruptcy estate as administrative claims may not be split between firms. [Footnote omitted.] However, bankruptcy law imposes no fee

sharing restrictions other than disclosure as to fees paid prepetition or from sources other than the estate. Ethically, fee sharing arrangements between lawyers are permissible when the client consents, the total fee is clearly reasonable, and the division is in proportion to the services rendered and responsibility assumed by each lawyer. [Footnote omitted.]

1987 Ann. Surv. of Bankr.Law 3 Ethical Guidelines for Representing Debtors and Debtors-In-Possession Norton Annual Survey of Bankruptcy Law, 1987 Edition, Susan M. Freeman, Author.

C. LBR 2016-1(a) Approval of Fees for Attorneys and Accountants

1. Provides **specific** requirements as to the content and format of fee application.

D. Project Billing Format - 28 C.F.R. Part 58 Appendix A

1. Threshold is \$20,000 in fees in Chapter 11 (LBR 2016-1(a)(15).

E. Common fee application problems

- 1. Transitory billing;
- 2. Non-legal work, clerical work;
- 3. Excessive research and other "learning curve" issues;
- 4. Lack of exercise of billing judgment;
 - a. Failure to "no charge" for services that were of no benefit to the estate;
 - b. Removing items "no charged" from the application before submission;
- 5. Lumping of time entries;
- 6. Improper categorization of time entries;
- 7. Vague entries;
- 8. Excessive intra-office conferences;
- 9. Duplication of services;
- 10. Failure to abide by LBR 2016-1(a) requirements;
- 11. Failure to obtain order of employment;
- 12. Insufficient itemization or documentation of expenses.

F. Fee cases of interest.

1. In re Nilges, 301 B.R. 321 (Bankr. N.D. Iowa 2003) (Counsel has a duty to supervise clients' conduct for compliance with the Bankruptcy Code. In re Kloubec, 251 B.R. 861, 866 (Bankr.N.D.Iowa 2000). As a professional, an attorney must instruct the debtor on appropriate conduct and must develop client control. In re Berg, 268 B.R. 250, 262 (Bankr.D.Mont.2001). "To foster such client control, an attorney must be: ... knowledgeable about the parameters and limits of available alternatives and remedies, and unwilling

to allow a client to direct or dictate the progress or activity in a case, if such activity is inconsistent with the requirements of the law." Id.)

2. In re S.T.N. Enterprises, Inc., 70 B.R. 823 (Bankr.D.Vermont, 1987)(J. Conrad) (good analysis of numerous categories of billing and expenses in chapter 11 cases.)

196

the Trustee be, and hereby are, directed to amend the Plan accordingly.

SO ORDERED.



IN RE: CHAMPAGNE SERVICES, LLC, Debtor.

Case No. 16-11683-RGM

United States Bankruptcy Court, E.D. Virginia, Alexandria Division.

Signed October 6, 2016

Background: Chapter 11 debtor filed application to employ counsel and his law firm. United States Trustee (UST) objected.

Holdings: The Bankruptcy Court, Robert G. Mayer, J., held that:

- (1) proposed counsel's employment application, to which the parties' retainer agreement should have been attached but was not, did not provide sufficient facts to enable a creditor or the UST to determine whether there was an actual conflict of interest, and
- (2) even if the employment application were complete, it would have been denied because the terms of the engagement were wholly unacceptable in this Chapter 11 case.

Application denied without prejudice.

1. Bankruptcy ⋘3160

In calculating a professional's fees, the minimum increment for which services are charged is one-tenth of an hour.

2. Bankruptcy \$\sim 3196\$

In calculating bankruptcy counsel's fees, dual rate structures, that is, separate

hourly rates for trial work and for out-ofcourt work, are not generally allowed.

3. Bankruptcy \$\sim 3177\$

There is no per se rule prohibiting debtor's counsel's fee being paid by or guaranteed by a third party; rather, the question is whether there is an actual conflict of interest. 11 U.S.C.A. § 327(a).

4. Attorney and Client \$\sim 21.5(6)\$

Employment application for proposed counsel of Chapter 11 debtor-limited liability company (LLC), to which the parties' retainer agreement should have been attached but was not, did not provide sufficient facts to enable a creditor or the United States Trustee (UST) to determine whether there was an actual conflict of interest, and so could not be approved; there was a wholesale failure to make full disclosure of the terms of the engagement as well as the connections between debtor's sole owner and debtor, the application should have disclosed the details of any past representation of debtor's sole owner by the law firm, and terms differing from customary terms were not set out, highlighted, or discussed in the application. 11 U.S.C.A. § 327(a).

5. Bankruptcy ≈3030

Burden is on proponent of proposed counsel's employment application to show that proposed counsel satisfies all requirements, including that he is disinterested; it is not the United States Trustee's (UST) burden to show that proposed counsel is not disinterested. 11 U.S.C.A. § 327(a).

6. Bankruptcy ≈3030

Even if employment application for proposed counsel of Chapter 11 debtorlimited liability company (LLC), to which the parties' retainer agreement had not been attached, had been complete, the bankruptcy court would have denied it because the terms of the engagement were

IN RE CHAMPAGNE SERVICES, LLC

Cite as 560 B.R. 196 (Bkrtcy.E.D.Va. 2016)

wholly unacceptable; quarter-hour billing increments and other minimum charges would not be honored, superpriority and liens on debtor's assets could not simply be set out in the retainer agreement but, rather, had to be specifically disclosed in the application and approved, proposed billing practices, pursuant to which monthly invoices would be e-mailed to debtor and counsel could withdraw without court approval if payment were not made within 10 days, were unacceptable, and, most egregiously, retainer agreement provided that neither debtor nor his sole owner would list proposed counsel's law firm as a creditor in any bankruptcy proceeding and that they would reaffirm any fee that might be discharged in bankruptcy. 11 U.S.C.A. § 327(a).

7. Bankruptcy \$\infty\$2966, 3030

In the context of bankruptcy counsel's fee application and retainer agreement, superpriority and liens on debtors' assets require specific approval; it is not appropriate or permissible for them to simply be set out in a retainer agreement and not specifically disclosed in the application.

8. Bankruptcy \$\infty\$3179

While informational billings to debtors by bankruptcy counsel are encouraged so that debtors are aware of the cost of the proceedings as they develop, counsel must be careful to advise the debtor with each draft billing invoice that it is a draft, that it is for informational purposes only, and that it is not to be paid except upon court order.

9. Bankruptcy \$\sim 3030\$

Any provisions for additional retainers need to be specifically set out in proposed bankruptcy counsel's employment application.

10. Bankruptcy \$\sim 3030\$

There is no automatic withdrawal of bankruptcy counsel when counsel has made an appearance in a court case; instead, withdrawal is only permitted by leave of court and for cause, which may include non-payment of fees.

197

11. Bankruptcy \$\sim 2324\$

In filing his bankruptcy schedules, debtor may not pick and choose which creditors to list; he may not knowingly omit creditors.

12. Bankruptcy ≈3030

One size does not fit all, with respect to bankruptcy counsel's retainer agreements; instead, counsel should draft bankruptcy-specific retainer agreements that reflect the requirements of the specific case sought to be filed and be complete enough to cover conversions from one chapter to another.

Whitney Lawrimore Hughes, Westlake Legal Group, Potomac Falls, VA, Thomas K. Plofchan, Jr., Westlake Legal Group, Sterling, VA, for Debtor.

MEMORANDUM OPINION

Robert G. Mayer, United States Bankruptcy Judge

This case was before the court on the debtor's application to employ counsel (Docket Entry 14), the United States trustee's responses and supplemental objection (Docket Entries 16, 25 and 42) and the debtor's response (Docket Entry 45). The application will be denied without prejudice.

The Employment Application and the Retainer Agreement

The debtor filed an application to employ counsel and his law firm. The Verified Statement signed by proposed counsel stated that there were no connections between proposed counsel and the creditors, parties in interest, their respective attorneys and accountants, or the United States trustee. However, he stated that the law firm had previously represented the debtor in various unrelated matters such as "defense of warrant in debt, demand letters and employment disputes." Verified Statement at ¶¶ 1-3. The United States trustee replied that the Verified Statement should "disclose the status of the prior litigation, dates when the representations occurred, and the amount of money paid" for the matters. In addition, the United States trustee asked that the retainer agreement be filed with the court. The debtor did not file any additional disclosures or the retainer agreement but provided the United States trustee with additional information about the prior engagements. At the conclusion of the hearing on the application, the court was satisfied that the prior representations did create actual conflicts of interest and announced that it would approve the employment application if the debtor filed the retainer agreement and the United States trustee had no further objections.

The debtor emailed a copy of the retainer agreement to the United States trustee but did not file it with the court. After reviewing the retainer agreement, the United States trustee filed additional objections and attached the 16-page retainer agreement as an exhibit. The United States trustee noted that Geoff Crawley, the debtor's sole owner, guaranteed proposed counsel's fees; that Mr. Crawley was a codebtor on various corporate debts; and that Mr. Crawley was paid \$167,088 within

one year prior to the filing of the petition in this case. The retainer agreement also contained two provisions of concern to the United State trustee. The United States trustee set them out in her objection:

- (D) "Client [Debtor] and Guarantor [Mr. Crawley] hereby irrevocably guarantee that the Client shall not declare the Firm as a creditor in any possible bankruptcy proceeding and that the obligation for payment of any fees shall be reaffirmed after any discharge in bankruptcy." ¶ 16, page 8, retainer agreement.
- (E) "Client and Guarantor hereby grant us a lien on any and all claims or causes of action that are subject to our representation under this Agreement. Our lien will be for any and all sums owing to us. The lien will attach to any recovery you may obtain, whether by arbitration award, judgment, settlement or otherwise." ¶ 17, page 8, retainer agreement. Retainer Agreement at ¶¶ 16-17.

The debtor, in response to the United States trustee's new objections, argued that the personal guarantee of the sole member of the debtor was not a *per se* conflict that disqualified counsel and that there was no actual conflict of interest. At the hearing on the objections, proposed counsel confirmed that Mr. Crawley was the sole member of the debtor limited liability company. *See also* Statement of Financial Affairs at ¶28.

The court raised additional concerns with the employment application and the retainer agreement. The employment application stated that the debtor paid an initial retainer to proposed counsel of \$2,000 "for legal services in this case and for the filing fee and other anticipated expenses." Application at ¶3. However, the retainer agreement stated that the debtor would pay a retainer of \$96.25. Retainer Agreement at ¶7. Proposed

IN RE CHAMPAGNE SERVICES, LLC Cite as 560 B.R. 196 (Bkrtcy,E.D.Va. 2016)

199

counsel's Rule 2014 Disclosure of Compensation of Attorney for Debtor stated that the agreed retainer was \$10,000 of which \$3,500 had been paid. The debtor's Statement of Financial Affairs stated that there were no payments made within the year preceding the filing of the petition related to bankruptcy. Statement of Financial Affairs at ¶ 11.1

There were other concerns with the retainer agreement. It proposed to pay counsel travel time on a "portal to portal" basis. While the court understands proposed counsel's concern, the established protocol in this court is to pay travel time at one-half counsel's hourly rate. There was no disclosure of the proposed departure from the protocol in the employment application.

[1, 2] The retainer agreement provided that services would be charged in minimum increments of one-quarter of an hour. There was no disclosure of this in the employment application. In this court, the minimum increment is one-tenth of an hour. In re Computer Learning Centers, Inc., 285 B.R. 191, 214 (Bank.E.D.Va. 2002). There are other minimum fees, such as one hour for any appearance outside the office; one-quarter hour for any telephone call; one-quarter hour for any email; and one-half an hour for any motion or order except an initial pleading for which there is a minimum of one hour. There are two hourly rates for counsel—one for out-ofcourt work and the other for trial work. Dual rate structures are not generally allowed. Id. at 217–18.

The retainer agreement required an additional trial deposit within one week after the debtor is notified of the amount if it

1. Paragraph 11 states:

List any payments of money or other transfers of property made by the debtor or person acting on behalf of the debtor within 1 year before the filing of this case to anoth-

appears that a matter will proceed to trial. "If the trial deposit is not made within ten (10) days from the date of notification, or at least ten (10) days before trial, you understand and agree that the Firm will withdraw as counsel of record." Retainer Agreement at \P 8.

The retainer agreement granted proposed counsel a lien. It also asserted an attorney's lien on "the cause of action for the fees incurred and owed by the Client to the Firm, against assets, marital property, spousal support and/or child support." *Id.* at ¶ 19. "If the Firm collects any funds on behalf of the Client, said funds will be used to pay the Client's current account balance with the Firm, if any. The remainder, if any, will be turned over to the Client." *Id.* at ¶ 20. There is a confession of judgment provision. *Id.* at ¶ 14.

The retainer agreement provided that proposed counsel would recover his attorney's fees in any collection matter, even if proposed counsel represents himself. The attorney's fees will not be less than 33% of all monies due to proposed counsel. *See Baker Botts LLP vs. ASARCO LLC*, — U.S. —, 135 S.Ct. 2158, 192 L.Ed.2d 208 (2015). Interest will be charged at the rate of 18% per annum. Retainer Agreement at ¶ 7.

Monthly invoices were to be emailed to the debtor and proposed counsel could withdraw from the case if payment is not made within 10 days of billing. Id. at ¶ 12. If a billing is not disputed in writing within thirty days after receipt, it "will be presumed to be correct and fair." Id. at ¶ 10.

The retainer agreement contains a fivepage bankruptcy addendum. It sets out the

er person or entity, including attorneys, that the debtor consulted about debt consolidation or restructuring, seeking bankruptcy relief, or filing a bankruptcy case. fees in chapter 7, 11 and 13 cases, the fee in a chapter 11 case being a retainer of \$3,500 against an hourly rate. Otherwise, it provides information about the documentation the debtor would need to provide, and the caution that "All assets and all liabilities are required to be completely and accurately disclosed." Addendum at 4.

The retainer agreement was signed by Mr. Crawley on May 5, 2016, and proposed counsel on May 12, 2016, the day the petition was filed.

The debtor's schedules reflect that Mr. Crawley is a codebtor on the largest debts and is likely a responsible party for substantial federal withholding taxes. The schedules list him as a codebtor on four debts. Schedule H. The debts are listed on Schedule E/F as unsecured claims, but on the Statement of Financial Affairs two are listed as secured. Statement of Financial Affairs at ¶3, "Certain Payments or Transfers to Creditors Within 90 Days Before Filing this Case."

Discussion

[3] There is no per se rule prohibiting debtor's counsel's fee being paid by or guaranteed by a third party. The question is whether there is an actual conflict of interest. Harold & Williams Dev. Co. United States Trustee (In re Harold & Williams Dev. Co.), 977 F.2d 906, 909–10 (4th Cir. 1992); In re Pinebrook, LLC, 441 B.R. 67 (Bankr.E.D.Va. 2009); In re Palumbo Family Ltd. P'ship, 182 B.R. 447 (Bankr.E.D.Va. 1995); In re Huntmar Beaumeade I Ltd. P'ship, 127 B.R. 363 (Bankr.E.D.Va. 1991). The rule was discussed in In re Johnson, 312 B.R. 810 (E.D.Va. 2004). The District Court stated:

Section 327 governs bankruptcy court approval of a trustee's employment of attorneys and other professionals. This provision is intended to ensure "that all professionals . . . tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary

responsibilities." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir.1994). And while the provision accords the bankruptcy court broad discretion in approving the employment of professionals, § 327(a) makes clear, as a general rule, that a trustee may employ, and the bankruptcy court may approve, the employment of an attorney or other professional person only if that individual or firm (i) does not hold or represent an interest adverse to the estate and (ii) is disinterested. 11 U.S.C. § 327(a); In re Harold & Williams Dev't. Co., 977 F.2d at 909. This is a stringent standard. Yet, § 327(c), which governs the employment of an attorney or professional who represents a creditor, creates a limited exception to this general rule. Pursuant to that provision, an attorney who represents a creditor is validly employed by the trustee provided that there is no "actual conflict of interest" between the attorney's representation of the creditor and his representation of the trustee. See 11 U.S.C. § 327(c); In re Interwest Bus. Equip., Inc., 23 F.3d 311, 316 (10th Cir.1994) ("[T]he bankruptcy judge can disqualify a professional solely on the basis of simultaneous representation, if it finds the joint representation creates an actual conflict.") (emphases in original). Thus, where a trustee employs a professional who represents a creditor, the stringent two-pronged test set forth in § 327(a) does not apply. Put differently, a trustee may employ a creditor's attorney under § 327(c) provided the dual representation presents no actual conflict of interest. And, this is so even if there exists a potential conflict of interest or an appearance of a conflict of interest that would otherwise disqualify the attorney from employment under § 327(a).

Id. at 818–20 (footnotes omitted).

[4, 5] The difficulty with this employment application is that it does not provide

IN RE CHAMPAGNE SERVICES, LLC Cite as 560 B.R. 196 (Bkrtcy,E.D.Va. 2016)

201

sufficient facts to enable a creditor or the United States trustee to determine whether there is an actual conflict of interest. The retainer agreement should have been filed with the employment application and the connections between Mr. Crawley and the debtor should have been disclosed and discussed. The application should have disclosed whether the law firm represented Mr. Crawley in the past or when the application was filed and the nature of the representation. The burden is on the proponent of the application to show that proposed counsel satisfies all requirements, including that he is disinterested. It is not the United States trustee's burden to show that he is not disinterested. Because the application for employment was incomplete and failed to show proposed counsel is disinterested, it will not be approved.

- [6] The employment application would be denied in any event because the terms of the engagement are wholly unacceptable in the chapter 11 case. The offending terms are not disclosed in the application and but for the diligence of the United States trustee would not have become known. The danger, of course, is that when counsel files his fee application, the application could easily be denied for failure to make full disclosure. Certainly counsel's expectations would not be met. The quarter-hour and other minimum charges, for example, would not be honored.
- [7] Other terms are clearly not acceptable. Superpriority and liens on debtors' assets require specific approval. It is not appropriate or permissible for them to simply be set out in a retainer agreement and not specifically disclosed in the application.
- [8, 9] The proposed billing practices are unacceptable. While informational billings to debtors are encouraged so that debtors are aware of the cost of the proceedings as they develop, counsel must be

careful to advise the debtor with each draft billing invoice that it is a draft, that it is for informational purposes only, and that it is not to be paid except upon court order. The provisions for additional retainers need to be specifically set out in the employment application.

- [10] There is no automatic withdrawal of counsel when counsel has made an appearance in a court case. Withdrawal is only permitted by leave of court and for cause. While non-payment may be cause, the retainer agreement gives the false impression that counsel may withdraw without any other action, such as court approval. As drafted, the retainer agreement may mislead clients and may induce them to take actions that may be inappropriate.
- [11] The most egregious portion of the retainer agreement is paragraph 16. It provides that neither the client nor Mr. Crawley will list the law firm as a creditor in any bankruptcy proceeding and that they will reaffirm any fee that it has that may be discharged in bankruptcy. Counsel knows better. In fact, his bankruptcy addendum to the retainer agreement states that "[a]ll ... liabilities are required to be completely and accurately disclosed in the documents filed." Addendum at 4. All bankruptcy schedules are filed under oath. A debtor may not pick and choose which creditors to list. He may not knowingly omit creditors. Advising otherwise puts the client at risk. Even if counsel is aware that such a provision is void and unenforceable, it is misleading to clients and may harm them. If they comply with the terms of the retainer agreement they run the risk of being denied a discharge for having filed false schedules. And, it will look fairly strange, if counsel submitted a reaffirmation agreement for his fees which were not scheduled by the debtor. This provision is

560 BANKRUPTCY REPORTER

always wrong. It should not appear in any retainer agreement, whether for bankruptcy or non-bankruptcy employment.

[12] There are two basic problems in this case. First, counsel has one retainer agreement that is intended, with an addendum, to fit every case. One size does not fit all. He should abandon that notion and draft bankruptcy-specific retainer agreements. The retainer agreements should reflect the requirements of the specific case sought to be filed and be complete enough to cover conversions from one chapter to another. Second, there was a wholesale failure to make full disclosure of connections and the terms of the engagement. The retainer agreement was not attached to the employment application and terms differing from customary terms were not set out, highlighted or discussed in the application.

Conclusion

The application for employment will be denied without prejudice. The debtor, if it wishes to continue with proposed counsel, will have the opportunity to file a proper employment application. Counsel, however, should be aware that this application has been denied because counsel failed to prepare a proper employment application, to make full disclosure and to have a retainer agreement with reasonable terms. While the court is generally liberal in allowing employment applications to be effective as of the petition date, counsel should not rely on that in this instance. A new employment application should be filed immediately.



In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

298 B.R. 703 United States Bankruptcy Court, D. Montana.

In re JORE CORPORATION, a.k.a. JB Tool, LLC, a.k.a. Jore, Inc., Debtor.

No. 01–31609–7. | July 28, 2003.

United States Trustee moved for entry of order disqualifying law firm from employment as counsel to Chapter 11 debtor, vacating employment order, and disallowing and requiring disgorgement of compensation paid. The Bankruptcy Court, Ralph B. Kirscher, J., held that: (1) law firm that was allowed to represent Chapter 11 debtor-in-possession (DIP), on representation that it had investigated potential conflicts of interest, had obtained or was in process of obtaining necessary waivers, and would continue to monitor conflicts and notify court of any problems, was under obligation to disclose limitation on DIP lender's waiver of conflict of interest, pursuant to which lender refused to consent to law firm's representation of debtor in any "litigation directly adverse" to lender; (2) violation by law firm of its disclosure obligations, in failing to disclose limitation on DIP lender's waiver of conflict of interest, was not mere de minimis failure, and warranted entry of order requiring disgorgement of fees; but (3) court would allow firm to be reimbursed for expenses that it incurred in complying with bankruptcy court's case management order.

Motion granted, except as to disgorgement of sums relating to case management order.

West Headnotes (18)

[1] Bankruptcy

Attorneys

Bankruptcy

Disclosure requirements

Application for attorney's employment must disclose, among other things, "all of [attorney's] connections with the debtor, creditors, [or] any other party in interest,"

to assist court in ensuring that attorney has no conflicts of interest and is disinterested. Bankr.Code, 11 U.S.C.A. § 327(a); Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[2] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy

Professional Persons in General

Federal Rule of Bankruptcy Procedure specifying the disclosure obligations of party filing application with bankruptcy court for leave to employ professional is to be read broadly. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[3] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy

Professional Persons in General

Bankruptcy

Disclosure requirements

Disclosure rules for bankruptcy professionals are to be applied literally, even if the results are sometimes harsh. Fed.Rules Bankr.Proc.Rule 2014, 11 U.S.C.A.

Cases that cite this headnote

[4] Bankruptcy

Attorneys

Bankruptcy

Disclosure requirements

Disclosure requirements for bankruptcy professionals are to be applied strictly, and do not give attorney the right to withhold information regarding actual or potential conflict simply because it is not apparent to attorney that conflict exists. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Cases that cite this headnote

[5] Bankruptcy

Attorneys

Bankruptcy

Disclosure requirements

All facts that may be pertinent to court's determination of whether attorney is disinterested or holds any interest adverse to estate must be disclosed in application for leave to employ attorney. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[6] Bankruptcy

Disclosure requirements

Negligent or inadvertent nature of attorney's omission will not vitiate attorney's violation of disclosure obligations under the Bankruptcy Rules. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[7] Bankruptcy

Disclosure requirements

Law firm that was allowed to represent Chapter 11 debtor-in-possession (DIP), on representation that it had investigated potential conflicts of interest, had obtained or was in process of obtaining necessary waivers, and would continue to monitor conflicts and notify court of any problems, was under obligation to disclose limitation on DIP lender's waiver of conflict of interest, pursuant to which lender refused to consent to law firm's representation of debtor in any "litigation directly adverse" to lender; by breaching this duty, firm violated disclosure requirements of Bankruptcy Rule, notwithstanding that debtor had waived all claims against DIP lender, that law firm provided valuable services to estate, and that law firm, when DIP lender refused to consent to its prosecution of matter against lender, had referred matter to another attorney. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

1 Cases that cite this headnote

[8] Bankruptcy

Disclosure requirements

In attempting to comply with his/her disclosure obligations under the Bankruptcy Rules, it is not for attorney to pick and choose which connections need not be disclosed, as being unimportant or trivial. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

1 Cases that cite this headnote

[9] Bankruptcy

Disclosure requirements

To comply with their disclosure obligations under the Bankruptcy Rules, it was not enough that Chapter 11 debtor's attorneys' disclose to Chapter 11 debtor-in-possession (DIP) a limitation upon DIP lender's waiver of conflict of interest; disclosure had to be made to court, not just to debtor. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[10] Bankruptcy

Frivolity or bad faith; sanctions

Violation of professional's disclosure obligations under the Bankruptcy Rules may result in sanctions, regardless of whether there is actual harm to estate. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[11] Bankruptcy

Disclosure requirements

Bankruptcy court has broad discretion in determining whether to deny or award fees when debtor's attorney has violated disclosure obligations under the Bankruptcy Rules. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Cases that cite this headnote

[12] Bankruptcy

Disclosure requirements

It is within bankruptcy court's discretion to deny all fees to debtor's attorney, based on attorney's violation of obligation to disclose all of his/her connections with parties in interest, notwithstanding the negligent or inadvertent nature of nondisclosure. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[13] Bankruptcy

Disclosure requirements

Violation by Chapter 11 debtor-inpossession's (DIP's) attorneys of their disclosure obligations under Bankruptcy Rule, in failing to disclose limitation on DIP lender's waiver of conflict of interest pursuant to which lender refused to consent to law firm's representation of debtor in any "litigation directly adverse" to lender, was not mere de minimis failure, but involved conflict of interest with largest creditor in case, on whose continued financing debtor depended for its existence as going concern, and was such as to warrant disgorgement of fees, notwithstanding that debtor had waived all claims against DIP lender, that law firm provided valuable services to estate, and that law firm, when DIP lender refused to consent to its prosecution of matter against lender, had referred matter to another attorney, where attorneys were experienced bankruptcy counsel who should have been familiar with disclosure obligations, and where attorneys continued with their nondisclosures until after debtor's assets were sold, despite numerous representations that they were continuing to monitor for conflicts. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

1 Cases that cite this headnote

[14] Bankruptcy

Disclosure requirements

Debtor's attorney must disclose conflicts of interest, and it is not for court, for United States Trustee, or for anyone else to search the file for conflicts of interest. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

Cases that cite this headnote

[15] Statutes

Language

Courts must presume that legislature says in statute what it means and means in statute what it says there.

3 Cases that cite this headnote

[16] Bankruptcy

Evidence; witnesses

Determination of weight to be given to expert testimony or evidence is matter within discretion of trier of fact.

2 Cases that cite this headnote

[17] Bankruptcy

Disclosure requirements

Bankruptcy court, and not expert, is to decide whether debtor's attorney has complied with legal requirements for disclosure of connections under Bankruptcy Rule. Fed.Rules Bankr.Proc.Rule 2014(a), 11 U.S.C.A.

1 Cases that cite this headnote

[18] Bankruptcy

Disclosure requirements

To ameliorate hardship of disgorgement order entered against Chapter 11 debtor's attorneys, based on their nondisclosure of actual conflict of interest, bankruptcy court would allow attorneys to be reimbursed for expenses that they incurred in complying with bankruptcy court's case management order.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Cases that cite this headnote

Attorneys and Law Firms

*705 James A. Bowditch, Boone Karlberg PC, Harold V. Dye, Missoula, MT, Bruce G. MacIntyre, Seattle, WA, for debtor.

*706 Scott H. Clark, Ray, Quinney & Nebeker, Salt Lake City, UT, Kimberly Dynowicz, Haverhill, MA, William Arthur Graham, Graham Law Firm, P.C., Gregory G. Schultz, Petit & Schultz, PLLP, Jon O. Shields, Missoula, MT, Soffer & Rech, New York City, Ward E. Taleff, Great Falls, MT, for creditors.

William L. Courshon, Office of the U.S. Trustee, U.S. Trustee's Office, Seattle, WA, for U.S. Trustee.

Allen J. Guon, Shaw, Gussis, Fishman, Glantz, Wolfson & Tow, Chicago, IL, Joel E. Guthals, Billings, MT, for trustee.

Daniel P. McKay, Office of the U.S. Trustee, U.S. Trustee's Office, Great Falls, MT, for U.S. Trustee.

MEMORANDUM OF DECISION

RALPH B. KIRSCHER, Bankruptcy Judge.

In this Chapter 7 case, which was converted from Chapter 11 upon the Debtor's motion by Order entered September 4, 2002, after due notice a hearing was held at Missoula on May 8-9, 2003, on the U.S. Trustee's "Motion to Disgualify Perkins Coie, Vacate Employment Order, and Disgorge and Disallow Fees" (hereinafter the "U.S. Trustee's Motion"). Perkins Coie LLP ("Perkins"), attorneys for the Debtor, filed an objection and was represented at the hearing in opposition by attorney Theodore Collins ("Collins"). The United States Trustee Diane E. Tebelius ("Tebelius") appeared in support of the U.S. Trustee's Motion, along with attorneys William L. Courshon ("Courshon") and Daniel P. McKay ("McKay"). Testimony of witnesses was heard and exhibits were admitted, and at the conclusion of the hearing the Court granted the parties time to file briefs, after which this matter would be deemed under advisement. Perkins filed its post-hearing brief on July

1, 2003, which has been reviewed by the Court together with the U.S. Trustee's post-hearing brief and the record. This matter is ready for decision. For the reasons set forth below, the U.S. Trustee's Motion will be granted by separate Order and Judgment, Perkins will be disqualified from its employment by the Debtor and the Order authorizing the Debtor to employ Perkins as its attorney will be vacated, and Perkins will be ordered to disgorge all compensation, fees and costs received from the Debtor during the course of this proceeding under Title 11, U.S.C., except as hereinafter provided for approved costs and expenses incurred in complying with the Case Management Order issued by this Court.

This Court has original and exclusive jurisdiction of this bankruptcy case pursuant to 28 U.S.C. § 1334(a). The U.S. Trustee's Motion is a core proceeding under 28 U.S.C. § 157(b)(2) involving Perkins Coie's employment and applications for professional compensation from the estate as an administrative expense. This memorandum includes the Court's findings of fact and conclusions of law under F.R.B.P. 7052 and 9014.

TRIAL PROCEEDINGS

Perkins Coie attorney Bruce G. MacIntyre ("MacIntyre") and Alan D. Smith ("Smith") testified, as did attorney Peter Richard Jarvis ("Jarvis"), who the parties stipulated is an expert in attorney professional responsibility. Attorneys Joel P. Guthals ("Guthals"), Harold V. Dye ("Dye"), and Jerome Shulkin ("Shulkin") each testified as experts on bankruptcy law and the practice in this Court for disclosure of conflicts of interest under F.R.B.P.2014(a). Attorney Bruce Fain ("Fain") testified as a fact witness, as did Debtor's controller Kelly Grove ("Grove"), and Debtor's consultant and turnaround *707 specialist Clyde Hamstreet ("Hamstreet"). Exhibits ("Ex.") 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16 (also designated "revised Ex. C" to Jarvis's declaration), 17, 18, 19, 20, 21 were admitted into evidence. Also admitted were the transcript of the deposition of expert David Boerner ("Boerner")—Ex. B; an Affidavit ("Aff.") of Gerald McConnell ("McConnell")-Ex. C, and a Rule 2004 examination transcript of McConnell-Ex. D. The Court took judicial notice of Guthals' affidavit (Ex. C attached to docket # 1202). At the close of Perkins Coie's case in chief the Court closed the record, granted the U.S.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Trustee 15 days to file its brief, and granted Perkins Coie 15 days thereafter to file its brief.

FACTS

This case commenced on May 22, 2001, when Jore Corporation (hereinafter "Jore" or "Debtor") filed its Chapter 11 petition. Jore was in the business of manufacturing and selling power tool drill bits and accessories to retailers. Grove testified that Jore had missed its sales plan for the year 2000 by a significant amount, and in 2001 faced a significant shortfall in cash. Transcript ("Tr.") Grove, pp. 4-5. Jore's loans from Wells Fargo were turned over to the workout group, and Jore attempted to restructure its financing with Wells Fargo's asset-based lender. However, an appraisal of Jore's assets came back much lower than anticipated, and Jore's auditor required a writedown for overvalued inventory of more than \$5 million. Tr. Grove, p. 7; Tr. Hamstreet, pp. 9-10; Ex. C, McConnell Aff., p. 7. Jore had no free and clear assets. Tr. Grove, p. 9.

Turnaround professionals were brought in at Wells Fargo's urging, but Jore was unable to avoid bankruptcy. Tr. Grove, p. 20; Ex. D, McConnell, pp. 71–72. Hamstreet was hired by Jore's board of directors before the bankruptcy to oversee the bankruptcy and restructuring, and find a buyer. Tr. Hamstreet, pp. 6-7. He testified that his first conversation with Wells Fargo after being hired involved the risk of missing payroll or bouncing checks, and that Wells Fargo was hesitant to loan Jore any more money. Tr. Hamstreet, pp. 8-9. McConnell was also hired a few weeks before the bankruptcy. Tr. Hamstreet, p. 12. Hamstreet testified that he knew right after being hired that Jore needed to file bankruptcy and restructure. Tr. Hamstreet, p. 11. However, the board of directors, including Matt Jore and Mike Jore, were insistent that they would not file bankruptcy or talk to the banks about bankruptcy and that if Hamstreet tried to bring up bankruptcy he would be fired. Tr. Hamstreet, pp. 11-12. This hesitancy resulted in what Hamstreet testified was a lost opportunity ¹. Tr. Hamstreet, p. 12.

I. Perkins' Employment.

Perkins was selected as Jore's bankruptcy counsel by Jore's in-house counsel Dave Bjornson, with Hamstreet's recommendation. Tr. Hamstreet, pp. 18–19; Ex. D, *708

McConnell, pp. 124–25; Tr. Smith, p. 6. Smith testified that before agreeing to represent Jore, Perkins conducted a conflicts check, and he recognized immediately that Perkins would need a waiver of conflicts from its client Wells Fargo. Tr. Smith, p. 16–17. The Perkins attorney who manages conflicts waivers is Boerner's former student. Ex. B, Boerner Dep., p. 96. MacIntyre became involved in early May of 2001, in early discussions with Wells Fargo. Tr. MacIntyre, p. 8. He made sure the conflicts check was run. Tr. MacIntyre, p. 18.

The Chapter 11 petition was filed on May 22, 2001. The bankruptcy case, as described by Perkins, was "demanding, contentious, and complicated". Perkins' Brief, p. 5; Tr. Smith, p. 34. MacIntyre testified that "from the outset it was clear" that unsecured creditors would not get anything, and that most of the secured debt would not be paid. Tr. MacIntyre, p. 74.

Perkins submitted an affidavit of MacIntyre in support of its application for employment as Debtor's bankruptcy counsel on May 22, 2001. Ex. 18. Ex. 18 identifies MacIntyre and Smith as Perkins' attorneys primarily responsible for representing the Debtor. MacIntyre states on Ex. 18: "I have undertaken an investigation of any connections that may exist between Perkins Coie and the Debtor, the creditors of the Debtor or any other party in interest To the best of my knowledge, I and Perkins Coie have no such connections and are 'disinterested persons' as defined in 11 U.S.C. § 101(14), except as stated in this Affidavit." Ex. 18, p. 2. Ex. 18 lists 19 creditors which were current clients of Perkins on unrelated matters, and 17 creditors which were former clients². Ex. 18 then states: "Perkins Coie currently represents Wells Fargo Bank, the parent corporation of First Security Bank N.A., Debtor's primary pre-petition lender and one of the proposed DIP lender[s] herein. All of Perkins Coie's past and present representation of Wells Fargo have been in matters unrelated to this Debtor." MacIntyre testified that he knew at that early stage, before the Chapter 11 case was filed, that "Wells Fargo was the company's primary prepetition lender", the only potential DIP lender, and that Wells Fargo would play a significant role in the case. Tr. MacIntyre, pp. 21, 42.

Ex. 18 states at page 4, subpart 2(f): "This Declaration includes all issues and parties in interest that I have identified at the present time. *Perkins Coie continues to review its connections* with shareholders, creditors,

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

potential creditors and other parties in interest in this Chapter 11 case. *Perkins Coie will notify the Court if any actual conflicts of interest or other significant connections are discovered in this process.*" (Emphasis added).

Addressing what it admits in its brief was a "significant potential for a conflict with one or more past or present clients", MacIntyre describes a "fallback" arrangement in Ex. 18, p. 4, paragraph 3:

The Debtor has agreed that in the event Perkins Coie has an actual unwaived conflict of interest with any party adverse to the Debtor herein, Perkins Coie will not represent either the Debtor or the adverse party for such matters. If an actual conflict of interest arises herein, Debtor will (i) request Perkins to obtain the necessary and appropriate waivers; (ii) apply to employ special counsel to the Debtor if required by the nature of such matters; or (iii) use *709 Jore's local counsel, Harold V. Dye or Jore's in-house counsel, David Bjornson, to represent Debtor in those matters.

McConnell testified that he was taught to make arrangements to handle unwaived conflicts in the above manner. Tr. MacIntyre, p. 22. He testified that Perkins and the Debtor agreed to this fallback plan in the event of unwaived conflicts, and he interpreted the Court and parties to have approved of the fallback plan since no one objected. Tr. MacIntyre, p. 56.

On June 4, 2001, Smith ³ wrote a letter to Scott L. Manookin ("Manookin"), Wells Fargo's vice president, regarding "Simultaneous Representation of Wells Fargo Bank and Jore Corporation". Ex. 1. In Ex. 1 Smith confirms that Perkins "has received the informed consent of Wells Fargo Bank ("Wells") to undertake the representation of Jore Corporation ("Jore") on a matter in which the interests of Jore and Wells are adverse, while continuing our representation of Wells on unrelated matters." Smith admits that "[c]ertain aspects of the Chapter 11 bankruptcy proceedings are adverse to Wells, including without limitation real estate, employment, litigation and unrelated bankruptcy matters" Smith

then discusses the rules of professional responsibility and conflicts of interest and the conditions required for Perkins to represent Jore on matters adverse to Wells Fargo, while representing Wells Fargo in separate, unrelated matters. Smith asks for Wells Fargo's consent, after stating:

"We have agreed that we will not represent Jore in litigation directly adverse to Wells, or in any matter involving the assertion against Wells of a claim of fraud, misrepresentation, or other dishonest conduct, and are confirming that understanding with Jore in writing.

Please confirm that Wells consents to the foregoing on an informed basis after full disclosure and with the recognition that the Firm's representation of Jore on a matter adverse to Wells, and simultaneous representation of Wells on an unrelated matter creates a conflict of interest."

Ex. 1 (emphasis added). Manookin signed Ex. 1 for Wells Fargo⁴, consenting to Perkins' representation of Jore, but the parties later disagreed on what it meant. Smith testified that the above language was drafted by Perkins' conflicts department, and included the "no litigation" language that had been used with other standard conflicts waivers with Wells Fargo. Tr. Smith, pp. 20-21, 31, 78. Smith testified that he was almost positive that no discussion or negotiations occurred between Perkins' conflicts department and Wells Fargo about the meaning of the no litigation language in Ex. 1. Tr. Smith, p. 78. MacIntyre testified that no litigation clauses in waivers come from more sophisticated parties such as banks and lenders. Tr. MacIntyre, p. 26. He did not see the limitations on Wells Fargo's waiver as significant to his representation of Jore, and did not recall even focusing on that language because he had come to expect it as a standard part of a waiver letter, and because Jore had waived its claims and defenses against Wells Fargo and Perkins had reviewed Wells Fargo's security interests and concluded they were perfected. Tr. MacIntyre, pp. 28-29.

*710 Smith testified that in bankruptcy "there's a lot of things that go on that are adverse but aren't, you know, litigation within the meaning of something like this." Tr. Smith, pp. 20–21, 92. He testified that he acknowledged that there was a grey area, but that neither side interpreted "litigation" as encompassing everything

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

adverse in front of a judge because then a waiver would be totally meaningless in a bankruptcy case. Tr. Smith, pp. 32, 80. Smith felt that the no litigation exception to Wells Fargo's conflicts waiver would not encompass the scope and meaning of the DIP financing order or cash collateral, because Perkins had represented the client in those negotiations and should be able to continue its representation to resolve disputes involving those matters. Tr. Smith, pp. 32, 96–97. MacIntyre testified that the nature of Wells Fargo's waiver, with the no litigation exception, did not change his conduct of the case in any way: "It never even crossed my mind. No one ever raised it to me. There was just never a thought that that would impact in any way the manner in which we conducted the case." Tr. MacIntyre, p. 43.

Smith sent letters similar to Ex. 1 dated June 4, 2001, to Jore's president and CEO McConnell (Ex. 10), and to General Electric Capital Corporation ("GECC") (Ex. 9) addressing the conflicts of interest which Smith stated were created by Perkins' representation of Jore and other clients. Ex. 9 differs from Ex. 1, in that in Ex. 9 Perkins does not agree that it will not represent Jore in litigation directly adverse to GECC, as Perkins agreed in Ex. 1. Rather, Perkins agrees in Ex. 9 that it "may not undertake any representation involving the assertion against GECC of a claim of fraud, misrepresentation, or other dishonest conduct." ⁵

In Ex. 10 Smith explains to McConnell Perkins' representation of Wells Fargo and GECC while representing Jore on matters adverse to those clients. Smith explains that Perkins "may not undertake any representation involving the assertion against either [Wells Fargo & GECC] of a claim of fraud, misrepresentation, or other dishonest conduct, or any representation in litigation directly adverse to Wells." Ex. 10. Smith asks Jore to recognize that Perkins' representation of Jore in matters adverse to Wells Fargo and GECC "creates a conflict of interest", and to consent to Perkins' representation. Ex. 10 states: "Wells' consent does not extend to Perkins Coie's representation of Jore in litigation directly adverse to Wells." McConnell signed Ex. 10 and consented ⁷. Ex. C, McConnell Aff., p. 5.

After Smith sent Manookin Ex. 1 dated June 4, 2001, MacIntyre filed a "Supplemental Declaration" on June 6, 2001, Ex. 19, in support of Perkins'

employment application, reaffirming and supplementing Ex. 18. MacIntyre in Ex. 19 describes Perkins' "ongoing investigation of any connections" with the Debtor, creditors and other parties, lists several more current or former clients which are creditors of Jore, and lists other connections between Perkins and Jore and its insiders. Ex. 19 *711 names 21 additional current clients of Perkins, on unrelated matters, which were creditors of the Debtor, and 32 former clients 8. At paragraph 2(b), MacIntyre discusses Perkins' past and present representation of Wells Fargo in matters unrelated to the Debtor, and states that due to Wells Fargo's role as primary pre-petition lender and proposed DIP lender, "Perkins Coie has received oral waivers from both Wells Fargo and Jore, and is in the process of obtaining written waivers from both parties." Ex. 19, p. 2; Tr. Smith, p. 103. At page 5, paragraph 6 of Ex. 19 MacIntyre states, in identical language to Ex. 18, paragraph 2(f), that "Perkins Coie continues to review its connections with shareholders, creditors, potential creditors and other parties in interest in this Chapter 11 case. Perkins Coie will notify the Court if any actual conflicts of interest or other significant connections are discovered in this process." (Emphasis added). MacIntyre concludes Ex. 19 by stating that nothing disclosed therein should disqualify Perkins from vigorous and unfettered representation of the Debtor's interests, and that the Debtor agrees that in the event Perkins Coie has an actual unwaived conflict of interest with any party adverse to the Debtor or if an actual conflict of interest arises, Perkins will obtain waivers or the matter would be handled by inhouse or local counsel. Ex. 19, page 5, paragraph 7.

Ex. 19 is dated after Ex. 1, but MacIntyre did not file anything with the Court disclosing the no litigation exception to Wells Fargo's conflicts waiver of Ex. 1, either in Ex. 19 or afterward. Tr. MacIntyre, pp. 55, 57. MacIntyre testified that the issue of whether to disclose the nature of Wells Fargo's waiver was never raised, never considered, and never decided, so there was no conscious decision to not disclose the no litigation limitation of Wells Fargo's conflicts waiver. Tr. MacIntyre, pp. 58–59. MacIntyre did disclose in Ex. 19 that a Perkins employee is a cousin of two of the Debtor's insiders; that another Perkins employee at one time traded in Jore's stock; and that MacIntyre's cousin Chuck works for the Clerk of the U.S. District Court for the District of Montana in Butte. Ex. 19, p. 4; Tr. MacIntyre, p. 58.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Under direct examination by Perkins' trial counsel about the no litigation exception, Smith testified, "I honestly don't remember thinking about it in order to think whether it should or should not be disclosed because it did not-it just didn't appear to me to be an important issue at the time. We just—we didn't have those claims, we couldn't prosecute them if we had them under the DIP order, and it just wasn't something that even struck me as —I don't even remember thinking about it." Tr. Smith, pp. 27–28. Under cross examination, Smith repeated his 2004 examination answer that the only way the Court or the U.S. Trustee would know that Wells Fargo's conflicts waiver was anything less than full or total was: "I'm not sure how anyone would do that other than asking us." Tr. Smith, p. 82⁹. Smith testified regarding Perkins' obligations to disclose connections with creditors: "I'm not sure that existence or non-existence of a letter is a connection in terms of a separate *712 connection that has to be disclosed, other than—the new relationship certainly is a connection that has to be disclosed. I certainly don't dispute that, and that was disclosed. I'm not sure that every letter or every other aspect is a separate connection that then has to be disclosed." Tr. Smith, p. 104. Perkins did not disclose the waiver of conflicts by GECC. Tr. Smith, p. 105; Tr. MacIntyre, p. 55. In fact, Smith testified he was not aware that Perkins ever received the waiver of conflicts from GECC in response to Ex. 9. Tr. Smith, pp. 25–26.

After a hearing, the Court granted final approval of Perkins' employment by the Debtor by Order entered June 28, 2001 ¹⁰. Perkins' employment application filed May 22, 2001, provides at page 6, paragraph 7(f) that the Debtor proposes to pay Perkins Coie monthly eighty percent (80%) of its monthly fees incurred, plus 100% of its disbursements and expenses, with the remaining 20% paid upon the Court's final approval of its application for compensation.

MacIntyre filed a further Supplemental Declaration in support of Perkins' employment application on August 15, 2001, Ex. 20. Ex. 20 reaffirms and supplements Ex. 18 and 19, revealing as a result of its "ongoing monitoring of any connections that may exist between Perkins Coie and the Debtors, the creditors ... an additional connection" in the form of a client and potential purchaser ¹¹ of substantially all of the Debtor's assets. Paragraph 5 of Ex. 20 states, similarly to Ex. 19 and 20:

This Declaration discloses all additional issues and potential conflicts of interest that have been identified at the present time. Perkins Coie continues to review and monitor its connections with shareholders, creditors, potential creditors and other parties in interest in this Chapter 11 case. Perkins Coie will notify the Court if any actual conflicts of interest or other significant connections are discovered in this process.

Actual conflicts arose between Wells Fargo and Perkins, but Perkins failed to disclose them. MacIntyre testified that Ex. 1 was not brought to the Court's attention until the issue came up in a Status Report. Tr. MacIntyre, p. 57.

II. DIP Financing & Use of Cash Collateral.

Even before the case commenced Jore's professionals recognized its need for debtor-in-possession ("DIP") financing. Tr. Hamstreet, pp. 10-11; Tr. Smith, p. 10; Tr. MacIntyre, pp. 8-9. Hamstreet and MacIntyre negotiated for DIP financing with Wells Fargo and its co-lender Harris Trust and Savings Bank ("Harris"). Tr. Hamstreet, pp. 12-13; Tr. MacIntyre, pp. 10-11. Jore needed DIP financing in order to acquire materials to manufacture inventory for sale during its peak season, in order to demonstrate to its suppliers and customers that it had adequate financing to operate and preserve the company for sale to a buyer. Tr. Hamstreet, pp. 14–15; Tr. Smith, p. 15. Hamstreet recognized that there was not enough equity to reorganize the company, and that "the only salvation for Jore was to find a buyer". Tr. Hamstreet, p. 14. McConnell, MacIntyre and Smith each testified that without a DIP financing order, Jore would not have stayed in business. Ex. D, Tr. McConnell, p. 67; Tr. MacIntyre, p. 17; Tr. Smith, p. 12. Interim post-petition financing and limited use of cash collateral *713 was authorized by the Court effective on the petition date, and it continued until a final hearing.

On May 24, 2001, Jore and Wells Fargo, for itself and Harris, filed a 31-page (excluding exhibits) stipulation providing for interim DIP financing, signed by MacIntyre for the Debtor and by attorney Gregory G. Schultz for Wells Fargo and Harris. That stipulation provided for, among other things, interim postpetition financing and use of cash collateral by the Debtor, and for senior liens and priority administrative expenses in favor of Wells Fargo with an exception for a "professional fee carve-out" ("carve-out") for professionals of the Debtor, trustee

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

or official, committee not to exceed a total of \$585,000. In addition, the stipulation provides for the Debtor's waiver of any surcharge claims against the lenders under 11 U.S.C. § 506(c), and in addition the Debtor waived any defenses, claims or counterclaims against the claims of the lenders. Tr. Smith, pp. 101–02; Tr. MacIntyre, pp. 14– 15, 17; Ex. C, McConnell Aff., p. 9. Hamstreet testified that he had never seen a DIP financing loan in which a lender did not require a debtor's waiver of claims against the bank "to clean the slate" ¹². Tr. Hamstreet, pp. 13–14. Smith testified that such a waiver of claims against a DIP lender is "more than standard". Tr. Smith, p. 12. Fain, who represented equipment lenders ¹³ and had objected, testified that he and his clients "felt like, essentially, the store had been given away to the lender". Tr. Fain, pp. 5, 23. Notwithstanding the Debtor's waiver of claims against Wells Fargo, the unsecured creditors' committee would have the right to examine such claims. Tr. Smith, p. 13; Tr. MacIntyre, pp. 14–15.

After a hearing held on June 28, 2001, the Court entered a Final DIP Financing Order on June 29, 2001. The Final DIP Financing Order includes Debtor's waiver of claims against Wells Fargo and Harris, and the carve-out provision for professional fees from the DIP financing stipulation. The DIP Order also required the Debtor to propose a Plan to which Wells Fargo would not object. Tr. Smith, pp. 39–40, 42. Armed with the Final DIP Financing Order, Jore proceeded to attempt to find a buyer for its assets.

On July 5, 2001, the Court entered a "Case Management Order" because of the number of creditors and to minimize the expense and delay. The Case Management Order made the moving party responsible for providing notice and service of any hearing and motion to all parties listed on the special mailing matrix. It also made Debtor's counsel Perkins responsible for serving orders entered by the Court, and for processing and maintaining claims and interests registers, thereby relieving the Clerk of Court of a large part of the burden and expense incurred in this case.

Perkins filed its First Interim Application for fees and costs on November 21, 2001, requesting interim fees in the amount of \$780,423,45 and costs in the amount of \$103,023.12. Perkins' Brief states that it has applied for reimbursement of \$215,765.77 in expenses and has received \$161,571.82, but no evidence exists *714 in the record showing how much of those expenses were incurred

by Perkins in complying with the Case Management Order. Neither is there any way for the Court to reliably estimate that proportion of expenses from the total expenses included in Perkins' three fee applications.

III. Proceedings Through Sale of Debtor's Assets.

Notwithstanding the Final DIP Financing Order, the Debtor and Wells Fargo continued difficult negotiations regarding the banks' treatment in a sale of the business. Hamstreet testified that one of his meetings with the banks was one of the most unpleasant meetings he ever had with a bank. Tr. Hamstreet, pp. 16–18. MacIntyre testified that the case "had a lot of shifting alliances throughout the case." Tr. MacIntyre, p. 32. McConnell testified that Harris would routinely renege on commitments made by Wells Fargo with respect to the DIP Financing Order, its interpretation and extension. Ex. D, McConnell, pp. 63–65; Tr. MacIntyre, p. 33. The situation became progressively worse, and the conflict between Wells Fargo and Perkins erupted in court in December of 2001.

The proposed sale to a "financial buyer" ¹⁴ identified as "NCA" had fallen through when NCA withdrew its offer. Tr. Smith p. 74; Tr. MacIntyre, p. 32. A "strategic buyer", Pentair, Inc. ("Pentair"), expressed some interest, but ultimately withdrew its first offer in February of 2002 ¹⁵.

On December 19, 2001, the Court heard on shortened notice the Debtor's motion to extend and amend the terms of the Final DIP Financing Order, and Debtor's alternative emergency motion for use of Wells Fargo's cash collateral. Smith testified that the hearing was quite contentious, and that the Debtor's use of cash collateral was "absolutely critical to the case going forward." Tr. Smith, p. 93. This Court noted in its Order entered December 21, 2001, that counsel for Wells Fargo appeared at the hearing and "strongly opposed" Debtor's request for use of cash collateral, complaining of a flawed business model and \$3 million in various professional fees incurred by the Debtor. Despite Perkins' agreement in Ex. 1 that it would not represent Jore in litigation directly adverse to Wells, MacIntyre appeared at the contested hearing representing Jore. Wells Fargo did not raise the issue of the "no litigation" exception to its conflicts waiver at the time, but was under no obligation to raise it although it had the right. Tr. Smith, pp. 93-94, 95-96, 98-99; Ex. B, Boerner, p. 65.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

The Court granted Jore's emergency motion for use of cash collateral, finding that the DIP Finance Order expired on December 28, 2001, and that if not extended Jore would be forced to immediately cease operations. The Court authorized Jore to use cash collateral through January 12, 2002.

Wells Fargo appealed and filed a motion to modify stay, as did other creditors. The motions to modify stay were settled, and on January 31, 2002, the Court entered *715 Orders incorporating the Debtor's third amended budget into the Final DIP Financing Order, and setting a deadline for establishing the first procedures for approval of the sale of substantially all of the Debtor's assets to Pentair. On February 4, 2002, Debtor filed a Disclosure Statement and two Chapter 11 Plans. The Disclosure Statement was approved, but that approval was later vacated on February 11, 2002, as was the approval of the bid procedures vacated by Order entered February 12, 2002, and the Debtor was directed to file an amended Disclosure Statement and Plan.

On February 25, 2002, the Debtor filed a report stating it was unable to file a revised Plan and Disclosure Statement. Motions to convert the case to Chapter 7 or appointment of a Chapter 11 trustee followed shortly, filed by creditors. Wells Fargo objected to conversion, but moved for appointment of a Chapter 11 trustee on March 1, 2002, for which a hearing was set for April 2, 2002 ¹⁶. On March 29, 2002, the Debtor filed motions to establish bid procedures and approve overbid minimums, and for sale of substantially all of the Debtor's assets, which were set for hearing on April 15, 2002. Wells Fargo, GECC and other secured creditors were authorized by the Court's Order entered April 2, 2002, to submit their own proposed bidding and sale procedures by April 4, 2002. Both the creditors and the Debtor filed proposed bid and sale procedures, and on April 5, 2002, the Court entered an Order establishing the bidding procedures and reserve prices of secured creditors to govern the hearing on the motion for sale on April 15, 2002. The Debtor's motion for sale, and Pentair, requested that the secured creditors not be allowed to credit bid, but the Court allowed credit bidding by the secured creditors. Tr. Fain, pp. 34, 38; Tr. MacIntyre, pp. 62-63. MacIntyre testified that Perkins argued adversely against Wells Fargo with respect to the proposed "break up" fee 17. Tr. MacIntyre, p. 34.

The Debtor, Wells Fargo and Harris filed another stipulation on April 12, 2002, to extend DIP financing through the sale, which was approved. However, relations between their professionals had continued to sour. MacIntyre testified that from December of 2002 and the sale in April, the Debtor's professionals agreed that their fees were at risk. Tr. MacIntyre, pp. 40-41. The night before the April 15, 2002, sale hearing, an issue of contention arose out of the "carve-out" for the Debtor's professional fees which had been a component of the Final DIP Financing Order. MacIntyre testified that at a dinner meeting in Missoula that night attended by himself, McConnell, Hamstreet, and representatives for Pentair and Wells Fargo: "[W]e were talking about the structure of Pentair's bid to buy the company and the potential that there would be an over-bid from Western Mortgage Company's Frank Tiegs. And we were talking about the current amount of unpaid fees And I'll never forget: Scott Clark leaned across the table and looked at me. And he said, 'what would you say if the bank took the position that the carve-out was already consumed and there was no more carve-out there?' And he kind of smiled." Tr. *716 MacIntyre, pp. 35–36. MacIntyre testified he answered:

I looked at him, and pardon my French, but I said, "You son of a bitch. Don't even go there. Just don't even go there."

And he sat back quietly and didn't say a word about it until the next day in the course—and I think it was the next day. I don't think there was a day in between. But during the course of the sale hearing—or the auction hearing, he made it clear that they were not going to honor the carve-out provision in the manner in which we had mutually, I believe, mutually understood it to be interpreted.

Tr. MacIntyre, p. 36.

The sale hearing took place on April 15, 2002, at Missoula. Pentair's bid was not sufficient to meet the secured creditors' release prices, and after negotiations with the creditors Western Mortgage & Realty Company ("Western Mortgage") made a winning bid of \$32,949,750, meeting the creditors' release prices. Tr. Fain, pp. 40–45. The Court approved the sale of substantially all of the Debtor's assets to Western Mortgage by Order entered April 17, 2002. All of the proceeds of that sale went to secured creditors, and none went to professional fees. Tr. MacIntyre, pp. 64–65. By

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

that time, MacIntyre testified, 92 or 93 percent of Perkins' hours and fees for work performed for the Debtor had been incurred. Tr. MacIntyre, pp. 43–44. The business assets sold to Western Mortgage remain operating in Ronan, Montana, employing an average of 300 persons full time. Tr. MacIntyre, p. 75.

IV. Subsequent Proceedings.

On May 2, 2002, Smith wrote Manookin addressing Ex. 1 and certain issues of contention between the parties, i.e., the carve-out for Jore's professionals and whether Debtor's waiver of § 506(c) surcharge claims against Wells Fargo and its equipment lessor affiliate and Harris Bank remained binding. Ex. 2. In Ex. 2 Smith states he recognizes that Wells Fargo and Harris dispute Perkins' contentions, and so requests Wells Fargo to sign and return Ex. 2 and thereby acknowledge that Wells Fargo's existing conflicts waiver of Ex. 1 covers such claims, or that Wells Fargo consents to a further waiver so that Perkins can represent Jore "in all of such matters adverse to Wells Fargo and its affiliates ..., while simultaneously representing Wells Fargo and affiliates in other matters." Tr. Smith, p. 31. Smith wanted to clear up any doubt whether a § 506(c) charging order action would be covered by Wells Fargo's waiver. Tr. Smith, pp. 85-86, 99-100. MacIntyre testified that Perkins felt it ought to be able to argue the carve-out issue, which simply involved interpretation of the carve-out language in the DIP Financing Order, before the Court. Tr. MacIntyre, p. 37.

Wells Fargo's attorney Scott Clark ("Clark") replied to Ex. 2 by a letter dated May 9, 2002, Ex. 3, refusing to sign Smith's request for acknowledgment of a waiver of conflicts. Tr. Smith, p. 86. In Ex. 3 Clark states that Ex. 2 "attempts to characterize Wells Fargo Bank's previous waiver of conflicts letter in broad brush terms, Wells Fargo Bank (in your view) having waived any right to object to Perkins Coie acting on behalf of the Debtor in any proceeding directly adverse to the interests of Wells Fargo Bank." Ex. 3. Clark then points out Ex. 1's language, underlining the passage that Perkins "agreed that we will not represent Jore in litigation directly adverse to Wells" Ex. 3. Clark then states:

I find your contention that the above numerated claims against Wells Fargo Bank—relating to the "carveout" and *717 the surcharge under Section 506(c)—"... are covered by the earlier letter" (i.e. the conflict of interest

had been previously waived by Wells Fargo Bank), to be incredulous. The reasonable reading of the words, "We have agreed that we will not represent Jore in litigation directly adverse to Wells, ..." is that Perkins Coie will not sue Wells Fargo Bank on behalf of Jore Corporation. Period.

We would invite you to reexamine "distinterestedness" of Perkins Coie when it opposed bidding by Western Mortgage & Realty and undertook to thwart the efforts of Western Mortgage & Realty to acquire the assets of Jore Corporation. This is clearly a case where the lawyer's economic interests had become adverse to the interests of the clients. We would admonish you to rethink whether or not Perkins Coie continues to believe that its continued representation of both Jore Corporation and Wells Fargo Bank (in other unrelated matters) will not adversely affect either client as required under Rule 1.7(b)(1) of the Rules of Professional Conduct.

Wells Fargo Bank will not countersign ... [Ex. 2].

Ex. 3, p. 2 (Emphasis in original).

After receiving Ex. 3—Wells Fargo's refusal to acknowledge that its waiver of Perkins' conflict of interest did not extend to the carve-out or § 506(c) surcharge —Perkins did not, notwithstanding MacIntyre's three earlier representations in Ex. 18, 19, and 20 that Perkins "continues to review its connections" and "will notify the Court if any actual conflicts of interest or other significant connections are discovered in this process", disclose to the Court or the U.S. Trustee the no litigation exception to Wells Fargo's conflicts waiver, or GECC's waiver. MacIntyre testified that the no litigation exception to Wells Fargo's conflicts waiver was not brought to the Court's attention until a status report in April of 2002. Tr. MacIntyre, p. 57. However, the docket reflects that no Status Report was filed during April of 2002.

Smith responded to Ex. 3 by letter dated May 24, 2002. Ex. 4. Smith acknowledged and recognized that without Wells Fargo's waiver Perkins was limited in what it could do. Smith advised Wells Fargo that Perkins would not represent Jore in carve-out and § 506(c) "litigation", but would cooperate with Jore's counsel (likely Dye) in those efforts and might indemnify or reimburse Jore's counsel for expenses. Ex. 4. Clark responded to Ex. 4 on behalf of Wells Fargo by letter dated May 29, 2002. Ex. 5. After

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

noting that little remained of the Debtor after the sale ¹⁸ Clark states:

Your letter [Ex. 4] demonstrates singular disregard for the terms and conditions of the waivers of conflict described in the letter of June 4, 2001 [Ex. 1], countersigned by Scott Manookin on behalf of Wells Fargo Bank. In essence, you have indicated that Perkins Coie will prosecute claims against Wells Fargo using its local proxy, Dye & Moe, and will support and indemnify Dye & Moe in its efforts. You freely admit that Perkins Coie will be the largest beneficiary of such litigation and will presumably receive the largest share of the proceeds of any recovery. You abandon all pretense that the prosecution of this litigation against Wells Fargo Bank will *718 not adversely affect Perkins Coie's relationship with Wells Fargo Bank. Ex. 5, p. 2.

The dispute was "kicked upstairs ¹⁹". Perkins' managing partner Robert E. Giles ("Giles") wrote to David Garfield ("Garfield") of Wells Fargo's law department a letter dated June 3, 2002. Ex. 6. Giles complains of the "fundamental unfairness" of Wells Fargo's position taken in Ex. 5. Giles asks Garfield to revisit the issues, hoping that Wells Fargo will conclude that Perkins' proposed indemnification and support of Dye in carve-out and § 506(c) surcharge litigation is reasonable, appropriate and ethical. Ex. 6, p. 2. MacIntyre testified that Perkins felt that Wells Fargo, "in our opinion, had precipitated the problem by, we believe, changing their position on the carve-out, the professional fees carve-out at the last minute. My understanding of Mr. Giles' letter is he's saying it's not fair to take a position that creates this problem and then try and exclude us from being about to have the problem resolved in front of the Court that granted the order that we negotiated that is now in dispute." Tr. MacIntyre, pp. 73-74. Giles ends Ex. 6 by expressing that Perkins values its relationship with Wells Fargo "quite highly, and desire that this matter not serve as a barrier to a continued development of that relationship."

Also on June 3, 2002, Perkins filed its Second Application for Compensation requesting fees in the amount of \$706,075.35 and costs in the amount of \$104,580.97. In the bankruptcy case, on June 14, 2002, the Debtor filed a liquidating Plan and Disclosure Statement, along with a Status Report and the Debtor's Second Supplemental

Application to Employ Dye to pursue the carve-out and § 506(c) charging claims against Wells Fargo. In the Second Supplemental Application Dye discloses certain provisions of a conflict waiver between Perkins and Wells Fargo. MacIntyre, in the Status Report filed June 14, 2002, for the first time discloses the limit of Wells Fargo's conflicts waiver, after identifying the carve-out and § 506(c) surcharge as remaining assets:

One aspect of that litigation is worthy of note. While Perkins Coie does not believe that the contention has merit, it must acknowledge that Wells Fargo Bank, a current client in unrelated matters, contends that Perkins Coie should not prosecute an action against Wells Fargo, whether for surcharge payments or to enforce the carveout provisions of the Final DIP Financing Order. Wells Fargo contends that the conflicts waiver it granted at the outset of the case does not allow Perkins Coie to represent Jore in these matters.

This is the first indication in the record that there were exceptions to Wells Fargo's conflicts waiver. MacIntyre testified: "It was not brought to the Court's attention, and there was no reason that I was aware of at any point during that time that it was worthy of bringing to the Court's attention." Tr. MacIntyre, p. 57. The U.S. Trustee first addresses the issue of the undisclosed conflicts waiver in the response filed by Assistant U.S. Trustee Neal Jensen ("Jensen") to the Second Supplement to Dye's Application for employment, filed June 21, 2002, in which Jensen requests that the Court require Perkins to provide him, the Court, and the parties with additional information related to Wells Fargo's limited waiver of conflicts before approving Dye's employment.

Garfield responded for Wells Fargo to Perkins' Ex. 6 by letter dated June 28, 2002. Ex. 7. Garfield acknowledges to *719 Giles that "this disagreement has been emotionally charged and contentious", and then addresses the carveout language and superpriority treatment of Wells Fargo in the Final DIP Financing Order. Ex. 7. Garfield opines that the language of the Final Order was conclusive and "there is no uncertainty about the meaning", and precluded any further payment to Perkins by Wells Fargo

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

under the carve-out. Ex. 7. Indeed, Ex. 7 notes the possibility that the Court may order disgorgement of fees already paid. Garfield claims that Wells Fargo ultimately lost over \$11 million in this case, and describes its response to Giles' accusation of "fundamental unfairness" as "exasperating and, in our opinion, mistaken and uninformed." Ex. 7, p. 6. Garfield complains about the amended Plan submitted by the Debtor which includes recovery from Wells Fargo on the basis of the carveout and § 506(c) surcharge litigation, which he asserts Perkins is prosecuting "primarily for its own benefit", and concludes Ex. 7 with: "Your response to this letter is important to Wells Fargo and its ongoing relationship with Perkins Coie." Ex. 7, p. 6. Ex. 8 reflects the revenue which MacIntyre states Perkins earned from its relationship with Wells Fargo as \$640,000 in 2000, \$656,000 in 2001, and \$278,000 to July 19, 2002, or between 2/10 and 3/10 of one percent of Perkins' gross income from 2000 to July 19, 2002. Ex. 8, pp. 1-2.

On July 15, 2002, the U.S. Trustee moved for a Rule 2004 examination of Manookin, which was granted. Wells Fargo filed a motion to convert this case to Chapter 7 on July 18, 2002. Perkins sent Jensen Ex. 8, a letter dated July 19, 2002, stating that Jensen had received Ex. 1, the original waiver letter sent by Smith to Manookin with the litigation exception. The U.S. Trustee filed a motion to convert to Chapter 7 on August 2, 2002, but it was deemed withdrawn and instead the U.S. Trustee joined Wells Fargo's motion to convert, which was heard on August 7, 2002, after which the parties were given time to file briefs.

On September 4, 2002, the Debtor filed its own motion to convert to Chapter 7, which was granted and the case was converted to a case under Chapter 7 of the Bankruptcy Code on September 4, 2002. Also on September 4, 2002, Dye filed a complaint against Wells Fargo in Adversary Proceeding No. 02–00102 seeking recovery from Wells Fargo on the basis of the carve-out and § 506(c) surcharge provisions of the Final DIP Financing Order. ²⁰

A Chapter 7 Trustee was appointed on September 5, 2002, and he filed an application to employ attorneys for the estate, including Guthals, on November 1, 2002, which was granted by Order entered January 24, 2003. Guthals filed an affidavit in support of his employment, Ex. A. In Ex. A Guthals discloses that he formerly represented a secured creditor, American Equipment Leasing, in

the Chapter 11 proceedings until he withdrew and was replaced by Fain. Ex. A states Guthals is unaware of any conflict of interest in his representation of the Chapter 7 Trustee, and there appears to be no adverse interest between the Trustee and American Equipment Leasing or its successor CitiCapital. If any conflict arises, Guthals states that he and his firm will abstain from representing the Trustee with regard *720 to such matter. Ex. A. There is nothing in the record indicating a surcharge or interest adverse between the Trustee and American Equipment Leasing/CitiCapital.

Perkins filed its Third and Final Application for Fees and Costs on February 13, 2003, requesting fees of \$132,003.50 and costs in the amount of \$8,161.68. In that Application MacIntyre waives all fees and costs incurred by Perkins after the conversion date, September 4, 2002. Perkins' post-hearing brief states that it expended over 7,161 hours of legal time for which it has filed fee applications seeking reimbursement of \$215,765.77 in expenses and \$1,618,502.30 in fees. The Final Application and Perkins' brief state that Perkins has received \$161,571.82 in expenses and \$624,617.48 of its requested fees, and recognizes that it has "little likelihood" of actual payment for the balance. Perkins' Brief, p. 5 n. 2.

The U.S. Trustee filed her "Motion to Disqualify Perkins Coie, Vacate Employment Order, and Disgorge and Disallow Fees" on March 5, 2003. After responses were filed, hearing on the matter was continued at Perkins' request until it commenced on May 8, 2003. The Court denied the U.S. Trustee's motion for summary judgment at the commencement of the hearing, and the parties proceeded to put on their cases-in-chief which concluded on May 9, 2003.

V. Expert Testimony.

Several witnesses testified as experts on applicable Rules of Professional Conduct, and on this Court's standard for requiring disclosure of conflicts and other connections under F.R.B.P. 2014(a).

1. Peter Richard Jarvis.

The parties stipulated that Jarvis is an expert in attorney professional responsibility, though not in bankruptcy law. Jore is a former client of his law firm. He testified that he reviewed Rule 2014 and this Court's case law construing that rule, the Montana Rules of Professional

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Conduct and ABA Model Rules of Professional Conduct in preparing to testify. Jarvis gave an opinion regarding Perkins' statements to the Court in Ex. 18, 19, and 20 with respect to its professional responsibility and the exceptions to Wells Fargo's conflicts waiver. Jarvis testified that the litigation, fraud and dishonesty exceptions in Ex. 1 were material, and that Perkins' statements made in Ex. 18, 19, and 20 to gain approval of its employment in Jore's Chapter 11 case fall short of Perkins' professional responsibilities of honesty and candor.

Conflicts waiver letters, Jarvis testified, are material and are construed against the attorney. When asked about Smith's opinion that the meaning of the no litigation exception in Ex. 1 was unclear, Jarvis testified that the extent to which the exception language is unclear makes it more important for Perkins to disclose the exception under rules of professional responsibility. Jarvis testified it is not important to disclose the conflicts waiver letters, but that the professional rules requiring honesty and candor require the attorney to disclose the terms of the limitations to a conflicts waiver.

Jarvis testified that Perkins' obligations under the rules of professional conduct are ongoing, and that notwithstanding MacIntyre's statements in Ex. 18 and 19 that all issues have been identified and Perkins will notify the Court if any actual conflicts are discovered, Perkins failed to disclose Wells Fargo's exceptions from its conflicts waiver in Ex. 1. Ex. 20 came after Ex. 1 and its exceptions to conflict waiver were accepted by Wells Fargo, and Jarvis testified that he accepted MacIntyre's representations in Ex. 20 that he undertook an *721 investigation of Perkins' connections, which bound Perkins to disclose the exceptions of Ex. 1 which Smith knew existed when Ex. 1 was drafted in June of 2001.

Jarvis testified that a client is not required to act in a reasonable manner with respect to conflicts waivers, and that the client is free to withhold consent to a waiver and still enjoy the client's attorney's duty of absolute loyalty. From a professional responsibility standpoint, Jarvis testified that neither the Debtor's waiver of claims against Wells Fargo nor the fallback position change Perkins' ethical obligations to disclose the terms of the limitations of Wells Fargo's conflicts waivers. He testified that the purpose of conflicts waiver letters are to cover what happens if things do not go according to plan, and

that there was a foreseeable prospect of litigation between the Debtor and Wells Fargo at the time Wells Fargo was given Ex. 1 by Perkins, which came to pass.

2. David Boerner.

Boerner's deposition, Ex. B ("Boerner Dep.") was admitted without objection. The parties stipulated that Boerner is an expert on ethics and attorney conflicts of interest in general, but not as to bankruptcy law. Boerner Dep., pp. 8, 34, 68-69, 80, 87, 113. Boerner gave an opinion that Perkins acted consistently with its ethical obligations in addressing its conflict of interest with Wells Fargo initially and when the actual conflict arose. Boerner Dep., p. 10. Boerner stated that Rule of Professional Conduct 1.8(f) would not require submission of Ex. 1 to the Court, and that the conflicts were disclosed. Boerner Dep., p. 30. Boerner relied on Dye's and Shulkin's opinions as to Perkins' obligation to file Ex. 1 and subsequent correspondence with the Court under Rule 2014(a). Boerner Dep., pp. 32, 34–35. Boerner testified that he did not examine the bankruptcy case law cited by the U.S. Trustee. Boerner Dep., p. 56–57.

Boerner disagreed with Jarvis's opinion that Perkins' failure to disclose the litigation exception to Wells Fargo's conflicts waiver violated Perkins' ethical responsibilities, because Boerner believes that disclosure was not required based on Dye's and Shulkin's opinions, and because of the fallback position where Perkins would step aside and allow Dye to handle litigation against Wells Fargo, and because Jore waived claims against Wells Fargo. Boerner Dep., pp. 36-38, 76-77. Boerner agreed with Jarvis' opinion that the no litigation exception to Wells Fargo's conflicts waiver was Wells Fargo's right, and that it did not have to be reasonable or have reasons for waiving or not. Boerner Dep., p. 65. Under cross examination, Boerner agreed that vague or ambiguous terms in conflicts waiver letters are construed against the drafter. Boerner Dep., p. 62.

Boerner testified that everyone understood that the no litigation clause in Ex. 1 did not include "the normal adversarialness that's inherent in a bankruptcy which some may argue is litigation." Boerner Dep., pp. 71, 98–100, 115. However, he admitted he did not know what litigation or "no litigation" means in a bankruptcy context. Boerner Dep., p. 97. He testified that he did not know what Wells Fargo meant by "litigation", but inferred that Wells Fargo did not view contested

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

matters in the bankruptcy case, such as the contested cash collateral hearing in December of 2001, as litigation because Wells Fargo did not invoke the litigation exception in Ex. 1 at the time. Boerner Dep., pp. 116–17.

3. Joel Guthals.

Guthals is employed by the Chapter 7 Trustee. He testified as an expert about *722 his practice in the District of Montana representing Chapter 11 debtors since 1977, his process for checking conflicts of interest regarding other clients, and determining whether client waiver of conflicts is feasible or desirable. Guthals testified that if he discovers a conflict with a client which affects his judgment or ability to represent a debtor-in-possession, he will turn down the engagement with the prospective client. If he determines that a conflict is merely technical or potential, he testified that he would disclose it to the Court in writing.

Guthals has practiced bankruptcy law in this Court for several years. He testified that he is familiar with the concept of limited waivers, and the disclosure of conflicts of interest in employment applications, after reviewing applicable case law. Guthals was asked what he would do if he had a situation where he represented a debtorin-possession and received a waiver of conflicts from a client which was a creditor that was not unconditional. Guthals testified that, based on the law and practice in Montana as he understands it, he feels he is obligated to disclose a conditional waiver. He testified that if he received a limitation of conflict waiver from a client which was a DIP lender he would have a difficult time showing he was disinterested, and that he would fully disclose the details of the limitation of conflict waiver plus any future developments as a continuing duty to disclose conflict developments exists in Montana. On cross examination Guthals admitted that he has never disclosed conflicts in his initial disclosure as he described above.

As the Chapter 7 Trustee's local counsel, Guthals submitted an affidavit, Ex. C attached to his employment application. In his affidavit Guthals described his representation of a former client, American Equipment Leasing, in the Chapter 11 case. He testified he obtained waivers of conflict from American Equipment Leasing, CitiCapital, and the Chapter 7 Trustee.

4. Jerome Shulkin.

Shulkin was one of two experts called by Perkins to testify on the disclosure required in Montana under Rule 2014. Shulkin was lead counsel for the official unsecured creditors committee ("UCC") while this case was in Chapter 11. Ex. 14. He testified he has practiced exclusively in bankruptcy law, Chapters 11 and 12, since 1957. Shulkin testified that Wells Fargo's limitation of its conflicts waiver in Ex. 1 was not significant, because the hard negotiations involving carve-outs and DIP financing were between the UCC and Wells Fargo, not between the Debtor and Wells Fargo. He testified that he did not view Perkins' relationship with Wells Fargo as a significant hindrance to its representation of the Debtor, and that Perkins' performance added benefit to the estate. He considered the results in this case to be a successful conclusion, because it was apparent early in the case that there was little likelihood the creditors would get anything and it was important to keep the business in the State and employees retained.

Shulkin testified that he has not in his practice seen a conflicts waiver letter filed with a court, and that the fallback position of bringing in another law firm is the way to deal with conflicts as they arise. He testified that he is familiar with the practice in Montana of disclosure of conflicts, and that Perkins' disclosure was consistent with the rule in the District of Montana.

5. Harold Van Dye.

Dye was employed as local counsel by the Debtor in Chapter 11, and testified as Perkins' expert on the standard of whether *723 Perkins' disclosures of its connections with Wells Fargo satisfied its obligations under Rule 2014(a) and the standard for practice in the District of Montana. Dye testified that in his opinion Perkins' disclosures satisfied the applicable standard. He testified that Perkins' affidavit and declarations, Ex. 18, 19, and 20, fully advised the Court that if a conflict arose Perkins would obtain a waiver or use other counsel as a fallback. He testified that the U.S. Trustee is advocating a more stringent standard than presently exists in this Court.

Dye testified that it is possible that potential conflicts may ripen into actual conflicts, and that in Montana bankruptcies, which generally involve smaller law firms, conflicts arise less often than in large firms, but that the fallback arrangement had him prepared to step in any time a conflict arose in this case. Looking at Guthals' affidavit of which the Court took judicial notice, Dye testified

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

that a conflict of interest might arise for Guthals in the form of a § 506(c) surcharge against American Equipment Leasing ²¹. When asked on cross examination whether such a conflict would be absolute, Dye testified that an unwaivable conflict is a direct adverse representation of a client

fallback position of referring conflict matters to Dye functioned as designed and had no effect on the estate. Perkins concludes that the harsh penalties sought by the U.S. *724 Trustee are inappropriate, and that the Court should take into consideration in its discretion the positive results obtained in this case.

CONTENTIONS OF THE PARTIES

The U.S. Trustee contends that Perkins' failure to disclose the conflicts waiver limitations it reached with Wells Fargo and GECC mere material and failed Perkins' duty under applicable Rules of Professional Responsibility, and failed the higher standard under the Bankruptcy Code, 11 U.S.C. § 327(a), and F.R.B.P. 2014(a). The U.S. Trustee argues that authority and case law in the Ninth Circuit and this Court impose a higher duty to disclose all facts that may be pertinent to a determination under § 327(a), that such duty is strictly applied and continuing and that Perkins' failure to disclose the limitations in its conflicts waivers violated that duty and is sanctionable by disqualification of Perkins as Debtor's attorney, disgorgement of all fees received by Perkins, and disallowance of all compensation incurred. Perkins is not excused, the U.S. Trustee contends, from its failure to disclose the limitations of the conflicts waivers either by the Debtor's waiver of any claims against Wells Fargo, or because no actual conflict arose, or by Perkins "fallback" position that if an actual conflict arose it would obtain additional waivers or refer matters involving Perkins' conflict to local counsel Dye or another attorney.

Perkins contends that its three (3) Rule 2014 disclosures satisfied the letter and spirit of the law, that the "no litigation" waiver with Wells Fargo was fully disclosed to the Debtor and had no impact on its representation of the Debtor, to which Perkins asserts it provided valuable services. Perkins argues that there is no evidence it willfully chose not to disclose the limitations of conflict waivers, and that such limitations were not material and did not affect the Debtor or creditors, including Wells Fargo which was not a significant client, in the least. Perkins argues that both it and Wells Fargo interpreted the waiver as encompassing all bankruptcy matters notwithstanding the "no litigation" language, and further argues that Perkins "at no time" performed any work adverse to Wells Fargo that was not within the scope of the waiver obtained from Wells Fargo. Perkins contends that its

DISCUSSION

Whether or not Perkins' disclosure complied with its obligations under the rules of professional responsibility is primarily a matter between Perkins and Wells Fargo, and the Court need not decide between the opinions of Jarvis and Boerner about whether Perkins violated its duty under those rules. The issue before this Court is whether Perkins' failure to disclose to the Court the exceptions to Wells Fargo's waiver of conflicts in Ex. 1 violated Perkins' duty of disclosure under Rule 2014(a), where MacIntyre made three declarations to the Court (Ex. 18, 19, and 20) that Perkins "continues to review its connections" and "will notify the Court if any actual conflicts of interest or other significant connections are discovered".

Perkins sought and was granted approval of its employment as a professional for the Debtor pursuant to § 327(a), which provides that a trustee ²², "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 or assist the trustee in carrying out the trustee's duties under this title." "Disinterested person" is defined at 11 U.S.C. § 101(14) as a person that is not, among other things, a creditor, equity security holder, or insider of the debtor and that "(E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor ..., or for any other reason."

I. Disclosure Under Rule 2014(a).

[1] Perkins was required in its employment application to comply with Rule 2014(a). F.R.B.P. Rule 2014(a) requires that an attorney's application for employment disclose, among other things, "all of the [applicant's] connections with the debtor, creditors, [or] any other party in interest...." to assist the court in ensuring that the attorney has no conflicts of interest and is disinterested, as

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

required by 11 U.S.C. § 327(a). *In re Park—Helena Corp.* ("*Park—Helena*"), 63 F.3d 877, 881 (9th Cir.1995), *cert. denied, Neben & Starrett, Inc. v. Chartwell Financial Corp.*, 516 U.S. 1049, 116 S.Ct. 712, 133 L.Ed.2d 667 (1996). The Ninth Circuit in *Park—Helena* explained:

The bankruptcy court must ensure that attorneys who represent the debtor do so in the best interests of the bankruptcy estate. See In re Lincoln N. Assocs., Ltd., 155 B.R. 804, 808 (Bankr.E.D.Mass.1993); In re EWC, Inc., 138 B.R. 276, 280-81 (Bankr.W.D.Okla.1992). The court must ensure, for example, that the attorneys do not have interests adverse to those of the estate, 11 U.S.C. § 327, that the attorneys only charge for services that benefit the estate, Pfeiffer v. Couch (In re Xebec), 147 B.R. 518, 523 (9th Cir. BAP 1992), and that they charge only "reasonable" fees, 11 U.S.C. § 329(b). To facilitate the court's policing responsibilities, the Bankruptcy Code and Federal Rules of *725 Bankruptcy Procedure impose several disclosure requirements on attorneys who seek to represent a debtor and who seek to recover fees. See 11 U.S.C. § 329; Fed.R.Bankr.P. 2014 & 2016. The disclosure rules impose upon attorneys an independent responsibility. Thus, failure to comply with the disclosure rules is a sanctionable violation, even if proper disclosure would have shown that the attorney had not actually violated any Bankruptcy Code provision or any Bankruptcy Rule. [In re Film Ventures Int'l, Inc., 75 B.R. 250, 252 (9th Cir. BAP 1987)].

Park-Helena, 63 F.3d at 880.

[2] Perkins asserts that the term "connections" is not defined in Rule 2014(a) or the Code. However, Rule 2014(a) has long been held to be read broadly. *In re*

Fjeldheim ("Fjeldheim"), 12 Mont. B.R. 267, 278, 1993 WL 590145 (Bankr.D.Mont.1993); In re Love ("Love"), 163 B.R. 164, 170–71 (Bankr.D.Mont.1993); EWC, 138 B.R. at 280.

Perkins cites an ABI journal article ²³ which describes the language of *Park–Helena* requiring all connections to be fully disclosed, "no matter how *de minimis*", as "sweeping dicta". Perkins' Brief, pp. 18–19. In this Circuit *Park–Helena* is binding precedent, not "sweeping dicta" that may be dismissed as dicta. *Silveira v. Lockyer*, 312 F.3d 1052, 1063 n. 10 (9th Cir.2002). Hence, while the cases from the Southern District of New York and other circuits cited by Perkins, *In re Enron Corp.*, 2003 U.S. Distr. Lexis 1442, *19–20, 2003 WL 223455, *4 (U.S.D.C.S.D.N.Y.2003), *In re Granite Partners L.P.*, 219 B.R. 22, (Bankr.S.D.N.Y.1998), and *A.V. By Versace v. Versace S.p.A.*, 160 F.Supp.2d 657, 662–63 (S.D.N.Y.2001), are illustrative, they are not binding on this Court like *Park–Helena* ²⁴.

[3] [4] [5] The disclosure rules "are applied literally, even if the results are sometimes harsh." Park-Helena, 63 F.3d at 881; see In re Plaza Hotel, 111 B.R. at 883. The disclosure requirements of Rule 2014 are applied as strictly as the requirements of Rule 2016 and 11 U.S.C. § 329, and do not give the attorney the right to withhold information because it is not apparent to him or her that a conflict exists. Park-Helena, 63 F.3d at 881, quoting In re Haldeman Pipe & Supply Co., 417 F.2d 1302, 1304 (9th Cir.1969). Thus, "All facts that may be pertinent to a court's determination of whether an attorney is disinterested or holds an adverse interest to the estate must be disclosed." Park-Helena, 63 F.3d at 882 (emphasis added in Park-Helena), quoting In re Hathaway Ranch Partnership ("Hathaway"), 116 B.R. 208, 219 (Bankr.C.D.Cal.1990); In re EWC, 138 B.R. at 280–81 ("The duty of professionals is to disclose all connections with the debtor, debtor-inpossession, insiders, creditors, and parties in interest.... They cannot pick and choose which connections are irrelevant or trivial.... No matter how old the connection, no matter how trivial it appears, the professional seeking employment must disclose it."); In re B.E.S. Concrete *Prods.*, 93 B.R. at 236 ("Appearances *726 count. Even conflicts more theoretical than real will be scrutinized.").

[6] [7] [8] MacIntyre and Smith both testified that it did not occur to them to disclose the no litigation exception to

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

Wells Fargo's conflicts waiver because they did not think it important. Tr. Smith, pp. 27–28; Tr. Macintyre, pp. 55, 57, 58–59. Perkins argues its failure to disclose was not willful. However, negligent or inadvertent omissions "do not vitiate the failure to disclose." Park-Helena, 63 F.3d at 881, quoting In re Maui 14K, Ltd., 133 B.R. 657, 660 (Bankr.D.Haw.1991). Smith, MacIntyre and Shulkin each testified that the no litigation exception was not important or material because it did not encompass matters in the bankruptcy case. Whether or not that is so 25, Perkins had the duty to disclose the exceptions to conflicts waivers by Wells Fargo and GECC to the Court. It did not have the right to pick and choose which connections were unimportant or trivial. Park-Helena, 63 F.3d at 881; In re EWC, 138 B.R. at 280-81. Having advised the Court in three declarations, Ex. 18, 19, and 20, that it has disclosed all "potential conflicts", "continues to review" its connections, and "will notify the Court if any actual conflicts of interest or other significant connections are discovered", Perkins was unarguably required to disclose Wells Fargo's exceptions to its conflicts waivers set forth in Ex. 1.

Wells Fargo was the Debtor's largest creditor, and with Harris was the only source of DIP financing without which everyone agreed the company would close. Ex. D, McConnell, p. 67; Tr. MacIntyre, p. 17; Tr. Smith, p. 12. By the time MacIntyre filed Ex. 20 in August of 2001, Wells Fargo's exception to its conflicts waiver in Ex. 1 was known to Perkins for almost 2 months, and MacIntyre stated in Ex. 20 that he undertook "an investigation of any connections that may exist" between Perkins and the Debtor, and creditors of the Debtor, yet failed to disclose Wells Fargo's exception to its conflict waiver. Compared with Ex. 19's disclosure of family relationships between Perkins and Jore, and with the District of Montana, Perkins' failure to disclose to the Court in Ex. 20 or later the exceptions to a conflicts waiver by the estate's largest creditor and DIP lender which was also Perkins' client, which Smith admitted in Ex. 1 "creates a conflict of interest", is shocking.

Based upon the above language from *Park–Helena*, *Hathaway*, and *EWC*, this Court finds that Perkins' failure to disclose the exceptions to Wells Fargo's conflicts waiver, and GECC's exceptions, to the Court violated its duty of disclosure under Rule 2014(a), and MacIntyre's and Smith's opinion that the exceptions were not important and that their failure to disclose was not

intentional or willful is no excuse. *Park—Helena*, 63 F.3d at 881–82; *In re EWC*, 138 B.R. at 280–81; *Hathaway*, 116 B.R. at 219; *In re Coastal Equities, Inc.*, 39 B.R. 304, 308 (Bankr.S.D.Cal.1984).

*727 [9] [10]Perkins' contention that it satisfied Rule 2014(a)'s disclosure requirements because it disclosed Wells Fargo's exception to its conflict waiver to the Debtor is without merit, because Perkins's duty under Rule 2014 was to file and disclose all of its connections with the Court, not just disclose to its client. Park-Helena, 63 F.3d at 881–82; Rule 2014(a). Likewise, the Court rejects Perkins' arguments that its failure to disclose had no impact on its representation of the Debtor because the Debtor waived all claims against Wells Fargo²⁶, that Perkins provided valuable services to the estate, and that its fallback strategy to refer conflict matters to Dye functioned as designed. None of these arguments excuse or mitigate Perkins' failure to disclose Wells Fargo's exception to its conflict waiver to the Court as required by Rule 2014²⁷. A disclosure violation may result in sanctions "regardless of actual harm to the estate." Park-Helena, 63 F.3d at 881, quoting In re Maui 14K, 133 B.R. at 660.

As to Perkins' contention, supported by the testimony of Dye, Smith and Shulkin that conflict waiver letters are not routinely filed, the Court views that argument as a red herring. Regardless of whether a professional decides to file an actual conflict waiver letter, Rule 2014(a) plainly requires disclosure of "all of the person's connections with the debtor, creditors," Smith and MacIntyre admitted that they did not disclose Wells Fargo's no litigation exception to its conflicts waiver. Tr. MacIntyre, pp. 55, 57; Tr. Smith, pp. 27–28, 82.

II. Court Discretion Under Rule 2014(a).

[11] This Court has broad discretion in determining whether to deny or award fees when a debtor's attorney has failed to disclose material facts. *Park—Helena*, 63 F.3d at 881 (bankruptcy court correctly denied fees to attorneys who willfully failed to disclose all their connections with the debtor, creditors, and any other party in interest); *Love*, 163 B.R. at 170–71, 13 Mont. B.R. at 24–35. The Ninth Circuit bolstered *Park—Helena* in *In re Lewis*, 113 F.3d 1040, 1045 (9th Cir.1997), holding that an attorney's failure to obey the disclosure and reporting requirements of the Bankruptcy Code and Rules gives the bankruptcy

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

court discretion to order disgorgement of attorney's fees. *Lewis* explains:

After noting [in *Park–Helena*] that "[e]ven a negligent or inadvertent failure to disclose fully relevant information [in a Rule 2016 statement] may result in a denial of all requested fees," *id.* at 882, we concluded that the bankruptcy court was within its discretion when it refused to approve the entire amount. *Id.* (citing *In re Hathaway Ranch Partnership*, 116 B.R. 208, 220 (Bankr.C.D.Cal.1990); *In re Crimson Invs.*, 109 B.R. 397, 402 (Bankr.D.Ariz.1989)).

Although we did not explicitly so recognize in In re Park-Helena, the bankruptcy court's authority to deny completely *728 these attorney's fees was grounded in the inherent authority over the debtor's attorney's compensation. The Bankruptcy Code contains a number of provisions (e.g., §§ 327, 329, 330, 331) designed to protect the debtor from the debtor's attorney. See, e.g., In re Walters, 868 F.2d 665, 668 (4th Cir.1989) (noting that § 329 and Rule 2017 are designed to protect the creditors and the debtor against overreaching by attorney). As a result, several courts have recognized that the bankruptcy court has broad and inherent authority to deny any and all compensation when an attorney fails to meet the requirements of these provisions. See, e.g., In re Downs, 103 F.3d 472, 479 (6th Cir.1996) ("[T]he bankruptcy court should deny all compensation to an attorney who exhibits a willful disregard of his fiduciary obligations to fully disclose the nature and circumstances of his fee arrangement under § 329 and Rule 2016. The authority to do so is inherent, and in the face of such infractions should be wielded forcefully."); *Matter of Prudhomme*, 43 F.3d 1000, 1003 (5th Cir.1995) ("Additionally, the court's broad discretion in awarding and denying fees paid in connection with bankruptcy proceedings empowers the bankruptcy court to order disgorgement as a sanction to debtors' counsel for nondisclosure."); In re Chapel Gate Apartments, Ltd., 64 B.R. 569, 575 (Bankr.N.D.Tex.1986) ("Indeed, a failure of counsel to obey the mandate of § 329 and Rule 2016 concerning disclosure, and by implication review by the Court, is a basis for entry of an order denying compensation and requiring the return of sums already paid.").

We agree with these courts, and so we have little difficulty in rejecting Franke's argument that the bankruptcy court's disgorgement order must be reversed because the court made no findings of excessiveness under § 329(b). An attorney's failure to obey the disclosure and reporting requirements of the Bankruptcy Code and Rules gives the bankruptcy court the discretion to order disgorgement of attorney's fees. In reaching this conclusion, we do not mean to say that the excessiveness or reasonableness of those fees is irrelevant in all cases; in appropriate circumstances, a bankruptcy court should inquire into these subjects as part of deciding whether and to what extent to order disgorgement. See, e.g., In re Film Ventures Int'l, Inc., 75 B.R. 250, 253 (9th Cir. BAP 1987).

A bankruptcy court must be able to rely on the veracity of the representations made by an attorney in an application for employment. A bankruptcy court must be certain that an attorney who has filed a Rule 2016(b) statement will supplement that statement if further compensation is received. Here, the bankruptcy court was able to do neither. Not only did Franke fail to supplement its Rule 2016(b) statements, but Franke included a false statement in its application for employment.

In light of Franke's transgressions, we cannot conclude that the bankruptcy court clearly erred when it concluded as a factual matter that Franke acted with "complete disregard" for the procedures and requirements of the Bankruptcy Rules and the Bankruptcy Code. Having reached that conclusion, the bankruptcy court had discretion over whether to permit Franke to receive any fees at all, regardless of their excessiveness or reasonableness. See In re Park—Helena, 63 F.3d at 882. Given the gravity of Franke's transgressions, an inquiry into the appropriate amount of the fee was *729 not required, and the bankruptcy court did not abuse its discretion.

In re Lewis. 113 F.3d at 1045-46.

The provisions of Rule 2014 are imposed as strictly, and impose an independent duty on attorneys, as the disclosure provisions of § 329 and Rule 2016 discussed in *Lewis. Park–Helena*, 63 F.3d at 881–82. Therefore, it makes no difference as Perkins contends, that *Lewis, Park–Helena*, and *Fjeldheim* each involved violations of both Rules 2014 and 2016.

As in *Lewis*, the Debtor's attorney MacIntyre made a false statement when he stated in Ex. 20, dated 2 months

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

after Ex. 1, that Ex. 20 "discloses all additional issues and potential conflicts of interest that have been identified at the present time." Ex. 1 included exceptions to Wells Fargo's and GECC's conflicts waiver which Perkins was required to disclose. MacIntyre's statement in Ex. 20 was false because there remained a dispute over the extent of Wells Fargo's waiver of conflict between Perkins' attorneys and Wells Fargo, which was not disclosed to the Court until after the Debtor's assets were sold and contested matters litigated. In Ex. 19 MacIntyre declared that Perkins received oral waiver of conflict, and was in the process of obtaining written waiver. Wells Fargo's written waiver in Ex. 1 contained exceptions which were additional issues MacIntyre failed to disclose in Ex. 20 despite representing to the Court that "all additional issues and potential conflicts of interest that have been identified at the present time."

[12] Negligent or inadvertent as well as willful failure to disclose fully relevant information required under Rule 2014 may result in a denial of all fees. *Park—Helena*, 63 F.3d at 882; *In re Maui 14K*, 133 B.R. at 660; *In re Coastal Equities*, 39 B.R. at 308. Denial of all of Perkins' fees is within this Court's discretion. *Park—Helena*, 63 F.3d at 882; *In re Maui 14K*, 133 B.R. at 660; *In re Coastal Equities*, 39 B.R. at 308; *Hathaway*, 116 B.R. at 220 (applicant who fails to provide complete disclosure may be ordered to disgorge previously paid compensation).

The Court notes that in one case in this circuit the Bankruptcy Appellate Panel reversed a fee award and remanded with instructions to deny all compensation and require that a debtor's attorneys disgorge all fees received by counsel which failed to disclose a conflict and continued to represent the debtor after the conflict was recognized and challenged. *See, In re Mirzai*, 236 B.R. 8, 9 (9th Cir. BAP 1999). The BAP's decision was affirmed by the Ninth Circuit. *In re Mirzai*, 203 F.3d 832 (9th Cir.1999) (Table). This Court is not inclined to exercise its discretion in Perkins' favor given its failure to disclose the plain conflict of interest in the instant case and the limiting language of the "no litigation" letter after representing to the Court by declaration that oral waivers had been obtained.

[13] [14] Factors which weighed in favor of full disgorgement in *Love* are present in this case. First is Perkins' failure of its duty of disclosure. *Love*, 163 B.R. at 171. Second, Perkins' attorneys are experienced

bankruptcy attorneys and familiar with the duty of disclosure, but contend that their duty did not require disclosure of the exceptions to Wells Fargo's conflicts waiver from Ex. 1. Third, while Perkins contends that Wells Fargo was not a large client of Perkins that would call into question its ability or desire to vigorously advocate on behalf of the Debtor, Wells Fargo was the largest creditor and the DIP finance lender, without which it is uncontested the Debtor would have had to close its doors. Finally, Perkins failed to disclose the exception to Wells Fargo's conflicts *730 waiver in spite of numerous representations (Ex. 18, 19, and 20) that it had investigated its connections, continues to review and monitor its connections, and that it "will notify the Court if any actual conflicts of interest or other significant connections are discovered". The fact that Perkins ultimately disclosed the exceptions to Wells Fargo's conflicts waiver in the Status Report and Dye's second application filed June 14, 2002, after the DIP financing dispute was concluded and substantially all of Debtor's assets were sold, does not excuse Perkins' failure to timely disclose. It was not the Court's, the U.S. Trustee's or anyone else's duty to search the file for any conflicts of interest. Love, 163 B.R. at 169– 70, 13 Mont. B.R. at 32–33, quoting *Fjeldheim*, 12 Mont. B.R. at 277-78; *Hathaway*, 116 B.R. at 219.

Perkins cites several cases from other circuits in support of its argument that *de minimis* failures to disclose should not result in disqualification and disgorgement. While such cases are illustrative, they are not binding on this Court as are *Lewis* and *Park—Helena*. Neither are they consistent with this Court's long-standing rule from *Love* ²⁸. In *Park—Helena* the Ninth Circuit cited cases such as *EWC*, *Hathaway*, *Film Ventures*, *Saturley*, and *In re B.E.S. Concrete Prods.*, *Inc.*, which this Court cited in *Love*, and *Love* remains good law in this district. In any event, Perkins' failure to disclose the exceptions to Wells Fargo's and GECC's conflict of interest cannot be construed as a *de minimis* failure.

Having determined that Perkins violated the disclosure rules of Rule 2014(a) by failing to disclose the terms of Wells Fargo's exceptions from its conflicts waivers while filing a declaration with the Court that all potential conflicts have been identified and disclosed, that Perkins continues to review its connections and will notify the Court if any actual conflicts arise, this Court need not revisit its rule from *Love* that such a violation is enough to disqualify a professional, deny compensation and

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

order disgorgement of fees regardless of whether the undisclosed connections were materially adverse to the estate or *de minimis. Love,* 13 Mont. B.R. at 32–33, 163 B.R. at 168 (quoting *In re Fjeldheim,* 12 Mont. B.R. 267, 278 (Bankr.D.Mont.1993)); *EWC,* 138 B.R. at 280; *Hathaway,* 116 B.R. at 219–220.

The Court reiterates that it does not view Perkins' failure to disclose the exceptions of Wells Fargo's conflict waiver as *de minimis* by any definition. Wells Fargo was the largest creditor in this case under Chapter 11, and was the DIP lender without which Smith, McConnell, Hamstreet and MacIntyre all testified the Debtor would have to close its doors. By failing to disclose Wells Fargo's limitations to its conflict waiver, Perkins failed to disclose an actual conflict of interest with the largest creditor in the case involved in arguably the most important issue in the entire case, DIP financing. This undisclosed conflict of interest was not *de minimis*.

Neither in this Court's view was Perkins' failure to disclose excusable because the Debtor waived claims against Wells Fargo or the fallback position of using Dye for conflict matters. Section 327(c) provides that in a Chapter 11 case, "a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States *731 trustee, in which case the court *shall* disapprove such employment if there is an actual conflict of interest." This statutory language is not ambiguous. The Ninth Circuit provides the following guidance in statutory interpretation:

The first and most important step in construing a statute is the statutory language itself. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council,* 467 U.S. 837, 842–44, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). We look to the text of the statute to "determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case." *Robinson v. Shell Oil Co.,* 519 U.S. 337, 340, 117 S.Ct. 843, 136 L.Ed.2d 808 (1997). Our inquiry ceases if from the plain meaning of the statute congressional intent is unambiguous, and the statutory scheme is coherent and consistent. *Id.*

Eskanos & Adler, P.C. v. Leetien, 309 F.3d 1210, 1213 (9th Cir.2002).

[15] Courts must presume that a legislature says in a statute what it means and means in a statute what it says

there. Connecticut National Bank v. Germain, 503 U.S. 249, 253-54, 112 S.Ct. 1146, 1149, 117 L.Ed.2d 391 (1992); United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241–242, 109 S.Ct. 1026, 1030–31, 103 L.Ed.2d 290 (1989). Applying this guidance, the U.S. Trustee objects to Perkins' employment because of its failure to disclose the limitations of Wells Fargo's conflicts waiver. Ex. 1 shows that there is an actual conflict, which Smith and MacIntyre admitted existed and which was not waived in the case of litigation. Thus, the plain language of § 327(c) requires disapproval of Perkins' employment. This is not a case where the debtor sought to appoint counsel only as special counsel, for a specific matter, in which case there need only be no conflict between the debtor and counsel's creditor client with respect to the specific matter itself. See Stoumbos v. Kilimnik, 988 F.2d 949, 964 (9th Cir.1993), cert. denied, 510 U.S. 867, 114 S.Ct. 190, 126 L.Ed.2d 148 (1993).

[16] [17] Perkins argues that its experts Dye and Shulkin each testified that its disclosures in this case satisfied this Court's standard for practice. The determination of the weight to be given expert testimony or evidence is a matter within the discretion of the trier of fact—which in a bench trial like the instant is the bankruptcy court. Fox v. Dannenberg, 906 F.2d 1253, 1256 (8th Cir.1990); Arkwright Mutual Insurance Co. v. Gwinner Oil Inc., 125 F.3d 1176, 1183 (8th Cir.1997); Barry Russell, *Bankruptcy* Evidence Manual, 2000 Ed., § 702.2. Perkins cites Aguilar v. International Longshoremen's Union, 966 F.2d 443, 447 (9th Cir.1992) for the proposition that the Court, not the expert, decides the legal requirements for disclosure under Rule 2014. The Court agrees, and gives little probative weight to Dye's and Shulkin's expert testimony regarding this Court's requirements for disclosure under Rule 2014 because that is a matter for the Court ²⁹. Boerner relied on Dye's and Shulkin's opinion in forming his own opinion, so his opinion carries the same lack of probative weight.

As discussed above, the Court concludes that Perkins' disclosure failed to satisfy its long-standing standard for disclosure under Rule 2014(a) from Love. The fact that two "experts" testified that such a failure to disclose an actual unwaived conflict of interest with the largest creditor involved *732 in the most important issue in the case satisfied this Court's standard, gives the Court further reason to impose the full harsh penalties of disqualification of Perkins from employment, and denial and disgorgement of all fees.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

III. Case Management Order.

[18] The Court recognizes that this decision is a harsh result, and a hardship on Perkins. The Court deems it appropriate to temper its decision in one limited area. The Court's "Case Management Order" was entered on July 5, 2001 because of the number of creditors and to minimize the expense and delay. The Case Management Order made Perkins responsible for serving orders entered by the Court, and for processing and maintaining claims and interests registers, thereby relieving the Clerk of Court of a large part of the burden and expense incurred in this case. The Court views Perkins expenses incurred in complying with the Case Management Order as beneficial to creditors, the parties, the estate, and the Court, and concludes that it is appropriate to allow Perkins reimbursement for its expenses incurred in complying with the Case Management Order ³⁰.

Perkins' Brief states that it has applied for reimbursement of \$215,765.77 in expenses and has received \$161,571.82, but there is no evidence in the record showing how much of those expenses were incurred by Perkins in complying with the Case Management Order. Neither is there any way for the Court to reliably estimate that proportion of expenses from the total expenses included in Perkins' three fee applications. Accordingly, Perkins will be given the opportunity to submit a request limited to such expenses incurred in complying with the Case Management Order, and the parties will have the opportunity to review and file responses.

CONCLUSIONS OF LAW

- 1. This Court has original and exclusive jurisdiction of this bankruptcy case pursuant to 28 U.S.C. § 1334(a).
- 2. The U.S. Trustee's Motion is a core proceeding under 28 U.S.C. § 157(b)(2).

- 3. Perkins failed to satisfy its duty under Rule 2014(a) to disclose all of its connections with creditors when it failed to disclose the limitations to Wells Fargo's waiver of conflicts in Ex. 1, while stating to the Court that it has disclosed all conflicts, continues to review its connections with creditors and will notify the Court of any actual conflicts of interest are discovered.
- 4. The Court concludes that it is an appropriate exercise of its discretion to grant the U.S. Trustee's "Motion to Disqualify Perkins Coie, Vacate Employment Order, and Disgorge and Disallow Fees", and to disqualify Perkins as Debtor's attorneys, vacate the Employment Order authorizing Perkins' employment by the Debtor, disallow all fees and costs incurred by Perkins in this case, and to order Perkins to disgorge all fees and costs received to date.
- 5. The Court deems it appropriate in the interests of justice and to alleviate hardship to allow Perkins the opportunity to submit an application for reimbursement of expenses incurred in complying with this Court's Case Management Order entered July 5, 2001.

IT IS ORDERED a separate Order and Judgment shall be entered in accordance *733 with the above granting the U.S. Trustee's "Motion to Disqualify Perkins Coie, Vacate Employment Order, and Disgorge and Disallow Fees" filed March 5, 2003; which shall provide that Perkins Coie will be disqualified from its employment by the Debtor and the Order authorizing the Debtor to employ Perkins Coie entered June 28, 2001, will be vacated, and ordering Perkins Coie to disgorge all compensation, fees and costs received from the Debtor during the pendency of this bankruptcy case., except to the allowance that may be provided to cover expenses and expenses incurred by Perkins Coie in complying with the Case Management Order.

All Citations

298 B.R. 703, 41 Bankr.Ct.Dec. 179

Footnotes

Hamstreet testified:

"[W]e lost an opportunity there, in that if you have enough time, you are in a better position to put your ducks in a row and get your counsel up to speed and negotiate.

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

But in this case we got a couple overadvances, and you know, the banks got a little latitude, but we already used that up and started bouncing payroll checks; there wasn't anything left.

So by the time we had to file bankruptcy, once the Jores finally realized it was over with, why by that time the board had an election and they know they were going to be removed unless they resigned so they resigned. And that's when the board appointed Jerry McConnell and myself." Tr. Hamstreet, p. 12.

- MacIntyre testified the total number of current or former Perkins' clients which showed up on the conflicts check was close to 90. Tr. MacIntyre, p. 70.
- 3 MacIntyre testified that Smith signed Ex. 1 because he has been employed by Perkins longer than MacIntyre, and it "felt more natural" for Smith to talk to Wells Fargo and obtain the waivers. Tr. MacIntyre, p. 25.
- 4 Perkins received Ex. 1 back from Manookin most likely June 18, 2001. Tr. Smith, p. 107.
- Perkins does agree that its personnel providing services to Jore in matters adverse to GECC will not be among those concurrently providing services to GECC.
- GECC had the potential to be a DIP lender or somehow fund a buyout early in the case, but those hopes faded. Tr. MacIntyre, pp. 30–31.
- 7 Ex. 11 and 12 are letters from Perkins to McConnell and Northwest Capital Appreciation, Inc. ("NCAI") addressing similar conflict of interest issues and McConnell's consent.
- 8 In all, Perkins states that it identified Wells Fargo and 89 other current or former clients that presented potential conflict issues. Perkins' Brief, p. 6.
- The next question put to Smith was: "Is that the Court's burden?"; to which Smith replied: "It calls for a legal conclusion, it's argumentative. I don't have to wait for my lawyer to give the legal objection. Neal, if you want to argue your case, please argue your case in front of the Judge, not in front of me." Tr. Smith pp. 82–83.
- 10 Perkins' employment had been conditionally approved by Order entered May 22, 2001.
- 11 The client is Northwest Capital Appreciation, Inc. ("NCAI"), which did not in the end purchase the Debtor's assets.
- Hamstreet was not familiar with restrictions against waiver of claims against a lender in DIP financing and cash collateral stipulations established in the United States Bankruptcy Court for the Western District of Washington, Ex. 15 ("General Order No. 2"—"Guidelines for Cash Collateral and Financing Stipulations"). Tr. Hamstreet, pp. 28–30. The General Order from the Western District of Washington, Ex. 15, does not apply in this Court.
- 13 Fain replaced Guthals as attorney for secured creditor American Equipment Leasing. Ex. A, Guthals Affidavit.
- A "financial buyer" is a buyer that is not in the business of the prospective seller, or "target"; while a "strategic buyer" is in the same or a closely-related business and therefore more familiar with the business and how to integrate it into its own business. Tr. Smith, p. 45.
- MacIntyre testified that Hamstreet valued the company at \$80 million prior to the September 11 terrorist attack, but that the resulting economic downturn changed the way companies such as the Debtor were valued to the point where Pentair's first offer was for \$40 million. Tr. MacIntyre, pp. 60–61. Pentair's second offer was \$26 million cash. Tr. MacIntyre, pp. 61–62.
- 16 The April 2, 2002, hearings were deemed preliminary hearings for which final hearings were set for April 15, 2002.
- MacIntyre further testified that Perkins was adverse to Wells Fargo with respect to the employment of Glass & Associates, although that was resolved prior to hearing. "So there were a number off [sic] issues, both in court and out of court, where we were adverse, and negotiating, or I suppose you can call it 'litigating', throughout the case." Tr. MacIntyre, p. 34.
- Clark states that the Debtor has no officers or employees and that Perkins is making the litigation decisions. However, McConnell testified that he remains an officer and director of the Debtor, although all employees resigned. Ex. D, McConnell, pp. 7–10, 14.
- 19 Tr. MacIntyre, p. 69.
- Adversary No. 02–00102 was dismissed without prejudice on June 30, 2003, upon motion of the Chapter 7 Trustee. The Trustee filed a report on May 23, 2003, stating that the probable recoveries in the adversary proceeding did not, in his opinion after investigation, justify the expenditures and that other adversary proceedings would address the Final DIP Financing Order.
- 21 Guthals testified that American Equipment Leasing was acquired by CitiCapital, and thereafter ceased to exist. That evidence is uncontroverted by Dye.
- A debtor in possession has rights, powers and duties of a trustee pursuant to 11 U.S.C. § 1107(a). Section 1107(b) provides that notwithstanding § 327(a), a person is not disqualified for employment under § 327 by a debtor in possession "solely because of such person's employment by or representation of a debtor before the commencement of the case."

In re Jore Corp., 298 B.R. 703 (2003)

41 Bankr.Ct.Dec. 179

- 23 C.R. Bowles Jr., "Straight & Narrow: Fighting Nazgul, Trolls and Ores is Easy; Disclosing Under Rule 2104 is Hard", ABI Journal, Apr. 2003, at 62.
- Even the district court in *Enron* wrote that "Rule 2014 disclosures are to be strictly construed and failure to disclose relevant connections is an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case." *In re Enron Corp.*, 2003 WL 223455, *4 (S.D.N.Y.); *In re The Leslie Fay Co., Inc.*, 175 B.R. 525, 533 (Bankr.S.D.N.Y.1994).
- Smith testified that neither side believed that the litigation exception encompassed adverse matters in the bankruptcy. In Ex. 3, Wells Fargo's attorney Clark called Smith's contention that the carve-out and § 506(c) surcharge were covered by the waiver in Ex. 1 "incredulous". Wells Fargo's position on the no litigation exception to its conflicts waiver was that Perkins would not sue Wells Fargo on behalf of Jore "Period". Ex. 3. Shulkin and MacIntyre testified that everything in a bankruptcy proceeding is "litigation". Ex. 14, p. 3; Tr. MacIntyre, p. 34. But Clark even questioned the distinterestedness of Perkins in opposing bidding by Western Mortgage. Ex. 3. Jarvis and Boerner agreed that it was Wells Fargo's right whether to assert the no litigation to its conflicts waiver, but clearly Perkins and Wells Fargo did not agree on what encompassed "litigation" in Ex. 1, which made it all the more reason for Perkins to disclose Wells Fargo's exception to its conflict waiver under Rule 2014.
- That waiver was based upon the Final DIP Financing Order, which Perkins later sought to avoid to pursue its carveout and 506(c) surcharge claims against Wells Fargo notwithstanding similar waivers the Final DIP Financing Order. Ex. 3, 4, 5, 6, 7.
- 27 If lack of impact on the estate or a fallback position are to be accepted as exceptions from the Rule 2014(a) disclosure requirements, then those are matters to be addressed by Congress or the drafters of the Federal Rules of Bankruptcy Procedure. Likewise, if the effect of Rule 2014(a) as presently written is to discourage large firms from undertaking representation of debtors, as Perkins contends, that also is a matter to be addressed by Congress if it deems it necessary or appropriate.
- This Court's decision in *Love* was appealed to the BAP, but the appeal was dismissed by stipulation of the parties on March 7, 1994.
- 29 From the result in this case, Guthals' expert testimony comes much closer to describing the applicable standard discussed in *Love* requiring continuing, complete disclosure of limitations to a waiver of conflicts.
- 30 Such reimbursement would not include any attorney's fees or lodging, meals, airfare or other travel expenses incurred by Perkins. Rather it would only consist of postage, copy costs, and some telephone and facsimile expenses directly related to complying with the Case Management Order.

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In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr. Ct. Dec. 62, Bankr. L. Rep. P 78,744

KeyCite Yellow Flag - Negative Treatment
Disagreed With by In re Triple Star Welding, Inc., 9th Cir.BAP (Ariz.),
April 28, 2005

304 F.3d 246 United States Court of Appeals, Third Circuit.

In re: PILLOWTEX, INC.
Patricia A. Staiano, the United
States Trustee, Appellant

No. 01-2775. | Argued June 10, 2002. | Filed: Sept. 23, 2002.

United States trustee objected to retention of particular law firm as counsel for Chapter 11 debtor. The bankruptcy court approved debtor's application. Trustee appealed. The United States District Court for the District of Delaware, Sue L. Robinson, Chief Judge, authorized law firm's retention. Trustee appealed. The Court of Appeals, Sloviter, Circuit Judge, held that bankruptcy court abused its discretion in retention of particular law firm as counsel for debtor.

Reversed and remanded.

West Headnotes (5)

[1] Bankruptcy

Moot Questions

Confirmation of Chapter 11 debtor's plan of reorganization did not moot appeal of United States Trustee who objected to retention of particular law firm as counsel for debtor on basis that law firm's receipt of funds from debtor within preference period may have been preferential transfer. Bankr.Code, 11 U.S.C.A. §§ 327(a), 547(b).

7 Cases that cite this headnote

[2] Bankruptcy

Discretion

The Court of Appeals reviews for abuse of discretion a bankruptcy court's decision to approve an application for employment.

10 Cases that cite this headnote

[3] Attorney and Client

Bankruptcy

Bankruptcy court abused its discretion in approving retention of particular law firm as counsel for Chapter 11 debtor, where law firm's receipt of funds from debtor within preference period may have been preferential transfer, even though law firm agreed to return any preference if it was determined to have received one and waive any claim resulting from preference. Bankr. Code, 11 U.S.C.A. §§ 327(a), 550, 547(b).

19 Cases that cite this headnote

[4] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Although a bankruptcy court enjoys considerable discretion in evaluating whether professionals suffer from conflicts, that discretion is not limitless; a bankruptcy court does not enjoy the discretion to bypass the requirements of the Bankruptcy Code. Bankr.code, 11 U.S.C.A. § 327.

12 Cases that cite this headnote

[5] Attorney and Client

Bankruptcy

In the context of retention of a professional, when there has been a facially plausible claim of a substantial preference, a bankruptcy court cannot avoid the clear mandate of the statute by the mere expedient of approving retention conditional on a later determination of the preference issue. Bankr.Code, 11 U.S.C.A. §§ 327(a), 547(b).

12 Cases that cite this headnote

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

Attorneys and Law Firms

*247 Robert D. McCallum, Jr., Assistant Attorney General, Joseph A. Guzinski, Acting General Counsel, P. Matthew Sutko, Attorney, Office of General Counsel, Anne Murphy (Argued), William Kanter, United States Department of Justice, Washington, DC, for Appellant.

Eric D. Schwartz, William H. Sudell, Jr., Morris, Nichols, Arsht & Tunnell, Wilmington, Fordham E. Huffman (Argued), David G. Heiman, Jones, Day, Reavis & Pogue, Columbus, OH, Gregory M. Gordon, Daniel P. Winikka, Jones, Day, Reavis & Pogue, Dallas, TX, for Appellees In re: Pillowtex, Inc. and its Affiliated Debtors.

John D. McLaughlin, Jr., Pauline K. Morgan, Young, Conaway, Stargatt & Taylor, Wilmington, DE, Fred S. Hodara (Argued), Akin, Gump, Strauss, Hauer & Feld, New York, NY, for Appellee Official Committee of Unsecured Creditors.

Before SLOVITER, ROTH and McKEE, Circuit Judges.

OPINION OF THE COURT

SLOVITER, Circuit Judge.

The U.S. Trustee appeals from the District Court's order authorizing the retention of Jones, Day, Reavis and Pogue ("Jones Day") as Pillowtex, Inc.'s Chapter 11 bankruptcy counsel. The U.S. Trustee argues that payments of fees by Pillowtex to Jones Day within the 90 days before bankruptcy may have constituted an avoidable preference and that the receipt of such a preference by Jones Day would constitute a conflict of interest with Pillowtex's creditors and its bankruptcy estate. The U.S. Trustee maintains that because the Bankruptcy Code provides that debtor's counsel may not "hold or represent an interest adverse to the estate" or "an interest materially adverse to the interest of ... any class of creditors," Jones Day may have been disqualified from serving as Pillowtex's bankruptcy counsel. Without ruling on the U.S. Trustee's preference allegation, the District Court approved Jones *248 Day's retention on condition, proposed by Jones Day, that if Jones Day is determined to have received a preference, it return the amount of the preference to Pillowtex's bankruptcy estates and waive any resulting claim. On appeal, the U.S. Trustee argues that the District Court erred in authorizing Jones Day's retention as counsel without making a determination whether Jones Day received a preference and asks this court to remand and direct the District Court to make such a determination promptly.

I.

FACTS AND PROCEDURAL POSTURE

Pillowtex Corporation and its subsidiaries (referred to collectively as Pillowtex) manufacture pillows, blankets, towels and other textiles. Jones Day has represented and advised Pillowtex since 1996 in a variety of matters, including corporate, financial, securities, real property, litigation, environmental, intellectual property, labor, employee benefits and tax affairs. Prior to filing its bankruptcy petition, Pillowtex retained Jones Day to assist it with contingency planning and bankruptcy preparation.

Pillowtex declared bankruptcy on November 14, 2000 by filing a petition under Chapter 11 of the Bankruptcy Code. At the time of filing, Pillowtex had approximately \$1,000,000,000 in trade debt, about \$750,000,000 in senior secured debt, and roughly \$400,000,000 in subordinated debt. For fiscal year 1999, Pillowtex's gross revenues exceeded \$1,500,000,000, and as of July 1, 2000 its assets were valued at approximately \$1,700,000,000.

On November 16, 2000, Pillowtex filed an application with the Bankruptcy Court to retain and employ Jones Day as its bankruptcy counsel pursuant to section 327 of the Bankruptcy Code. Pillowtex also applied to retain other professionals to assist it in its restructuring, including KPMG LLP (KPMG) as an independent auditor and consultant. As part of Jones Day's retention application, Jones Day set forth the date and amount of each payment that Pillowtex made to the firm during the year immediately preceding the filing for bankruptcy. The disclosure by Jones Day showed that Pillowtex made the following payments to Jones Day for services rendered:

11/29/99 \$ 203,520.69 12/27/99 450,573.79

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

12/30/99	155,912.06	
2/23/00	181,550.01	
3/31/00	67,482.73	
4/30/00	146,520.71	
6/30/00 ¹	180,585.22	
7/7/00	132,299.71	
9/11/00	78,652.94	
11/3/00	40,759.09	
11/10/00	778,157.33	
11/13/00	300,000.00	(retainer-approx. \$100,000 toward prepetition fees)

The last payment listed, that on November 13, 2000, was made the day before Pillowtex filed its petition for bankruptcy and was a retainer of \$300,000 for services rendered or to be rendered by Jones Day and for reimbursement of expenses. Including *249 the applied portion of the retainer, Pillowtex paid Jones Day \$2,516,014 in the year before it declared bankruptcy. Of those payments \$997,569.36 were made in the ninety days before Pillowtex filed its petition for bankruptcy.

The U.S. Trustee³ filed an objection to the application by Jones Day and KPMG for retention, arguing that both KPMG and Jones Day had received payments which constituted voidable preferences under section 547 of the Bankruptcy Code. According to the U.S. Trustee, Jones Day "received payments before the filing of the petition which were voidable as preferences.... As a result of these payments, Jones Day is not a disinterested person and cannot be retained to represent the debtors in possession [Pillowtex]." App. at 125. Eventually, the U.S. Trustee withdrew his objection to KPMG's retention pursuant to stipulation, but continues to press its objection as to Jones Day and requested a hearing.

Before the District Court, Jones Day argued that Pillowtex's payments to it "were substantially within the historical pattern of payments between Jones Day and the Debtors, which included wide swings in the timing of payments." App. at 133. Jones Day opposed the requested

hearing, arguing that it was "not necessary or appropriate for the Debtors' estates to incur the time and expense of litigating the preference issue." App. at 133. It proposed instead that "if a preference action against the firm is initiated and a final order is entered determining that Jones Day in fact received a preference, Jones Day will return to the Debtors' estates the full amount of the preferential payment and waive any related claim." App. at 133. Jones Day noted that "the U.S. Trustee has previously adopted" the same approach "with respect to Debtors' accountants," KMPG, but "[i]nexplicably, the U.S. Trustee will not agree to this resolution with Jones Day." App. at 133.

The District Court did not definitively determine whether Jones Day had received a preference from Pillowtex. Instead, the court adopted Jones Day's suggestion that it authorize the firm's retention on condition that if Jones Day was determined to have received preferential transfers, "Jones Day shall promptly return the same to [Pillowtex's] estate[] and waive any unsecured claim it has by virtue thereof." App. at 3. According to the District Court, "Subject to the provisions of this Order, Jones Day does not hold or represent any interest adverse to the Debtors' estates and is a 'disinterested person,' as defined in section 101(14) of the Bankruptcy Code and as required by section 327(a) of the Bankruptcy Code." App. at 2. The U.S. Trustee timely filed this appeal of the retention order.

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

The bankruptcy proceeding continued while this appeal proceeded. In the interim, no party has brought a preference action against Jones Day. The District Court ultimately confirmed Pillowtex's Second Amended Joint Plan of Reorganization by an order entered May 2, 2002. At oral argument before this court, Fred Hodara, an attorney for the Official Committee of Unsecured Creditors of Pillowtex which joined in Pillowtex's brief on appeal, agreed with the U.S. Trustee that under Pillowtex's confirmed plan of reorganization the unsecured creditors only receive pennies on the dollar for their claims.

*250 II.

JURISDICTION AND STANDARD OF REVIEW

[1] This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). The District Court exercised jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. That court's determination of Pillowtex's application for retention of counsel is a final order, see, e.g., United States Trustee v. First Jersey Secs., Inc. (In re First Jersey Secs., Inc.), 180 F.3d 504, 508 (3d Cir.1999), which this court has jurisdiction to review pursuant to 28 U.S.C. § 1291, see, e.g., In re Marvel Entm't Group, Inc., 140 F.3d 463, 470-71 (3d Cir.1998). The confirmation of Pillowtex's plan of reorganization does not moot this appeal. See, e.g., Citicorp Venture Capital Ltd. v. Committee of Unsecured Creditors, 160 F.3d 982, 986 (3d Cir.1998) (exercising jurisdiction over appeal despite confirmation of a Chapter 11 plan); Michel v. Federated Department Stores, Inc. (In re Federated Department Stores, Inc.), 44 F.3d 1310, 1315-17 (6th Cir.1995) (holding appeal not moot despite confirmation of plan because bankruptcy court had power on remand to deny pending fee requests and order disgorgement of previously awarded fees).

The U.S. Trustee has standing to appeal the retention order. The U.S. Trustee has statutory responsibility to monitor applications for retention of professional persons in bankruptcy cases, and, "whenever the United States trustee deems it appropriate, [to file] with the court comments with respect to the approval of such applications." 28 U.S.C. § 586(a)(3)(H). The relevant statute addresses the U.S. Trustee's standing by explicitly providing that "[t]he United States trustee may raise and may appear and be heard on any issue in any case or proceeding under this title." 11 U.S.C. § 307. See also

United States Trustee v. Price Waterhouse, 19 F.3d 138, 141 (3d Cir.1994).

Although Jones Day argues that it is significant that none of the parties in interest to the bankruptcy objected to its retention as counsel, the House Report to the legislation expanding and implementing the U.S. Trustee program on a national scale, embodied in 11 U.S.C. § 307, expressly puts the U.S. Trustee on the level of a party, as it states: "The U.S. Trustee is given the same right to be heard as a party in interest, but retains discretion to decide when a matter of concern to the proper administration of the bankruptcy laws should be raised." H.R.Rep. No. 764, 99th Cong., 2d Sess. 27 (1986), reprinted in 1986 U.S.C.C.A.N. 5227, 5240. See also In re Columbia Gas Sys. Inc., 33 F.3d 294, 296 (3d Cir.1994). Accordingly, we proceed to consider the issues presented.

III.

DISCUSSION

[2] We review a bankruptcy court's decision to approve an application for employment for abuse of discretion. See In re Marvel Ent'mt Group, Inc., 140 F.3d 463, 470 (3d Cir.1998) ("An abuse of discretion exists where the district court's decision rests upon a clearly erroneous finding of fact, an errant conclusion of law or an improper application of law to fact.") (quoting ACLU v. Black Horse Pike Reg'l Bd. of Educ., 84 F.3d 1471, 1476 (3d Cir.1996)).

A debtor in possession, such as Pillowtex, may, with bankruptcy court approval, employ one or more attorneys to represent it and to assist it in fulfilling its duties. See 11 U.S.C. § 327(a). The attorneys selected may not be persons who "hold or represent an interest adverse to the estate," and must be "disinterested persons." Id. The Bankruptcy Code includes as a "disinterested person," someone who "does *251 not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor ..., or for any other reason." 11 U.S.C. § 101(14)(E). Prior representation of the debtor does not, of itself, merit disqualification. See 11 U.S.C. § 1107(b) ("[A] person is not disqualified for employment under section 327 of this title by a debtor in possession solely because

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

of such person's employment by or representation of the debtor before the commencement of the case.").

We have considered the statutory requirements for retention of counsel in several opinions. In In re BH&P, Inc., 949 F.2d 1300 (3d Cir.1991), the bankruptcy court had disqualified counsel after finding that the law firm had an actual conflict of interest by representing both the trustee for the debtor in its chapter 7 proceeding and the two principals of the debtor who had also filed chapter 7 proceedings. In affirming the disqualification of counsel (as well as the trustee), we stated that a conflict is actual, and hence per se disqualifying, if it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest. See id. at 1315. We noted that, "[t]he term 'actual conflict of interest' is not defined in the Code and has been given meaning largely through a case-by-case evaluation of particular situations arising in the bankruptcy context."

We again considered the standards applicable to retention of trustee's counsel in *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463 (3d Cir.1998). Because the parties urged "conflicting interpretations of *BH&P*, we expressly reiterat[ed]" our earlier holding that:

(1) Section 327(a), as well as § 327(c), imposes a per se disqualification as trustee's counsel of any attorney who has an *actual conflict of interest*; (2) the district court may within its discretion-pursuant to § 327(a) and consistent with § 327(c)-disqualify an attorney who has a *potential conflict of interest* and (3) the district court may not disqualify an attorney on the *appearance of conflict* alone.

Id. at 476 (emphases added). In *Marvel Entertainment*, we reversed the district court's disqualification of the trustee and trustee's counsel because it was predicated only on the appearance of a conflict. We held that under section 327(a) the district court could disqualify counsel "only if it had an actual or potential conflict of interest." *Id.* at 477.

Although the retention of counsel for the trustee was at issue in both *BH&P* and *Marvel Entertainment*, the same standards apply to the retention of counsel for the debtor in possession. *See* 11 U.S.C. § 1107(a) ("Subject to

any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a) (2), (3), and (4) of this title, of a trustee serving in a case under this chapter.").

In In re First Jersey Securities, Inc., 180 F.3d 504 (3d Cir.1999), the U.S. Trustee objected to retention of the counsel proposed by the debtor in possession on the ground that counsel had received a preferential payment, constituting an interest adverse to the estate. Notwithstanding that both the bankruptcy court and the district court had approved counsel's *252 retention, this court reversed. We stated that "[w]here there is an actual conflict of interest ... disqualification is mandatory." Id. at 509 (citing In re Marvel Entertainment, 140 F.3d at 476). Then, in language that the U.S. Trustee here emphasizes, we stated that "[a] preferential transfer to [debtor's counsel] would constitute an actual conflict of interest between counsel and the debtor, and would require the firm's disqualification." 180 F.3d at 509 (emphasis in original).

We held that counsel was disqualified because within 90 days of the filing for bankruptcy it had received from the debtor stock in payment of a bill of \$250,000 in settlement for antecedent legal work. Counsel had argued that the stock payment was made in the ordinary course of business and therefore not subject to avoidance, but we rejected that contention because payment of fees in unregistered restricted securities was a method of payment inconsistent with the parties' prior course of dealings. See id. at 513. The U.S. Trustee relies on the authority of First Jersey Securities in pointing to Pillowtex's payment of substantial fees to Jones Day as a possible preference.

[3] In this case, the District Court never decided whether Jones Day received an avoidable preference from Pillowtex when it accelerated billing for and received payment for past due bills during the ninety days before Pillowtex declared bankruptcy. An avoidable preference is defined in section 547(b) of the Bankruptcy Code as

any transfer of an interest of the debtor in property-(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr. Ct. Dec. 62, Bankr. L. Rep. P 78,744

by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made-(A) on or within 90 days before the date of the filing of the petition; ... (5) that enables such creditor to receive more than such creditor would receive [in a Chapter 7 distribution].

11 U.S.C. § 547(b).

The preference rule prevents debtors from depleting the estate to pay favored creditors with assets that otherwise would have been apportioned among creditors according to the prioritization scheme of the Bankruptcy Code. See, e.g., George M. Treister et al., Fundamentals of Bankruptcy Law § 4.03(c), at 169 (noting that § 547 "is designed to achieve the policy of fostering equality of distribution among the creditors of an insolvent debtor"). When the debtor becomes insolvent, a payment to one creditor from the estate's limited assets is necessarily paid at the expense of another creditor. The receipt of a preference by a creditor thus creates a conflict with unpaid creditors, whose share of the remaining assets is diminished by the payment. ⁴

*253 In this court, Jones Day explained that it sought payment from Pillowtex of its outstanding bills in order that it would not be a creditor at the time of the bankruptcy, as that would have disqualified it from retention as counsel. 5 The record does not show how much of the fee Jones Day received within the 90 days before bankruptcy was for bankruptcy preparation, how much was for legal work done years earlier, and what the ordinary practice was in Jones Day's billings to Pillowtex and Pillowtex's payments. Jones Day did not make a proffer of such information. Instead, it argued merely that a hearing was expensive and unnecessary, and proposed that the court could avoid any possible conflict by authorizing retention of Jones Day subject to the conditions that (1) Jones Day return any preference it is determined to have received, and (2) Jones Day waive any claim resulting from the preference.

We agree with the U.S. Trustee that the court's order incorporating the two conditions does not resolve the question whether Jones Day received an avoidable preference and was therefore not disinterested and whether it should have been disqualified. If payments to

Jones Day were determined to be preferences, Jones Day would, in any event, be obliged to return the funds to the estate. *See* 11 U.S.C. § 550 ("[T]o the extent a transfer is avoided under section ... 547 ... of this title, the trustee may recover, for the benefit of the estate, the property transferred, or ... the value of such property.").

Nor does its undertaking to waive the claims resulting from the preference resolve the issue of its possible disqualification if the fee payment was an avoidable preference. Jones Day cites a series of cases to illustrate that a professional can eliminate an adverse interest by waiving any claim it has against the estate, but it is not in the same position as the professionals in these cases. *See, e.g., In re Princeton Medical Mgmt., Inc.,* 249 B.R. 813, 816 (Bkrtcy.M.D.Fla.2000); *In re Fulgham Enters., Inc.,* 181 B.R. 139, 142 (Bkrtcy.N.D.Ala.1995); *In re E. Charter Tours, Inc.,* 167 B.R. 995, 996 (Bkrtcy.M.D.Ga.1994); *In re Adam Furniture Indus., Inc.,* 158 B.R. 291, 297 (Bkrtcy.S.D.Ga.1993); *In re Watervliet Paper Co., Inc.,* 96 B.R. 768, 774 (Bkrtcy.W.D.Mich.1989).

In each of the cited cases, the professional waived its fees prior to being approved for retention under section 327(a). See, e.g., Princeton, 249 B.R. at 816 (noting requirement that retention be denied absent waiver); Fulgham, 181 B.R. at 142 ("Unless Mr. Beck waives his prepetition claim he may not be employed by the Debtor"); Charter, 167 B.R. at 998 (denying retention absent waiver); Adam, 158 B.R. at 297 (approving law firm's retainers in light of waiver); Watervliet, 96 B.R. at 774 (permitting retention as debtor's counsel upon waiver). Here, Jones Day has not actually waived any fees as there has been no determination that there was a preference and its amount, but Jones Day was retained nonetheless.

Jones Day points to the decision in *In re Midland Food Servs.*, *LLC*, No. 00-4036 (Bankr.D.Del. Dec. 14, 2000) (oral order granting retention), where a bankruptcy court, despite a creditor's claim that the proposed counsel had been paid a preference, granted a retention petition by debtor's *254 counsel based on a conditional waiver similar to that approved in the District Court's order in this case. The bankruptcy court permitted retention based on the court's conclusion that a conflict was only potential until the preference was definitively adjudicated. App. at 186, 189-90. That decision was not appealed to this court and appears to be inconsistent with the decision we reach today.

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr. Ct. Dec. 62, Bankr. L. Rep. P 78,744

At the heart of the U.S. Trustee's objection to retention of Jones Day as counsel before the preference issue was decided is the improbability that Jones Day, as counsel to the debtor-in-possession, would bring an action against itself to recover any preference. As the U.S. Trustee states in its brief, "[b]ecause Jones Day has taken and retained payments that may be preferential and it 'will not be advising the Debtors to seek to recover payments made to Jones Day' ... the conflict of interests, if any, has been in place since Jones Day's retention was approved and is an actual conflict of interest today." Appellant's Reply Br. at 6-7.

Jones Day responds that there are other creditors who could raise the preference issue, if it is a matter of concern. However, the relationship between a debtor and its creditors is not always adversarial. ⁶ In such a situation, the U.S. Trustee can play an important role in assuring adherence to the requirements of the Bankruptcy Code.

Of course, Jones Day does not concede that it received a preference. It argues that the \$997,569.36 it received within the 90-day period was in the ordinary course of business, and therefore not an avoidable preference under section 547(c)(2). Moreover, it argues that any conflict created by that preference was not material, and notes that, "once a court concludes the debtor paid a preference to a professional, it must evaluate whether the preference creates an 'interest materially adverse to the interest of ... any class of creditors.' " § 101(14)(E). See note 4, supra. According to Jones Day, given the uncertainty over whether it was paid a preference, let alone a preference constituting a materially adverse interest to other creditors, the District Court was well within its discretion to order its retention.

It is true that "historically, bankruptcy courts have been accorded wide discretion in connection with ... the terms and conditions of the employment of professionals." Appellee's Br. at 10 (quoting *BH&P*, 949 F.2d at 1316). Jones Day argues that therefore a court sitting in bankruptcy also enjoys considerable discretion in determining how to address an allegation of a conflict of interest.

[4] Although a bankruptcy court enjoys considerable discretion in evaluating whether professionals suffer from conflicts, that discretion is not limitless. A bankruptcy

court does not enjoy the discretion to bypass the requirements of the Bankruptcy Code. For example, we held in *United States Trustee v. Price Waterhouse*, 19 F.3d 138 (3d Cir.1994), that, based on the language of the Code, a bankruptcy court that approves the retention of a prepetition creditor of the estate necessarily abuses its discretion. *Id.* at 141 ("These provisions [of the Bankruptcy Code], taken together, unambiguously forbid a debtor in possession from retaining a prepetition creditor to assist it in the execution of its Title 11 duties.").

At the oral argument, Jones Day contended that all bankruptcy lawyers find themselves with past due bills from putative *255 debtors on the eve of bankruptcy and seek to clear the accounts so that they are qualified to serve as counsel for the debtor. It suggested that if this court were to hold that such payments may be avoidable preferences which must be determined before retention can be approved, we will disrupt the already hectic period after bankruptcy filing when the bankruptcy court is occupied with first day orders and the parties are meeting to form creditors committees. We believe that some accommodation can undoubtedly be made between the need of counsel for payment of appropriate fees and the explicit provisions of the Code. The U.S. Trustee agrees that counsel are entitled to receive fees for the bankruptcy preparation, although we reserve the issue how this can be done consistently with the provisions of the Code. The U.S. Trustee maintained before the District Court that "professionals entering bankruptcy cases protect themselves from the preference issue by obtaining a retainer, and they ... draw down on the retainer during the 90 day period so as to avoid raising the issue of whether or not they received preferential payments." App. at 207. It also argues that many preference claims may be insubstantial and that bankruptcy counsel typically waive past fees due. The U.S. Trustee focuses on Jones Day's receipt of payments for past bills which enabled it to receive 100% of all past due bills rather than waiving those for earlier work. It argues that "[playing hundreds of thousands of dollars of accrued fees on the eve of bankruptcy was not typical." Appellant's Br. at 18-19.

The record does not show which view is accurate. The parties may choose to present evidence at the hearing on remand that would permit the District Court to make a finding of fact on the matter.

In re Pillowtex, Inc., 304 F.3d 246 (2002)

40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

[5] Because there has never been a judicial determination whether Jones Day received a preference, it is unclear at this time whether the preference, if there were one, presents a conflict which would require Jones Day's disqualification. We hold that when there has been a facially plausible claim of a substantial preference, the district court and/or the bankruptcy court cannot avoid the clear mandate of the statute by the mere expedient of approving retention conditional on a later determination of the preference issue.

The District Court in this case could not adequately evaluate the alleged conflict and was not in a position

to conclude that any preference did not pose a conflict with Pillowtex's estate or a material conflict with the other creditors. We therefore agree with the U.S. Trustee that the District Court must hold a hearing on whether Pillowtex received a preference, and will remand for that purpose. ⁷

All Citations

304 F.3d 246, 40 Bankr.Ct.Dec. 62, Bankr. L. Rep. P 78,744

Footnotes

- 1 In the Disclosure of Compensation that Jones Day filed as part of Pillowtex's retention application, Jones Day listed this payment as having been made on 6/30/99, but its placement in an otherwise chronological listing of payments suggests that date is a scrivener's error. In its brief, the U.S. Trustee lists the payment as having been made in the year 2000.
- Although Jones Day initially represented that it had applied \$100,000 of that retainer as payment of fees through November 13, 2000, it now explains that it inadvertently failed to transfer that sum from its trust account into a non-trust account as of that date.
- The reference is to the United States Trustee authorized to supervise the administration of bankruptcy cases in "[t]he judicial districts established for the States of Delaware, New Jersey, and Pennsylvania," 28 U.S.C. § 581(a)(3), also known as "Region 3."
- Section 327(a) sets forth two relevant standards for disqualification, one applicable to conflicts with the debtor's estate and one governing conflicts with other creditors. The first prohibits a professional from "hold[ing] or represent[ing] an interest adverse to the estate." 11 U.S.C. § 327(a). The second, contained in the definition of "disinterested person," requires that a professional be free of "an interest materially adverse to the interest of ... any class of creditors." 11 U.S.C. § 101(14)(E). Thus, a professional may not have *any* conflict with the estate, while a conflict with creditors must be "material."
 - It is unclear whether, as the U.S. Trustee argues, the receipt of a preference will always create a conflict with the debtor. "Preference law ... is not part of the arsenal of rights and remedies between a *debtor* and his *creditors* preference law focuses on relationships *among creditors* in light of the advantages of a collective proceeding, not on relationships *between creditors and the debtor*." Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725, 757 (1984) (emphasis in original). We reserve the U.S. Trustee's argument for future resolution.
- The Bankruptcy Code prohibits retention of a professional who is a prepetition creditor of the debtor. See 11 U.S.C. § 101(14)(A) (stating that a disinterested person "is not a creditor"); Price Waterhouse, 19 F.3d at 141. If Jones Day were determined to have received a preference, its resulting claim for fees would transform it into a prepetition creditor, which would pose a disqualifying conflict.
- See generally In the Matter of Arkansas Company, Inc., 798 F.2d 645, 649 (3d Cir.1986) (discussing conduct of some attorneys for creditors as one of bases for requirement of court approval of counsel for creditors committee).
- There was some confusion at oral argument about whether the U.S. Trustee has standing to pursue the preference action below. Although we leave the question to the District Court on remand in the first instance, we call to its attention our discussion in *U.S. Trustee v. Columbia Gas Sys. Inc.* (In re Columbia Gas Sys. Inc.), 33 F.3d 294 (3d Cir.1994), where we observed of section 307 of the Code, "[i]t is difficult to conceive of a statute that more clearly signifies Congress's intent to confer standing." Id. at 296.

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In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

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7. 2011

431 B.R. 363 United States Bankruptcy Court, S.D. New York,

In re PROJECT ORANGE ASSOCIATES, LLC, Debtor.

No. 10–12307(MG). | June 23, 2010.

Synopsis

Background: United States Trustee (UST) objected to Chapter 11 debtor's retention of law firm as general bankruptcy counsel, based on firm's representation in unrelated matters of debtor's largest unsecured creditor and essential supplier.

Holdings: The Bankruptcy Court, Martin Glenn, J., held that:

- [1] debtor's execution of stipulation with creditor did not resolve conflict of interest between creditor and law firm;
- [2] creditor's conflicts waiver did not permit law firm's employment under statute; and
- [3] debtor's use of conflicts counsel did not allow debtor's employment of firm as general bankruptcy counsel.

Objection sustained.

West Headnotes (13)

[1] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Professionals must be both disinterested and not hold or represent any interest adverse to the estate to be employed to represent estate under Bankruptcy Code. 11 U.S.C.A. § 327(a).

12 Cases that cite this headnote

[2] Attorney and Client

Bankruptcy

Prohibition on adverse interests under conflicts of interests test for estate's employment of professionals includes economic and personal interests of an attorney. 11 U.S.C.A. § 327(a).

6 Cases that cite this headnote

[3] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Conflicts of interests test for estate's employment of professionals is not retrospective; courts only examine present interests when determining whether a party has an adverse interest. 11 U.S.C.A. § 327(a).

6 Cases that cite this headnote

[4] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Generally, the adverse interest test for estate's employment of professionals is objective and excludes any interest or relationship, however slight, that would even faintly color the independence and impartial attitude required by the Bankruptcy Code and rules. 11 U.S.C.A. § 327(a).

3 Cases that cite this headnote

[5] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Courts determine existence of adverse interest precluding estate's employment of professional on a case-by-case basis, examining the specific facts in a case. 11 U.S.C.A. § 327(a).

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

2 Cases that cite this headnote

[6] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy courts may consider the interests of the estate and the debtor's creditors, accounting for the expeditious resolution of a case, when analyzing a retention motion. 11 U.S.C.A. § 327(a).

Cases that cite this headnote

[7] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Courts must take the requirements of statute governing estate's employment of professionals seriously, as they ensure that a professional fulfills his duties in accordance with his fiduciary duties to the estate. 11 U.S.C.A. § 327.

Cases that cite this headnote

[8] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy courts lack the power to authorize estate's employment of a professional who has a conflict of interest. 11 U.S.C.A. § 327.

Cases that cite this headnote

[9] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy Code requires disqualification of a professional from employment by estate following an objection from United States Trustee (UST) or a creditor where there is an actual conflict of interest. 11 U.S.C.A. § 327(c).

Cases that cite this headnote

[10] Bankruptcy

Employment of Professional Persons or Debtor's Officers

Bankruptcy statute governing estate's employment of professionals prevents disqualification based solely on professional's prior representation of or employment by a creditor, but does not obviate the essential requirement that a professional not have an interest adverse to estate. 11 U.S.C.A. § 327(c).

Cases that cite this headnote

[11] Attorney and Client

Bankruptcy

Chapter 11 debtor's execution of stipulation with creditor did not resolve disabling conflict of interest between creditor and law firm that debtor sought to retain as its general bankruptcy counsel where stipulation, by its terms, was not effective without court approval and adversity would still remain even if court approved stipulation, given requirement under parties' settlement that creditor repair turbine components before installing turbines at debtor's steam and electricity cogeneration facility, and given debtor's highly contentious statecourt litigation with its landlord; debtor and creditor remained completely adverse until repair and installation of turbines was complete, and landlord's success in establishing prepetition lease termination would leave debtor without assets to pay creditor. 11 U.S.C.A. § 327(a); Fed.Rules Bankr.Proc.Rule 9019, 11 U.S.C.A.

1 Cases that cite this headnote

[12] Attorney and Client

Bankruptcy

Conflicts waiver obtained from creditor by law firm that Chapter 11 debtor sought to retain as general bankruptcy counsel did not, by contractually permitting firm to represent debtor on some matters adverse to creditor, trump statutory requirements governing estate's employment of professionals and

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

severely limited firm's ability to act in debtor's best interests with regard to creditor, by barring law firm from bringing action and threatening to bring action against creditor or its affiliates for monetary damages or equitable relief, even within context of negotiations, and therefore waiver did not permit firm's employment under statute. 11 U.S.C.A. § 327(a).

3 Cases that cite this headnote

[13] Attorney and Client

Bankruptcy

Chapter 11 debtor's use of conflicts counsel did not allow debtor's employment, as general bankruptcy counsel, of law firm that had conflict of interest with creditor that was both debtor's largest creditor and central to debtor's reorganization, which hinged upon creditor's return and installation of turbines at debtor's steam and electricity cogeneration facility; given creditor's strong interests and active stance in case, addressing issues with creditor would take considerable time and skill on range of matters. 11 U.S.C.A. § 327(a).

4 Cases that cite this headnote

Attorneys and Law Firms

*365 Diana G. Adams, by Elisabetta G. Gasparini, Esq., New York, NY, United States Trustee for Region 2.

DLA Piper LLP (US), by Timothy W. Walsh, Esq., Christopher R. Thompson, Esq., New York, NY, Proposed Attorneys for the Debtor and Debtor in Possession.

MEMORANDUM OPINION AND ORDER
SUSTAINING THE UNITED STATES TRUSTEE'S
OBJECTION TO DEBTOR'S APPLICATION
FOR AN ORDER AUTHORIZING THE
EMPLOYMENT AND RETENTION OF
DLA PIPER LLP (US) AS COUNSEL NUNC
PRO TUNC TO THE PETITION DATE

MARTIN GLENN, Bankruptcy Judge.

This opinion addresses an important issue whether the use of conflicts counsel to deal with the debtor's largest unsecured creditor and essential supplier is sufficient to permit court approval under section 327(a) of the Bankruptcy Code of a debtor's choice for general bankruptcy counsel that also represents that creditor in unrelated matters. Project Orange Associates, LLC ("Project Orange" or "Debtor") seeks to retain DLA Piper LLP (US) ("DLA Piper") as general bankruptcy counsel pursuant to section 327(a) of the Bankruptcy Code. The United States Trustee ("U.S. Trustee") objects, arguing that DLA Piper's representation of certain General Electric ("GE") entities, as well as inadequate disclosure about DLA Piper's relationship with other creditors, requires the Court to deny DLA Piper's employment application. GE is the Debtor's largest *366 unsecured creditor. Perhaps more importantly, the Debtor has acknowledged that resolving all past and future issues with GE—the supplier of gas turbines to Debtor's operations —is essential to the Debtor's successful reorganization. DLA Piper argues that it does not have a disqualifying conflict with GE, and that, in any event, the Debtor's use of conflicts counsel to deal with certain aspects of the Debtor's relationship with GE, is sufficient to avoid DLA Piper's conflict and to permit its retention as general bankruptcy counsel. For the following reasons, the Court agrees with the U.S. Trustee and denies DLA Piper's employment application.

I. BACKGROUND

The Debtor filed for chapter 11 protection in this Court on April 29, 2010. On May 20, 2010, DLA Piper filed its employment application (the "DLA Employment Application"). (ECF # 58.) The U.S. Trustee filed its objection on May 27, 2010 (the "U.S. Trustee's Obj."). (ECF # 68.) The Court heard argument on the DLA Employment Application on June 7, 2010. Following the hearing, DLA Piper requested permission to file a supplemental brief in support of the DLA Employment Application. (ECF # 95.) The Court granted the request, permitting both DLA Piper and the U.S. Trustee to file supplemental briefs. (ECF # 96.)

The Debtor has retained ownership and continues to operate a steam and electricity cogeneration facility

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

(the "Facility") in Syracuse, New York. (Affidavit of Adam Victor Pursuant to Rule 1007-2 of the Local Bankruptcy Rules ("Victor Local Rule 1007–2 Aff.") at \P 5–7 (ECF # 4).) The Debtor attributes its current financial predicament to the deregulation of the New York State energy market, ongoing litigation with Syracuse University (where the cogeneration facility is located pursuant to a lease and other agreements), and maintenance issues with two electric turbines (the "Turbines") manufactured and, until recently, maintained by GE. (See id. at ¶¶ 12–16.) The Debtor earns money by, inter alia, providing electrical services to the New York Independent System Operator ("NYISO"), an entity charged with overseeing New York's electricity markets. NYISO makes payments to the Debtor for (i) producing and supplying electricity to NYISO ("Energy Payments"); (ii) being available to produce electricity, if required ("Capacity Payments"); (iii) selling "Vars" or so-called "reactive power"; and (iv) permitting NYISO to control the load levels of the Debtor's generators while they are operational ("Regulation Payments"). The Debtor states that it is not generating sufficient income because of maintenance issues with its GE gas turbines. 1 (Id. at ¶24.)

A. The Debtor's History with GE

In 1992, Project Orange and GE entered into a maintenance agreement (the "Maintenance Agreement") for long term maintenance, including necessary repairs to the Turbines. The Debtor states that, starting *367 in 2004, the Turbines began suffering from failures that impacted Project Orange's energy production. (*Id.* at ¶20.) The problems continued throughout 2004, and according to the Debtor, in April 2005 one of the Turbines suffered a "catastrophic failure." Following this event, GE and Project Orange amended the Maintenance Agreement. (*See id.* at ¶21.)

These contractual changes did not resolve the Debtor's issues with the Turbines. The Turbines allegedly continued to breakdown, and in 2008 one Turbine failed less than two days after being repaired by GE. GE removed the Turbine for repairs. Shortly afterwards the remaining Turbine failed, leaving Project Orange with no operational turbines and prompting GE to install a temporary loaned turbine. The Debtor, however, claims that it cannot operate this loaned turbine for extended periods of time due to faulty maintenance performed by GE. This negatively affects the Energy Payments the

Debtor receives from NYISO for providing electricity as well as the Regulation Payments the Debtor receives in consideration for allowing NYISO to control load levels of its Turbines when operating. The Debtor also maintains that operating the replacement turbine at capacity would result in its failure, stripping the Debtor of the Capacity Payments NYISO makes in consideration of the Debtor's availability to produce electricity, if necessary. (*Id.* at ¶22.)

The Debtor's issues with GE eventually led to disagreements over invoices. On December 17, 2008, GE commenced an arbitration against Project Orange to recover approximately \$2.5 million in outstanding fees and \$5,249,604.93 plus interest for services rendered and termination of the Maintenance Agreement (the "Arbitration"). On April 11, 2010, the arbitrator concluded that GE properly terminated the Maintenance Agreement and awarded GE \$4,113,017.35 plus interest. The Debtor's schedules reflect a claim in this amount in favor of GE. (Id. at ¶ 25.) GE filed a motion to have the arbitration award confirmed in New York State Supreme Court. Briefing in that matter is stayed as a result of the automatic bankruptcy stay. GE also filed a motion requesting relief from the automatic stay to permit the state court to confirm the arbitration award. (See U.S. Trustee's Obj. at ¶¶ 16–17.)

Despite these issues, the Debtor now maintains that "all major litigation with GE has been substantially resolved." (DLA Piper's Resp. to U.S. Trustee's Obj. at 1 (ECF # 84).) Indeed, the Debtor has presented a settlement stipulation (the "Stipulation") between itself and GE to the Court for approval. (ECF # 118.) The Stipulation recites that GE asserts that, at a minimum, \$1,227,152.99 of the Arbitration award represents amounts invoiced for services in repairing one of the Turbines and is secured by a possessory artisan's lien on the Turbine and spare parts. (Stipulation at ¶ E.) The terms of the Stipulation call for certain payments to GE, funded by the Debtor's various insurers, to satisfy this lien and pay for the installation of certain Turbine components, a gas generator and accompanying spare parts. (Stipulation at ¶ 3.) These payments, however, do not eliminate GE's entire claim against Project Orange, only the secured portion. (Stipulation at \P 3(c).) After receipt of these amounts, GE would deliver the gas generator and the spare parts to the Debtor. GE would then install these components after the completion

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

of repairs and installation of another key Turbine component, the power turbine.

B. DLA Piper's Relationship with GE and other Potential Parties in Interest

The Debtor's application to employ DLA Piper is supported with three declarations *368 from Timothy W. Walsh ("Walsh"), a partner and Vice Chair of DLA Piper's Restructuring Practice Group. The first Walsh Declaration (the "Initial Walsh Declaration") reveals that Walsh and his partners represent certain GE affiliates in matters unrelated to this bankruptcy. (Initial Walsh Declaration at ¶ 8 (ECF # 58).) Walsh maintains that the "vast majority" of work DLA Piper completes for GE entities is for General Electric Healthcare ("GEHC"). (Id.) The Initial Walsh Declaration also discloses that the GE affiliate which is a creditor in this case, General Electric International, Inc. ("GEII"), is not, and never has been, a client of DLA Piper, but instead is a client of DLA Piper International, LLP ("DLA Piper International"), a separate affiliate of DLA Piper. (Id.)

Walsh's second declaration (the "Supplemental Walsh Declaration") further explains the relationship between DLA Piper and DLA Piper International. (ECF # 84.) DLA Piper and DLA Piper International are the two components of DLA Piper Global, a Swiss verein entity. The Supplemental Walsh Declaration claims that GEII is technically a client of Advokafirma DLA Piper Norway DA, which is a limited partner in DLA Piper International. Walsh argues that as a result DLA Piper receives no financial benefit from the work DLA Piper International and its components complete for GEII. (Supplemental Walsh Declaration at ¶ 2–3.)

The Walsh Declarations also state that DLA Piper has represented, and may currently represent, numerous other potential parties in interest including Syracuse University, AECOM, National Grid, JP Morgan Chase, U.S. Bank, City of Syracuse, Chartis National Union Fire Insurance Company of Pittsburgh, PA., and BP Energy Company (together with GEII, the "Conflict Parties"). (Initial Walsh Declaration at ¶ 8; Schedule 2 to Initial Walsh Declaration.) Walsh's Supplemental Declaration clarifies that DLA Piper may be adverse to Syracuse University. (Supplemental Walsh Declaration at ¶¶ 2–3.) Walsh further reveals that the Conflict Parties, with the exception of GE, represent less than 1% of the revenues generated

by DLA Piper in 2008, 2009, and to date in 2010. (Initial Walsh Declaration at ¶8 n. 5.) Walsh also notes, however, that DLA Piper's work for GE entities constituted .92% of revenue in 2008, 1.6% of revenue in 2009, and has accounted for .90% of revenues to date in 2010. (*Id.* n. 6.)

Walsh's third declaration (the "Second Supplemental Walsh Declaration"), filed after the June 7, 2010 hearing on this motion, clarifies that DLA Piper would not sue certain Conflict Parties, specifically AECOM, Chartis National Union Fire Insurance Company of Pittsburgh, PA., BP Energy Company, and GEII. (Second Supplemental Walsh Declaration at Ex. A. (ECF # 101).)

The DLA Employment Application acknowledges that DLA Piper's relationship with GE gives rise to a conflict. (DLA Employment Application at ¶ 19.) At the June 7, 2010 hearing on the DLA Employment Application, DLA Piper affirmed its conflict with GE. (June 7, 2010 Tr. 55:23-56:5 ("The Court:.... Don't you agree you have a conflict [with GE]? Mr. Walsh: I do.").) Following the June 7, 2010 hearing, however, DLA Piper retreated from its position, and now argues that it has no *369 conflict of interest in representing the Debtor. (Supplement to Application of Debtor for Order Authorizing Employment and Retention of DLA Piper LLP (US) ("DLA Supplemental Brief") at 2 (ECF # 102).) Notably, DLA Piper does not maintain that it doesn't have a conflict with GE. In fact, the Debtor has retained Golenbock Eisenman Assor Bell & Peskoe LLP ("Golenbock") to handle all matters for which DLA Piper cannot adequately represent the Debtor, including issues regarding GEII. (See Order Granting Application to Employ Golenbock as Conflicts Counsel, ECF # 106.)

Despite DLA Piper's current position, its relationship with GE caused it sufficient concern that it obtained a conflict waiver from GE to shield it from allegations of ethical wrongdoing (the "Conflict Waiver"). (See U.S. Trustee's Objection at ¶¶ 30–31.) A copy of the Conflict Waiver is attached as an Exhibit to the Supplemental Walsh Declaration. (See ECF # 84.) The Conflict Waiver is contained in a letter from DLA Piper, not DLA Piper International, and is addressed to GEII, care of senior general counsel for GE. The Conflict Waiver states that DLA Piper "will not bring any litigation or threaten any litigation for the recovery of monetary damages from GE or its affiliates or for any equitable relief against GE or

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

any of its affiliates." (Conflict Waiver at 1.) The Conflict Waiver, however, would permit DLA Piper to

(a) negotiate with GE on all matters, and (b) review loan, lease or other documents relating to the prepetition credit facilities or lease; provided, however that [the Debtor] has engaged special counsel of its own choosing ... with respect to the potential of bringing or prosecuting any such adversary proceeding or contested matter against GE....

(Conflict Waiver at 1–2.) Lastly, the Conflict Waiver indicates that DLA Piper may take positions regarding relief from the automatic stay, use of cash collateral, DIP financing, or confirmation of a plan that differ from that of GE "except to the extent that any such position taken by [the Debtor] may not be more inconsistent with any provision of any intercreditor agreement." (Conflict Waiver at 2.) DLA Piper claims that no such intercreditor agreement exists. (DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 7.)

II. DISCUSSION

A. Retention of Professionals under Section 327(a) of the Bankruptcy Code

[1] Section 327(a) of the Bankruptcy Code permits a debtor in possession to employ professionals to represent the estate during bankruptcy with court approval. *In re WorldCom, Inc.*, 311 B.R. 151, 163 (Bankr.S.D.N.Y.2004). The statute reads:

Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

11 U.S.C. § 327(a). Professionals must be both disinterested and not hold or represent any interest

adverse to the estate to be employed under section 327(a). *Vouzianas v. Ready & Pontisakos (In re Vouzianas)*, 259 F.3d 103, 107 (2d Cir.2001) (citing *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610, 621 (2d Cir.1999)).

The structure of the Bankruptcy Code distills these dual requirements into a single *370 test for analysis of a conflict of interest. Bankruptcy Code § 101(14) defines a "disinterested person." In re WorldCom, 311 B.R. at 164. Under section 101(14)(C) a disinterested person is one who "does not have an interest materially adverse to the interest of the estate or of any class of creditors" for any reason. 11 U.S.C. § 101(14)(C). This definition overlaps with the adverse interest requirement of section 327(a), creating a single test for courts to employ when examining conflicts of interest. Hogil Pharm. Corp. v. Sapir (In re Innomed Labs, LLC), No. 07 Civ. 4778(WCC), 2008 WL 276490, at *2 (S.D.N.Y. Jan.29, 2008) (citing In re WorldCom, 311 B.R. at 164). A professional must not "hold or represent an interest adverse to the estate." See In re AroChem Corp., 176 F.3d at 622-23 (observing that the "adverse interest" language appears in section 327(a) and in the definitions in section 101 regarding disinterested persons and articulating the relevant test as whether an entity "hold[s] or represent[s] an interest adverse to the estate"); In re Innomed Labs, LLC, 2008 WL 276490, at *2 (same). See also In re Granite Partners, L.P., 219 B.R. 22, 33 (Bankr.S.D.N.Y.1998) (observing that "the two prongs of section 327(a) are duplicative and form a single test to judge conflicts of interest") (internal citation omitted).

[2] [3] [4] The Second Circuit has defined "hold or represent an adverse interest" as

(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.

In re AroChem Corp., 176 F.3d at 623 (quoting In re Roberts, 46 B.R. 815, 827 (Bankr.D.Utah 1985), aff'd in part and rev'd in part on other grounds, 75 B.R. 402 (D.Utah 1987)). The prohibition on adverse interests includes "economic and personal interests of an attorney."

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

See In re Mercury, 280 B.R. 35, 54 (Bankr.S.D.N.Y.2002) (citation omitted). The test is not retrospective; courts only examine present interests when determining whether a party has an adverse interest. In re AroChem, 176 F.3d at 623-24 (observing that Congress intended only to proscribe those who presently have an adverse interest from representing a debtor under section 327(a)). Generally stated, the adverse interest test is objective and excludes "any interest or relationship, however slight, that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules." In re Granite Partners, 219 B.R. at 33; see also In re Angelika Films 57th, 227 B.R. 29, 38 (Bankr.S.D.N.Y.1998) ("The determination of adverse interest is objective and is concerned with the appearance of impropriety.")

interest exists on a case-by-case basis, examining the specific facts in a case. In re AroChem Corp., 176 F.3d at 623 ("Whether an adverse interest exists is best determined on a case-by-case basis."); In re Angelika Films 57th, 227 B.R. at 39 (stating that "the determination of counsel's disinterestedness is a fact-specific inquiry"). Bankruptcy courts may consider the interests of the estate and the debtor's creditors, accounting for the expeditious resolution of a case when analyzing a retention order. In re Vouzianas, 259 F.3d at 107 (quoting In re AroChem, 176 F.3d at 621). Courts, however, must take the requirements of section 327 seriously, as they ensure that a professional fulfills his duties in accordance with his fiduciary duties to the estate. In re Leslie Fay *371 Cos., 175 B.R. 525, 532 (Bankr.S.D.N.Y.1994) ("The requirements of section 327 cannot be taken lightly, for they 'serve the important policy of ensuring that all professionals appointed pursuant to [the section] tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." (quoting *Rome v.* Braunstein, 19 F.3d 54, 58 (1st Cir.1994)). Moreover, courts lack the power to authorize the "employment of a professional who has a conflict of interest." *In re Mercury*, 280 B.R. at 55.

Congress has explicitly stated that a [9] professional's representation of a creditor in another case does not automatically disqualify it from being retained under section 327. See 11 U.S.C. § 327(c) ("a person is not disqualified for employment under this section solely because of such person's employment or representation of a creditor"). The statute, however,

requires disqualification of a professional following an objection from the U.S. Trustee or a creditor where there is an actual conflict of interest. Id. ("the court shall disapprove such employment if there is an actual conflict of interest"). Section 327(c) acknowledges the difficulties debtors have in large chapter 11 bankruptcies to retain competent attorneys with the resources to handle the scope of the cases. See 3 COLLIER ON BANKRUPTCY ¶ 327.04[7][b] (15th ed. rev.2010). The statute "prevents" disqualification based solely on the professional's prior representation of or employment by a creditor" but does not obviate the essential requirement that a professional not have an interest adverse to the estate. In re AroChem, 176 F.3d at 621 (quoting In re Interwest Bus. Equip., 23 F.3d 311, 316 (10th Cir.1994)). Thus, even where section 327(c) is applicable, if a court determines that there is an [7] [8] Courts determine whether an adverse ctual conflict of interest following an objection from the U.S. Trustee or a creditor the court must disapprove the employment.

B. DLA Piper's Relationship with GE Precludes it from Being Employed by the Debtor Under § 327(a)

DLA Piper attempts to distance itself from GE, maintaining that the creditor in this case, GEII, is not even a client of DLA Piper, but rather a client of DLA Piper International. (Initial Walsh Declaration at ¶ 8; Supplemental Walsh Declaration at ¶¶ 2-3.) But the Conflict Waiver severely undermines DLA Piper's effort to segregate its relationship to GEII. Specifically, the Conflict Waiver was sent by DLA Piper, not DLA Piper International. Moreover, it is addressed to GEII "care of" an attorney at GE itself. Lastly, the Conflict Waiver combines GEII and GE into a single entity, GE, when requesting a waiver. Thus, the Court does not accept DLA Piper's effort to draw artificial lines in an attempt to isolate itself from GEII. As DLA Piper's Conflict Waiver conflates GE and GEII as a single entity, this Court too will treat them as one and the same for purposes of this motion.³

*372 Using this approach the U.S. Trustee argues that DLA Piper's ongoing relationship with GE precludes it from being retained as general bankruptcy counsel in this matter. (U.S. Trustee Obj. at 1-2, 14.) Indeed, the Debtor and DLA Piper agree that DLA Piper cannot represent the Debtor in many matters regarding GE. Specifically, the DLA Employment Application admits that DLA Piper is conflicted from taking certain actions in

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

the bankruptcy due to its representation of GE affiliates. (See DLA Employment Application at ¶ 19.) And, during the hearing on the retention application, counsel for DLA Piper confirmed the presence of a conflict with GE. (June 7, 2010 Tr. 55:23–56:5.) DLA Piper's Supplemental Brief also confirms the presence of conflict between the DLA Piper and GE. (DLA Supplemental Brief at 2 ("no conflict will exist between DLA Piper and GE going forward after a settlement is finalized regarding the turbine").)

Despite this acknowledged conflict, DLA Piper argues that it "does not have a conflict of interest in representing the Debtor." (Id. at 2.) It is only barred from acting in "litigation directly adverse to GE" and it has "no conflict with representing the Debtor opposite GE in developing and negotiating a plan of reorganization." (DLA Piper's Resp. to U.S. Trustee's Obj. at 1–2.) In support of this position, DLA Piper argues that the Court should focus "on the actions DLA Piper proposes to take as to [Project Orange] in this bankruptcy case" and eschew DLA Piper's other relationships. (See DLA Supplemental Brief at 3.) DLA Piper apparently believes that the Stipulation with GE—which would provide for the eventual return of Turbine components to the Debtor, but not resolve GE's unsecured claim against the estate—combined with the Conflict Waiver and its use of conflicts counsel somehow permits DLA Piper to represent the Debtor as general bankruptcy counsel despite its close relationship and acknowledged conflict with GE. The Court disagrees with DLA Piper's assessment of the law.

1. The Debtor's Execution of the Stipulation did not Resolve DLA Piper's Conflict with GE

[11] DLA Piper argues in its Supplemental Brief—filed after the Debtor entered into the Stipulation with GE—that the Debtor's signing of the Stipulation resolved all conflicts between itself and GE. (DLA Supplemental Brief at 2.) DLA Piper is severely mistaken. The Stipulation, by its own terms, is not effective until this Court reviews the Stipulation in accordance with Federal Rule of Bankruptcy Procedure 9019 and approves the settlement. (Stipulation at ¶ 1.) Until then, no settlement exists and GE remains directly adverse to Project Orange. Notably, even if the Court approves the Stipulation, adversity would still remain. Under the terms of the settlement, GE must complete repairing a Turbine component before it can install the Turbine in accordance with other

Stipulation provisions. Repairs on the component are anticipated to be completed by July 10, 2010, but the Stipulation states that this date is subject to change. If repairs are more difficult than anticipated, the return of the Debtor's Turbines to operation is not assured. Moreover, there would likely be contentious *373 litigation over the installation of the Turbines. As summer is the Debtor's busiest months, any delay on GE's part would almost necessitate the Debtor to threaten a lawsuit to expedite the repair and installation process. Indeed, until the repair and installation of the Turbines is complete, GE and Project Orange remain wholly adverse.

Moreover, Project Orange is locked in highly contentious -but currently stayed-litigation in state court with its landlord, Syracuse University, regarding the validity of their lease. The University maintains that the lease was terminated prepetition as a result of several Project Orange defaults. Under the terms of the Debtor's lease with the University, arguments exist that termination of the lease would result in the entire Facility reverting to the University: Section 27.02(b)(ii) of the lease specifically allows the University to repossess both the leased property as well as the Facility on termination of the lease. As defined in other agreements between the two parties, the Facility includes the Turbines. Thus, even if the Stipulation and settlement become effective, if Syracuse University is successful in establishing that the lease terminated prepetition, Project Orange will have no assets to liquidate to pay its largest unsecured creditor.

DLA Piper, however, ignores these clear conflicts, suggesting that the Stipulation resolved all adversity in this case. DLA Piper cites to cases that distinguish between present and potential conflicts, arguing that because only the potential for adversity with GE exists, it may be retained in this case. But other bankruptcy judges in this district have refused to distinguish between actual and potential conflicts. In re Angelika Films 57th, 227 B.R. at 39 ("The distinction between 'potential' and 'hypothetical' conflicts merely confuses the analysis, and several courts have rejected it as artificial."); In re Granite Partners, 219 B.R. at 33 ("The distinction [between actual and potential conflicts] often seems artificial, and some courts have rejected it."). These judges instead focus on the facts of each case to determine whether an attorney has an adverse interest without limiting labels. See, e.g., In re Leslie Fay Cos., 175 B.R. at 532-33 (rejecting the actual/potential

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

dichotomy and observing that courts should focus on the facts of a case when reviewing retention applications).

Even if the Court ignores the disfavored actual/potential distinction, the cases cited by DLA Piper fail to persuade the Court that DLA Piper has no disabling conflict of interest with GE. Indeed, the two cases DLA Piper most heavily relies upon are easily distinguishable from the present case. In In re Rockaway Bedding, Inc., No. 07-14890, 2007 WL 1461319 (Bankr.D.N.J. May 14, 2007), the court determined that a law firm that represented a debtor's biggest secured creditor in unrelated matters could be the debtor's general bankruptcy counsel. Central to the court's decision was the fact that there was no ongoing litigation between the debtor and the secured creditor and no such litigation was envisioned. See id. at *3-4 ("The Debtors are not in any active litigation against [secured creditor] or any other creditor ... and the Court is advised that no such litigation is envisioned."). Similarly, in In re Dynamark, Ltd., 137 B.R. 380 (Bankr.S.D.Cal.1991), the court approved the retention of an attorney as general bankruptcy counsel who represented the estate's largest secured creditor in unrelated matters, finding no outstanding litigation between the parties. See id. at 381 ("it appears that no actual conflict or adverse interest has surfaced in this case so far"). In stark contrast, here the Debtor had litigation pending with GE, DLA Piper's client, before the bankruptcy was even *374 filed. The Debtor and GE are still directly adverse, as the Stipulation has not yet been approved by the Court. Moreover, enforcement and performance of the Stipulation will continue to place the Debtor and GE directly at odds and could well give rise to new litigation.

2. DLA Piper's Conflict Waiver Does Not Permit DLA Piper's Employment Under 327(a)

[12] The Conflict Waiver does not save DLA Piper's application from these infirmities. Both commentators and courts conclude that disabling adverse interests may exist where the professional to be retained also represents creditors of the debtor. *In re American Printers & Lithographers, Inc.*, 148 B.R. 862, 865–66 (Bankr.N.D.III.1992) (finding adverse interest between debtor's proposed law firm and the debtor's secured creditor based on law firm's continuing representation of secured creditor in unrelated matters); 2 NORTON

BANKRUPTCY LAW AND PRACTICE 3D § 30:5 (3d ed.2010) (observing that the "most common areas in which conflicts arise are where the professional also represents ... creditors of the debtor"). Indeed, in American Printers, the court concluded that a conflict existed because debtor's proposed counsel, who represented a secured creditor of the debtor in unrelated matters, could not negotiate with the secured creditor on the debtor's behalf. Thus, the proposed attorney was disqualified. See In re American Printers, 148 B.R. at 865– 66. Here, DLA Piper contemplates engaging in the exact conduct the American Printers court determined created a disabling conflict between proposed counsel and the debtor's secured creditor—"developing and negotiating a plan of reorganization." 4 (DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 7.)

DLA Piper argues that because GE has contractually permitted DLA Piper to represent the Debtor on some matters adverse to GE that it cures all conflicts for purposes of section 327(a). But an agreement between DLA Piper and GE, i.e., the Conflicts Waiver, cannot trump the requirements of section 327(a). Even if GE agreed that DLA Piper could act against GE on all issues, through litigation, negotiation or otherwise, DLA Piper must still satisfy the statutory requirements of section 327(a) to be retained as general bankruptcy counsel. See, e.g., In re Granite Partners, L.P., 219 B.R. at 34 (observing that while clients may, in some instances, waive conflicts, "the mandatory provisions of section 327(a) do not allow for waiver"); In re Perry, 194 B.R. 875, 880 (E.D.Cal.1996) (stating that "section 327(a) has a strict requirement of disinterestedness and absence of representation of an adverse interest which trumps the rules of professional conduct").

*375 Moreover, the Conflict Waiver severely limits DLA Piper's ability to act in the best interests of the Debtor with regards to GE. Under the terms of the Conflict Waiver, DLA Piper is barred from both bringing suit and threatening to bring suit against GE or its affiliates for monetary damages or equitable relief. (Conflict Waiver at 1.) While the Conflict Waiver purportedly allows DLA Piper to negotiate with GE "on all matters" and review loan or lease documents relating to the Debtor's prepetition credit facilities and lease, the Court does not believe that DLA Piper can negotiate with full efficacy without at least being able to hint at the possibility of litigation. *In re American Printers & Lithographers, Inc.*,

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

148 B.R. at 865–66 ("Debtor's counsel must at least vigorously negotiate ... in order to fulfill its duties to Debtor, even if litigation is not warranted.").

This is particularly true with regards to the Stipulation. The Debtor's ongoing relationship with GE is a core issue for a successful reorganization of the Debtor. Specifically, return of the Turbines to operation is central to the Debtor's profitability. (See May 3, 2010 Tr. at 15-16, 19 ("Mr. Victor: Nobody's going to get paid unless we can run [both Turbines] and let ... us see how we can maximize [them].").) Yet, as indicated above, under the Stipulation there is a possibility that the installation date of the Turbines may slip. If this occurs, Project Orange will be forced to quickly and vigorously negotiate the installation schedule to take advantage of the summer electricity season. Valid negotiation strategies may include threatening lawsuits or withholding payments to be made under the Stipulation. It is unclear whether the Conflict Waiver would permit DLA Piper to take either course of action.

3. The Debtor's Use of Conflicts Counsel Does Not Warrant DLA Piper's Employment Under 327(a)

[13] In many cases, the employment of conflicts counsel to handle issues where general bankruptcy counsel has an adverse interest solves most questions regarding the retention of general bankruptcy counsel. Indeed, DLA Piper has identified cases where courts determined that the use of conflicts counsel could insulate proposed counsel from hypothetical and speculative conflicts that may arise in the course of a bankruptcy case with entities that are not central to the debtor's reorganization efforts. See, e.g., In re Enron Corp., No. 01-16034(ALG), 2002 WL 32034346, at *9–10 (Bankr.S.D.N.Y. May 23, 2002) (refusing to disqualify law firm on mere speculation that it had an adverse interest and finding that use of conflicts counsel was appropriate to handle certain limited investigations where firm had an adverse interest). But DLA Piper has not provided the Court with any case law indicating that the use of conflicts counsel warrants retention under section 327(a) where the proposed general bankruptcy counsel has a conflict of interest with a creditor that is central to the debtor's reorganization. The Court determines that this is such a case where the use of conflicts counsel does not allow the retention of the Debtor's chosen counsel under section 327(a).

Even if Golenbock performed all work related to GE in this case, the fig leaf of conflicts counsel does not convince the Court that retention of DLA Piper as general bankruptcy counsel is appropriate in these circumstances. As previously indicated, GE is central to this case. It is the Debtor's largest unsecured creditor. The return and installation of the Turbines, which are central to the Debtor's ability to reorganize, is currently subject to a Stipulation *376 which may or may not be entered by the Court. Moreover, even if the Court approves the Stipulation, there is considerable uncertainty regarding the timeline for installation of the Turbines. Any disagreement on installation would likely give rise to highly contentious proceedings. In fact, GE has shown its willingness to vigorously defend itself in this forum by making multiple filings. GE has moved the Court to lift the automatic stay to confirm its \$4.1 million arbitration award. (ECF # 13.) GE has also objected to the Debtor's request to pay prepetition wages, salaries, and taxes. (ECF # 15.) GE has further filed a motion to lift the automatic stay with regards to two checks issued by AIG to both the Debtor and GE. (ECF # 64.) Given GE's strong interests and active stance in this case, it is clear that addressing issues with GE will take considerable time and skill on a range of matters. Indeed, the Debtor essentially acknowledged that Golenbock would need to take numerous actions in this case by seeking to retain the firm pursuant to section 327(a) of the Bankruptcy Code and not the more limited "special purpose" contemplated by section 327(e). Thus, even assuming DLA Piper does not complete any work regarding GE, the Court does not believe DLA Piper's employment is permissible.

Other courts have determined that where proposed counsel is conflicted from representing a debtor with regards to matters central to the bankruptcy, even the presence of conflicts counsel does not make the retention appropriate. ⁵ In *In re Amdura Corp.*, 121 B.R. 862 (Bankr.D.Colo.1990), the court examined an attempt to use conflicts counsel to enable an otherwise conflicted general bankruptcy counsel to be retained under section 327(a). Winston & Strawn ("Winston") sought to represent the debtor. The primary creditor in the case, Continental Bank ("Continental"), had loaned the debtor \$215 million. *Id.* at 866. Winston previously represented—and continued to represent—Continental during the bankruptcy in unrelated matters. Winston stated that it could not investigate the loan Continental

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

made to the debtor but an examiner could be appointed to do so. Winston further stated that, to the extent the debtor needed to sue Continental, it could use separate counsel. *Id.* at 867. The court found that Winston's inability to be adverse to Continental constituted a conflict of interest disallowing its retention under section 327(a). Id. The court further found that this conflict could not be resolved through the use of separate counsel. While theorizing that the use of conflicts counsel may resolve conflicts issues where proposed general counsel previously represented smaller creditors whose interests were not central to the resolution of the case, the court concluded that because resolution of issues with Continental could be the "lynchpin of the case," Winston had a conflict that could not be resolved through the use of alternative counsel. The court specifically questioned Winston's ability to adequately advise the debtor in negotiations with Continental and draft a plan of reorganization. Id.

*377 DLA Piper argues that *Amdura* is distinguishable because "DLA is willing and able if necessary to take positions opposed by [GE] and advance a plan of reorganization that is in the best interests of the Debtor." (See DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 9.) This argument erroneously assumes that DLA Piper can contractually obviate the mandatory requirements of section 327(a) with its Conflict Waiver. See, e.g., In re Granite Partners, L.P., 219 B.R. at 34 (stating that "the mandatory provisions of section 327(a) do not allow for waiver"). Moreover, this case shares much in common with Amdura: in both cases, proposed counsel could not investigate and prosecute claims against the key creditor in the case; in both cases, the conflict existed with the largest creditor and raised issues central to the resolution of the bankruptcy case. As in Amdura, it does not appear that DLA Piper can "fairly and fully advise" in the negotiation and drafting of a plan when it may not even be able to advocate litigation against GE. In re Amdura Corp., 121 B.R. at 867.

Similarly, in *In re Git–N–Go, Inc.*, 321 B.R. 54 (Bankr.N.D.Okla.2004), the bankruptcy court reviewed an employment application under section 327(a). The proposed counsel was intimately involved with a holding company ("Holding Company") central to the bankruptcy. The relationship between the Holding Company and proposed counsel had lasted for decades and the parties intended to continue the arrangement following the bankruptcy case. *Id.* at 57. The Holding

Company owned 87% of the debtor's stock and the debtor was forced to file for bankruptcy in part due its relationship with a wholly owned subsidiary of the holding company, 4 Front Petroleum, Inc. ("4 Front"). 4 Front purchased gas from Citgo and resold the gas to the debtor, who in turn sold the gas to consumers. Citgo, however, withheld hundreds of thousands of dollars in the debtor's gas sales to set off against debt 4 Front owed to Citgo. Despite the bankruptcy, Citgo continued to withhold and set off the debtor's gas sales. Id. at 57-58. Proposed counsel disclosed that it represented Citgo in unrelated matters and that Citgo accounted for approximately 1% of its revenues from the previous years. While proposed counsel had a waiver from Citgo allowing it to contest Citgo's withholding of gas sales from the debtor, it never did so and instead counseled the debtor to retain alternative counsel to challenge Citgo's actions. Id. at 58. The court determined that proposed counsel's relationship with the Holding Company and Citgo created conflicts of interest. Id. at 59, 61 (concluding that due to its relationship with the Holding Company, its subsidiaries and Citgo, Proposed Counsel "cannot provide the objective and independent advice ... required for the Debtor's performance of its fiduciary obligations"). With respect to proposed counsel's conflict with the Holding Company, the court determined that substituting the creditors' committee in its stead would not resolve the conflict. The court reasoned that investigating potential causes of action against the Holding Company was "among the primary duties assigned to the debtor in possession, and ... cannot simply be delegated to a creditors' committee when the debtor's counsel is unavailable because representation of the estate would implicate an adverse interest." Id. at 60-61. As to proposed counsel's conflict with Citgo, the court determined that proposed counsel's refusal to be directly adverse to Citgo could not be cured by the use of conflicts counsel. The court reasoned that conflicts counsel would need to represent the debtor in "core bankruptcy matters" and it would not be "appropriate or in the best interests of the estate" to use conflicts *378 counsel to conduct the duties of general bankruptcy counsel. *Id.* at 61–62.

DLA Piper attempts to distinguish *Git–N–Go*, arguing that unlike the case at bar proposed counsel in *Git–N–Go* (i) represented both the debtor and "several" adverse parties; (ii) admitted it was ethically incapable of acting as counsel for the debtor in certain circumstances; and (iii) represented parties in interest in matters regarding

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

the debtor prior to the petition date. (DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 10.) DLA Piper's distinctions fail. As an initial matter, proposed counsel in Git-N-Go only represented two parties in interest in the case prior to the petition date, the Holding Company and Citgo. In re Git-N-Go, Inc., 321 B.R. at 56-58. The court found that both of these relationships created conflicts. Id. at 60–62. The conflict with the Holding Company could not be resolved by having the creditors' committee investigate potential claims against a creditor. Id. at 60-61. Nor could the conflict with Citgo be resolved through the use of conflicts counsel. Id. at 61-62. DLA Piper misreads Git-N-Go, implying that the fact that proposed counsel represented Citgo with regards to matters pending in the bankruptcy before the petition date was dispositive to the court's decision. (DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 10 ("unlike the firm involved in Git-N-Go, prior to the Petition Date, the only party in interest that DLA represented in matters involving the Debtor was the Debtor").) Rather, the court found that it was proposed counsel's unwillingness to represent the debtor in its dispute with Citgo that created a conflict of interest that could not be resolved through the use of other counsel. In re Git-N-Go, Inc., 321 B.R. at 60-61 (observing "the fact that [proposed counsel] is unable or unwilling to represent the [d]ebtor in its dispute with Citgo also creates an actual disqualifying conflict of interest" which cannot be cured through the use of conflicts counsel). In fact, proposed counsel in Git-N-Go only represented Citgo in matters unrelated to the debtor. Id. at 58. Here, just as in Git-N-Go, DLA Piper represented GE prior to the petition in matters unrelated to the Debtor and is unable to take certain actions against GE pursuant to the Conflict Waiver.

Finally, the bankruptcy court in *In re Envirodyne Indus.*, *Inc.*, 150 B.R. 1008 (Bankr.N.D.Ill.1993), analyzed a similar situation. The court analyzed a motion to vacate an order authorizing the employment of Cleary, Gottlieb, Steen & Hamilton ("Cleary"). *Id.* at 1011. Cleary had represented an investment bank, Salomon Brothers, Inc. ("Salomon"), in connection with a leveraged buy-out ("LBO") of the debtor. Salomon owned nearly two-thirds of the entity that purchased the debtor and held a majority of seats on the debtor's board of directors. Salomon was also a creditor of the debtor. After the LBO was completed Cleary represented the debtor in most matters requiring outside counsel, including two bond issues—both underwritten by Salomon—and in structuring a

loan from Salomon to the debtor. Cleary also advised the debtor on debt restructuring and the possibility of seeking chapter 11 protection. *Id.* at 1011–12. When restructuring talks began counsel for a committee of ad hoc bondholders began investigating causes of action related to the LBO. Cleary counseled Salomon to seek other attorneys to represent it with regards to these possible claims. *Id.* at 1012. Cleary, however, continued to represent Salomon in unrelated matters. Id. at 1013. Cleary argued that it could represent the debtor because it would not pursue an action against Salomon for claims arising out of the LBO and noted that any such action was a "remote contingency." Id. at 1019. The court rejected *379 Cleary's position, stating that Cleary had an "affirmative duty to investigate potential claims" and that its characterization of a potential lawsuit as "remote" revealed that Cleary had already made a determination regarding the pursuit of claims against Salomon. Id.

DLA Piper's retention application suffers from the same issues faced by Cleary in In re Envirodyne. Like Cleary, DLA Piper argues it is "disinterested" for purposes of the Bankruptcy Code because it will not bring litigation against GE and because the Stipulation has allegedly resolved all disputes between the Debtor and GE. (See DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 7; see also DLA Supplemental Brief at 2.) Also like Cleary, DLA Piper seemingly assumes that developing and negotiating a plan of reorganization will not make it directly adverse to GE. (See DLA Piper's Resp. to U.S. Trustee's Obj. at ¶ 7; see also DLA Supplemental Brief at 2.) And just like Cleary, DLA Piper's assumption that it is not conflicted in developing a plan reveals that it has already made a determination regarding the status of matters with GE, specifically with regards to the Stipulation and the resolution of GE's unsecured claim. Prejudging the status of matters with a debtor's largest unsecured creditor, as the *Envirodyne* court noted, is not consistent with the Debtor's duty to investigate all possible claims.

On the facts of this case, as DLA Piper's conflict is with the Debtor's largest unsecured creditor that is central to the issues in this case, the Court concludes that it is inappropriate to approve the retention application. It is not a sufficient answer, as DLA Piper posits, that the firm has had a long-standing relationship with the Debtor. Conflicts rules do not apply only when application of the rules will not inconvenience the party seeking to retain conflicted counsel.

In re Project Orange Associates, LLC, 431 B.R. 363 (2010)

53 Bankr.Ct.Dec. 114

CONCLUSION

DLA Piper's representation of GE creates a conflict of interest with the Debtor. GE is the largest creditor in this case, has been highly active in the proceedings, and is certain to play a key role in any plan negotiations or confirmation hearing. Here, given DLA Piper's admitted conflict of interest with GE and GE's central role in this

case, the Court does not believe that the use of conflicts counsel warrants DLA Piper's retention in this matter. Thus, the DLA Employment Application is **DENIED.**

IT IS SO ORDERED.

All Citations

431 B.R. 363, 53 Bankr.Ct.Dec. 114

Footnotes

- Debtor's cogeneration facility was built on property owned by Syracuse University. The Debtor and Syracuse University are parties to a written lease that by its terms is scheduled to expire in 2032. Syracuse University argues, however, and the parties have litigated in state court for several years, that the lease terminated prepetition because of Project Orange's defaults in the lease and other agreements between them. The details of the dispute are omitted from this Opinion. Suffice it to say, however, that if the lease terminated prepetition, the Debtor is unlikely to be able to reorganize as an operating business. Syracuse University has filed a motion to lift the automatic stay to permit it to proceed with the state court litigation. A separate opinion or order will be entered concerning that motion.
- A Swiss verein is essentially an incorporated membership association, but has no precise counterpart in the United States. *In re Lernout & Hauspie Secs. Litig.*, 230 F.Supp.2d 152, 171 (D.Mass.2002); Megan E. Vetula, *From the Big Four to Big Law: The Swiss Verein and the Global Law Firm*, 22 GEO. J. LEGAL ETHICS 1177, 1180 (2009).
- Since DLA Piper dealt with itself and its affiliates as one entity in negotiating a conflict waiver with GE entities (likewise treated as one entity), the Court does not need to consider whether different conflicts rules might apply in some circumstances where international law firms share a relationship through a Swiss verein. DLA Piper's website proclaims that "DLA Piper became one of the largest legal service providers in the world in 2005 through a merger of unprecedented scope in the legal sector. While large in scale, the merger strategy was simple—to create an international legal practice capable of taking care of the most important legal needs of clients wherever they do business.... DLA Piper today has 3,500 lawyers in offices throughout Asia, Europe, the Middle East and the United States. We represent more clients in a broader range of geographies and practice disciplines than virtually any other law firm in the world." See http://www.dlapiper.com/global/about/overview/ (last visited June 23, 2010). DLA Piper holds itself out to the world as one firm, although it now tries to separate itself into separate firms for conflicts purposes. Followed to its logical conclusion, this would lead to the anomalous result that DLA Piper, on behalf of one client, could be adverse to DLA Piper International, on behalf of one of its clients, without violating ethical standards.
- DLA Piper's attorneys have also shown that they are tone-deaf when it comes to conflicts issues. During the June 7, 2010 hearing, counsel presented a proposed settlement between the Debtor and BP regarding the delivery of natural gas needed to operate the Debtor's Turbines. No objections were filed to the proposed settlement. The Court indicated that it would approve the settlement. Later in the hearing, however, almost in passing, counsel acknowledged that it could not be adverse to BP, an existing client of DLA Piper. The U.S. Trustee then questioned how DLA Piper could negotiate and present the settlement if it cannot be adverse to BP. Counsel then responded that it had identified BP as a conflict party in exhibits to its retention application, as if the disclosure could cure the conflict. The Court withdrew its approval of the settlement, which has since been resubmitted by Golenbock, Debtor's conflict counsel. Identifying conflicts does not involve a game of "gotcha," where disclosure of a conflict party in one schedule excuses counsel from the consequences of a conflict if no one finds the earlier disclosure and objects.
- The Court is surprised at the dearth of precedent on this point. In addition to the case law discussed in this Opinion, at least one commentator concurs with the Court's assessment in an analogous setting. See Susan M. Freeman, Are DIP and Committee Counsel Fiduciaries for their Clients' Constituents or the Bankruptcy Estate? What is a Fiduciary Anyway?, 17 AM. BANKR.INST. L. REV. 291, 367 (2009) ("Courts have allowed ... counsel to avoid the lack of disinterestedness or existence of an adverse interest caused by the role of other firm clients in the bankruptcy case by appointing special counsel to deal with all matters adverse to the other clients. If a creditor client's role is central to the case, such as carve-out of ... representation may be infeasible.") (footnotes omitted).

	In re	Project	Orange	Associates,	LLC,	431	B.R.	363	(2010)	١
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53 Bankr.Ct.Dec. 114

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UNITED STATES BANKRUPTCY COURT EASTERN DISTRICT OF MICHIGAN SOUTHERN DIVISION

In re:		Chapter 11
HardRock HDD, Inc.,		Case No. 17-46425
Debtor.	/	Hon. Phillip J. Shefferly

OPINION GRANTING APPLICATION FOR ORDER APPROVING EMPLOYMENT OF ATTORNEYS FOR DEBTOR IN POSSESSION

Introduction

On Monday, May 22, 2017, the Court held a hearing on an application to approve the employment of an attorney for the Chapter 11 debtor in possession. Because the applicant and an objecting party each filed pleadings over the weekend just prior to the hearing, the Court took the matter under advisement at the end of the hearing so that it could review those pleadings. After its review, the Court entered an order on May 25, 2017 granting the application. The Court is now issuing this opinion to explain its reasons.

Background

HardRock HDD, Inc. ("HardRock"), Patrick Horizontal Drilling, L.L.C. ("Patrick Horizontal"), and Patrick Leasing, L.L.C. ("Patrick Leasing") are three related companies that own and lease equipment and perform underground drilling and utility work. All three companies are owned by Danny Patrick, Sr. ("Danny") and his son, Jeffery Patrick ("Jeffery"). Each of these companies (hereafter, "Debtors") filed a Chapter 11 petition on April 28, 2017.

On May 16, 2017, Silverman & Morris, P.L.L.C. ("Law Firm") filed an application (collectively, "Applications") in each of the cases requesting an order appointing the Law Firm as attorney for the debtor in possession. The Applications are identical and are supported by an

17-46425-pjs Doc 63 Filed 05/25/17 Entered 05/26/17 07:11:48 Page 1 of 13

affidavit of disinterestedness ("Affidavit") pursuant to Fed. R. Bankr. P. 2014 and E.D. Mich. LBR 2014-1, signed by Thomas R. Morris, a principal of the Law Firm. The Affidavit states that beginning in August, 2016, the Law Firm provided legal services to all three Debtors and to their two owners, Danny and Jeffery. The Affidavit also states that the Law Firm appeared on behalf of HardRock and Jeffery in a lawsuit brought against them in federal district court. The Affidavit explains that the Debtors owe the Law Firm approximately \$21,000.00 for pre-petition legal services, but that the Law Firm has agreed to waive any claim against the Debtors so that the Law Firm can be appointed to represent them as attorney for the debtor in possession in each of the three cases.

On May 17, 2017, the Law Firm requested the Court to schedule a hearing on the Applications.¹ Because the question of whether an attorney for a debtor in possession should be appointed is one that must be resolved in the very earliest stages of a Chapter 11 case, the Court scheduled the Applications for hearing on the following Monday, May 22, 2017 at 10:30 a.m. On May 18, 2017, a creditor, People's United Equipment Finance Corp. ("People's United") filed an objection. On the following day, the Law Firm filed a memorandum in support of the Applications. Over the weekend, more pleadings were filed. On Saturday, May 20, 2017, the UST filed an objection to the Applications. On Sunday, May 21, 2017, the Law Firm filed an amended declaration ("Amended Declaration") in support of the Applications.

¹ In the Eastern District of Michigan, pursuant to E.D. Mich. LBR 2014-1(b), if the United States Trustee ("UST") files a statement of concurrence in an application to approve the employment of a professional, the applicant may submit to the Court a proposed order approving the employment. The rule states that if the UST does not concur in the application within seven days, then the applicant may contact the assigned judge's courtroom deputy clerk and obtain a hearing date on the application. In all three of the Debtors' cases, the Law Firm contacted the courtroom deputy clerk on May 17, 2017 to advise that the UST had not filed a statement of concurrence and to request that the Court schedule a hearing.

On May 22, 2017, the Court held the hearing. In addition to the UST and People's United, another creditor, Old National Bank ("Bank"), appeared at the hearing and objected to the Applications.

The objections by People's United and the Bank are similar to one another. Basically, those creditors argue that the Debtors do not have sufficient revenue to pay the Law Firm, pay other administrative expenses, or fund a plan, and that the Applications should be denied because the Debtors' Chapter 11 cases are futile. The UST's objections do not focus on the viability of the Debtors' cases, but instead go to the Law Firm's eligibility to represent the Debtors in their cases. The UST argues that the Law Firm "has several conflicts of interest, holds and represents materially adverse interests, and is not disinterested."

Even though the Debtors' cases are not presently jointly administered,² the Court will address all three of the Applications and the objections to them in this opinion as the issues in each case are identical.

Jurisdiction

This is a core proceeding under 28 U.S.C. § 157(b)(2)(A), over which the Court has jurisdiction pursuant to 28 U.S.C. §§ 1334(a) and 157(a).

Legal Standard

Under § 1107(a) of the Bankruptcy Code, a debtor in possession has all of the rights and powers of a trustee serving in a case under Chapter 11, including the right to employ attorneys pursuant to § 327(a) of the Bankruptcy Code, which reads as follows:

² Shortly after filing, the Debtors filed a motion for joint administration of the three cases. The time to respond to the motion has not yet expired, but these cases look like good candidates for joint administration.

Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

To qualify for employment under § 327(a), the attorney must be a disinterested person. That term is defined in § 101(14) of the Bankruptcy Code as any person that:

- (A) is not a creditor, an equity security holder, or an insider;
- (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
- (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

Under Fed. R. Bankr. P. 2014(a), an order approving the employment of an attorney shall only be made on an application that states the name of the attorney, the necessity for the employment, the reasons for the selection of the attorney, the services to be rendered, the compensation arrangement and, to the best of the applicant's knowledge, all of the applicant's connections with the debtor, creditors and other parties in interest. The rule also requires that the application be accompanied by a verified statement that describes the applicant's connections with the debtor, creditors and other parties in interest.

In the Eastern District of Michigan, LBR 2014-1(a) augments these disclosure requirements by also requiring disclosure of all connections between any associates of the applicant with the debtor, creditors, or any other party in interest, their respective attorneys and accountants.

"The Sixth Circuit has strictly construed the provisions [of § 327(a) and Rule 2014,] and has not hesitated to disqualify professionals who fail to meet the statutory criteria, even though there may be practical reasons for retaining them." <u>In re Seven Counties Services, Inc.</u>, No. 13-31442, 2014 WL 69880, at *3 (Bankr. W.D. Ken. Jan. 9, 2014) (citing <u>In re Federated Department Stores</u>,

<u>Inc.</u>, 44 F.3d 1310 (6th Cir. 1995); <u>In re Eagle-Picher Industries</u>, 999 F.2d 969 (6th Cir. 1993); and <u>In re Middleton Arms L.P.</u>, 934 F.2d 723 (6th Cir. 1991)).

Discussion

The Court will first consider the UST's objections and then turn to the objections of People's United and the Bank.

The UST asserts that the Law Firm holds and represents interests that are adverse to the Debtors' estates and that the Law Firm is not disinterested. The UST relies on the following facts. First, the Law Firm is a creditor of the Debtors because it holds a pre-petition claim of \$21,000.00 for legal services. Second, the Law Firm holds a security interest in all of HardRock's assets granted to the Law Firm on February 15, 2017 to secure payment of the Law Firm's pre-petition claim. Third, the Law Firm received \$13,500.00 in payments from HardRock and Patrick Horizontal during the 90 days before they filed their Chapter 11 petitions that may constitute preferential transfers. Fourth, before the Debtors filed their Chapter 11 petitions, the Law Firm represented both the Debtors and the owners of the Debtors, Danny and Jeffery. Fifth, even after the Debtors filed their Chapter 11 petitions, the Law Firm still remains counsel of record for Jeffery in a lawsuit pending in federal district court.

The Law Firm concedes that its pre-petition claim against the Debtors is an interest adverse to the Debtors' estates under § 327(a) and that this pre-petition claim makes the Law Firm a creditor, and thus not disinterested under § 101(14). However, the Law Firm expressly states both in paragraph 7 of the Affidavit and in paragraph 10 of the Amended Declaration that it agrees to waive its pre-petition claim against the Debtors. With that waiver, the Law Firm will no longer hold an interest adverse to the Debtors' estates nor will it be a creditor of the Debtors. Further, paragraph 11 of the Amended Declaration contains an acknowledgment by the Law Firm that the waiver of the

-5-

Law Firm's pre-petition claim will also extinguish the Law Firm's security interest in HardRock's assets. Without a pre-petition claim and security interest, the Law Firm argues that it does not hold an interest adverse to the Debtors' estates, nor is it a creditor of the Debtors' estates.

The Court agrees with the Law Firm. It is not uncommon for an attorney selected by a debtor in possession to have also represented the debtor pre-petition. It is also not uncommon for there to be an unpaid balance of fees owing by the debtor to that attorney. If the attorney continues to hold a claim against the debtor for the unpaid fees, the attorney holds an interest adverse to the debtor's estate and is not disinterested. But if the attorney agrees to waive the claim, this impediment is removed: the attorney no longer holds an adverse interest and is no longer a creditor. The Law Firm's express agreement to waive its pre-petition claim and security interest solves this problem.

Even with the Law Firm's express waiver of its pre-petition claim, the UST asserts that the Law Firm still holds an interest adverse to the Debtors' estates, and is not disinterested, because the \$13,500.00 received by the Law Firm from the Debtors in the 90 days before bankruptcy may constitute preferential transfers that may one day have to be repaid to the Debtors' estates. According to the UST, any request by the Debtors for the repayment of these potentially preferential transfers necessarily places the Law Firm in direct conflict with the interests of the Debtors' estates.

Although there is no controlling precedent in the Sixth Circuit regarding the issue of whether a possible preferential transfer is enough to disqualify an attorney under § 327(a), there is case law in other circuits. The UST cites In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002), for the proposition that the existence of a potential preference must be resolved before an attorney's application for approval of employment could be approved.

In <u>Pillowtex</u>, the debtor in possession sought to employ the Jones Day law firm to represent it as debtor in possession. Jones Day had represented Pillowtex in a variety of matters before Pillowtex filed its Chapter 11 petition. Pillowtex paid Jones Day over \$2.5 million pre-petition, of which approximately \$1 million was paid in the 90 days before the Chapter 11 petition was filed, including a payment of \$300,000.00 the day before the petition was filed. The UST objected to the application to employ Jones Day, on the ground that Jones Day had received voidable preferential transfers from Pillowtex under § 547 of the Bankruptcy Code and, therefore, held an interest adverse to the debtor's estate and was not disinterested. Jones Day argued in response that the payments it received were substantially within the historical pattern of payments between Pillowtex and Jones Day and proposed that, if a preference action was filed against Jones Day and it was determined that Jones Day had received a preference, Jones Day would agree to repay the debtor's estate the full amount of the preference and waive any related claim. The bankruptcy court approved the application to employ Jones Day. <u>Id.</u> at 248-49.

The Third Circuit Court of Appeals reversed, holding that Jones Day's agreement to repay any amount ultimately found to be preferential did not resolve the question of whether Jones Day was disinterested at the time of the debtor's application to employ Jones Day. Noting that "there has never been a judicial determination whether Jones Days received a preference," the court found that it was unclear from the record whether Jones Day should be disqualified from representing the debtor. <u>Id.</u> at 255. The court remanded the case back to the district court to determine whether Jones Day had received a preferential transfer from Pillowtex. In doing so, the court held as follows:

We hold that when there has been a facially plausible claim of a substantial preference, the district court and/or the bankruptcy court cannot avoid the clear mandate of the statute by the mere expedient of approving retention conditional on a later determination of the preference issue.

Id.

-7-

The Law Firm argues that a bankruptcy court is not required to conduct a full blown trial to adjudicate whether an attorney received a pre-petition preferential transfer before deciding whether that attorney is eligible to be appointed under § 327(a). But even allowing that the Court must conduct some inquiry before deciding the Applications, the Law Firm argues that the facts in this case do not support a finding that there is a facially plausible preference claim against it. In support, the Law Firm points to paragraph 14 of the Amended Declaration, where the Law Firm admits that it received payments totaling \$13,500.00 from the Debtors during the 90 days before the Chapter 11 cases, but asserts that it has two valid defenses to any possible claim for a preferential transfer. First, it provided subsequent new value consisting of services and expenses totaling \$15,063.59 after the payments were made to it. Second, any payments made to it were substantially contemporaneous transfers for new value.

Although the UST does not provide the Court with any facts to refute the Law Firm's statements in the Amended Declaration, the UST points out that there were three separate drafts of pre-petition retainer agreements between the Debtors and the Law Firm, none of which were signed. As a result, the UST argues that it is difficult to tell whether there were preferential transfers to the Law Firm because it is not clear under which of these unsigned retention agreements the Debtors' payments were made. The Law Firm concedes that there are three separate drafts of unsigned retention agreements but argues that this fact is irrelevant. According to the Law Firm, what is relevant is that the payments to the Law Firm were contemporaneous exchanges for current services and reimbursement of costs, and that the Law Firm continued to provide the Debtors with subsequent new value after the Debtors made those payments.

The Court agrees with the holding of <u>Pillowtex</u> that when there is a facially plausible claim of a substantial preference, the Court cannot approve an application of employment conditioned on

some later determination of the preference issue. But the facts in the record before the Court do not demonstrate the existence of a facially plausible claim of a substantial preference.

The Amended Declaration states that the Law Firm performed pre-petition services having a value greater than the amount of the payments it received during the 90 days before the Chapter 11 petitions were filed. The Amended Declaration is a verified statement containing facts that tend to support one or more defenses to any claim of preferential transfer. The UST does not attempt to refute those facts nor does it identify any other facts to refute the Law Firm's contention that it has a complete defense based on subsequent new value or substantially contemporaneous exchange defenses. The only fact identified at all by the UST other than the fact of the payments themselves, is that there were no signed retention agreements between the Debtors and the Law Firm during the pre-petition period in which the Law Firm rendered services to the Debtors. However, that fact is not probative one way or the other as to whether there is a facially plausible claim of a preferential transfer.

In contrast to <u>Pillowtex</u>, there is no facially plausible preference claim against the Law Firm. Just because payments were made during the 90 days before bankruptcy does not mean that there is a facially plausible claim to recover those payments. There must be a showing of more facts to make a facially plausible claim. Perhaps there are other facts that could be marshaled to support a preference claim against the Law Firm, but none have been brought to the Court's attention nor has any party asked for the opportunity to take discovery or conduct any further proceedings to uncover any more facts. The only facts before the Court are those contained in the Affidavit and the

-9-

Amended Declaration, and they are not enough for the Court to find a facially plausible preference claim.³

Even if the Court were to find that there is a facially plausible claim of a preference, it is not one that is substantial. The total payments made to the Law Firm are \$13,500.00. The Chapter 11 petitions of the Debtors in the aggregate show assets of \$2,735,648.00 and debts of \$5,937,348.00. In this context, \$13,500.00 is not a substantial amount. Section 101(14)(C) requires that a disinterested person must not have "an interest materially adverse to the interest of the estate." For the same reason that the Court does not consider the amount of the alleged preferential transfers to be substantial in the sense that the <u>Pillowtex</u> opinion used that term, it does not consider the Law Firm's interest in the receipt of these payments to be material.

In sum, the Court agrees with the legal standards set forth in <u>Pillowtex</u>, but does not find that these cases demonstrate the existence of a facially plausible claim of a substantial preference to the Law Firm. The UST's allegations regarding preferential payments by the Debtors to the Law Firm does not preclude the Law Firm's employment under § 327(a).

The UST next argues that the Law Firm's pre-petition representation of Danny and Jeffery makes the Law Firm ineligible under § 327(a) to represent the Debtors. The UST also argues that the Law Firm's prior representation of Danny presents a conflict because Danny may have guaranteed payment of the Debtors' pre-petition legal fees to the Law Firm.

Section 327(a) focuses on whether the attorney whose employment is sought presently holds or represents an interest adverse to the estate. Likewise, § 101(14)'s disinterestedness test focuses on whether the attorney sought to be employed is presently a creditor or presently holds an interest

³ That does not mean that the Debtors — or, more precisely, the Debtors' creditors — are precluded from ever bringing a preference claim against the Law Firm, but only that there is no facially plausible claim in the record before the Court regarding the Applications.

materially adverse to the estate. The analysis of the UST's argument differs when applied to Danny and Jeffery.

The Law Firm states that it no longer represents Danny at all. There are no contrary facts in the record. The fact that the Law Firm previously represented Danny prior to the Debtors' Chapter 11 petitions is not remarkable, since it is common in the Court's experience for both closely held business entities and their owners to use the same attorney. It is also not uncommon for a principal of a closely held business to guaranty payment of certain debts of that business. But the mere fact of pre-petition representation of a principal of the business does not make the Law Firm ineligible under § 327(a) so long as the representation of the principal terminated on the date of the bankruptcy petition.

As to Jeffery, the Law Firm admits that it represented Jeffery as a defendant in a lawsuit brought in federal district court. The Affidavit and the Amended Declaration both state that Jeffery has discharged the Law Firm as his attorney in that lawsuit, that the Law Firm has filed a motion to withdraw from further representation of Jeffery in that lawsuit, that opposing counsel has consented to the withdrawal, and that the only delay in completion of the withdrawal is that the federal district court has scheduled a hearing on the Law Firm's motion for May 30, 2017. The Affidavit and the Amended Declaration both state that the Law Firm fully expects the motion to be granted at that time. There are no contrary facts in the record.

Without having more knowledge of the matters at issue in the federal district court lawsuit, it is conceivable to the Court that there could be a potential conflict of interest in the continuing representation of Jeffery in that lawsuit. However, because it is undisputed that Jeffery has discharged the Law Firm, the Law Firm's motion to withdraw has been consented to by the other party in that lawsuit, and there is a hearing scheduled on May 30, 2017 on the motion, it seems likely

-11-

to the Court that any further representation will be officially terminated on May 30, 2017, a matter of a few days. The Court cannot find from the record that the fact of the Law Firm's appearance on behalf of Jeffery constitutes either the holding or representing of a materially adverse interest that would disqualify the Law Firm under § 327(a).

The UST has raised a number of legitimate questions regarding the Applications. After all, there are multiple Debtors whose cases have not yet been jointly administered; the Debtors and their owners were all represented by the Law Firm pre-petition; the Law Firm was paid \$13,500.00 in the 90 days prior to the Debtors' Chapter 11 petitions; there were no written fee agreements executed between the Debtors and the Law Firm pre-petition; and the Law Firm continues to remain as counsel of record for one of the owners, Jeffery, in a lawsuit pending in federal district court, albeit with a pending unopposed motion to withdraw. These facts and the questions raised by them explain why the UST would not sign an order approving the Applications. The UST has a legitimate interest, indeed duty, to ensure that any applications for employment of an attorney in a Chapter 11 case pass muster under § 327(a) and § 101(14). However, having now reviewed the Affidavit and the Amended Declaration, and the facts that the Law Firm has identified in response to the UST's objections, the Court finds that the Law Firm is eligible to represent the Debtors and that the UST's objections must be overruled.

That leaves the objections of People's United and the Bank. Both of these entities are creditors. They both have understandable concerns about the viability of the Debtors' Chapter 11 cases. However, the arguments that they made both in writing and at the hearing do not address the Law Firm's eligibility to represent the Debtors. Instead, they really focus on whether these creditors may be entitled to some other form of relief in these Chapter 11 cases, such as relief from the automatic stay, dismissal or conversion. The Court takes the concerns of these creditors seriously.

But they do not provide the Court with a basis to deny the Applications. Even if the potential success of a Chapter 11 case is dubious, a Chapter 11 debtor in possession has the right to select its own attorney subject to the qualifications in § 327(a) and to the Court's approval. The Court finds that the Law Firm is eligible to be employed by the Debtors under § 327(a), and that is why the Court has entered orders granting the Applications.

The Court will docket a copy of this opinion in each of the Debtors' cases.

Signed on May 25, 2017

/s/ Phillip J. Shefferly
Phillip J. Shefferly
United States Bankruptcy Judge

Case:17-90131-jtg Doc #:53 Filed: 07/14/17 Page 1 of 9

UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF MICHIGAN NORTHERN DIVISION

	Case No. DM 17-90131 Hon. Scott W. Dales Chapter 11
/	
	/

MEMORANDUM OF DECISION & ORDER

PRESENT: HONORABLE SCOTT W. DALES Chief United States Bankruptcy Judge

I. INTRODUCTION

The Young Mens Christian Association of Marquette County ("YMCA") seeks approval of its selection of counsel to represent it as chapter 11 debtor-in-possession, but the United States Trustee filed an objection raising two main grounds for disqualification. First, he argues that the YMCA's proposed counsel is not "disinterested" and therefore ineligible for appointment under 11 U.S.C. § 327(a) because a current YMCA board member, Derek Swajanen, Esq., has referred bankruptcy cases to the firm in the past. Second, he objects to the appointment because an associate attorney at the firm, Glen Sarka, Esq., served as a YMCA board member within two years of the bankruptcy filing, rendering him not "disinterested" under the statute, a disqualification that the United States Trustee asks the court to impute to the firm.

The court held an evidentiary hearing to consider the dispute on July 11, 2017, in Marquette, Michigan. The following constitutes the court's findings of fact and conclusions of law under Fed. R. Civ. P. 52, made applicable to this contested matter by Fed. R. Bankr. P. 7052 and 9014.

II. JURISDICTION

The United States District Court for the Western District of Michigan has jurisdiction over the YMCA's chapter 11 bankruptcy case pursuant to 28 U.S.C. § 1334, and has referred that case, and all related proceedings, to the United States Bankruptcy Court pursuant to 28 U.S.C. § 157(a) and W.D. Mich. L.Civ.R. 83.2(a). The contested matter arising from the YMCA's Application for Appointment of Attorneys (the "Application," ECF No. 32), and the Objection to Debtor's Application for Appointment of Attorneys (the "Objection," ECF No. 41) filed by the United States Trustee ("UST") is a "core proceeding" within the meaning of 28 U.S.C. § 157(b)(2)(A). *See also* 28 U.S.C. § 1334(e)(2). Therefore, the court has authority to determine whether the Quinnell Law Firm, P.L.L.C. ("Quinnell Law") is eligible for appointment as counsel to the YMCA as the bankruptcy estate's fiduciary.

III. ANALYSIS

The YMCA filed a voluntary petition for relief under chapter 11 on May 5, 2017, and continues to operate its business as debtor-in-possession under §§ 1107 & 1108.¹ The credible testimony from the YMCA's current chief executive officer or CEO, Ms. Jenna Zdunek, suggests that mismanagement of grant monies and loan proceeds and other financial irregularities attributed to the prior chief executive, Ms. Lisa Coombs-Gerou, jeopardized the YMCA's survival as a social service agency serving the people of Marquette County and its environs. Although Ms. Zdunek could not rule out embezzlement by Ms. Coombs-Gerou, her testimony suggested misfeasance rather than malfeasance by the former CEO dating back to approximately 2012. The problems

¹ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532.

included, but were not limited to, spending grant monies in a manner inconsistent with the requirements of donor-foundations such as the W.K. Kellogg Foundation and the Walmart Foundation, misusing construction loan draws from the United States Department of Agriculture, and incurring half a million dollars of debt -- all without the formal authority, or perhaps even the knowledge, of the former board of directors. From Exhibit B, it also appears that Ms. Coombs-Gerou hired friends and family members to work at the YMCA without performing customary pre-employment practices, including reference checks.

Credible testimony from Ms. Zdunek and Ms. Michele Butler (a founder of the YMCA in Marquette and its current board chair) established that a former board of directors ignored by-laws, committee structures, and other governance procedures during much of Ms. Coombs-Gerou's tenure at the YMCA. The former board of directors took a "hands off" approach to the day-to-day affairs, deferring entirely to the then-CEO and otherwise requiring minimal accountability from senior management. Reasonable minds may infer that the former board's insouciance and inattention to the activities of the YMCA's senior management may have enabled or contributed to the missteps that eventually landed the YMCA in bankruptcy. Testimony also established that for approximately eight months, and at Ms. Coombs-Gerou's invitation, Glen Sarka served on the board that allegedly enabled or at least tolerated the former CEO's supposed misfeasance. He resigned for personal reasons in late August, 2015, shortly after joining the board but within two years of the petition date. He began working as an associate for Quinnell Law in December, 2016.

After Mr. Sarka's resignation from the board and before his hiring by Quinnell Law, the YMCA retained a down-state bankruptcy lawyer to give advice with respect to its financial distress. Ultimately, the YMCA rejected the former-counsel's advice to seek relief from the court in 2016. Instead, according to current board chair Michele Butler, the YMCA negotiated with its

creditors, including Gundlach Champion, rebuilt relationships with donors, and addressed creditor lawsuits, including by tendering the defense of at least one such lawsuit to its "directors and officers" insurance carrier.

Eventually, the YMCA sought bankruptcy counsel closer to home, and retained attorney Timothy C. Quinnell, Esq., and his law firm, Quinnell Law, to prepare and file a bankruptcy petition and schedules. Quinnell Law filed the Application, making customary disclosures under Fed. R. Bankr. P. 2014, and amending the disclosures, after the UST identified several deficiencies, probably innocent but nevertheless material.

In its Objection, in addition to noting disclosure shortcomings, the UST contends that Quinnell Law is not eligible for appointment under § 327(a) given its employment relationship with Mr. Sarka and the case referrals from Mr. Swajanen.

The approval of any professional to represent a bankruptcy estate (as here) depends on the professional's ability to satisfy the requirements of § 327, a statute which provides in relevant part as follows:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

11 U.S.C. § 327(a). As the Sixth Circuit noted in *Morgenstern v. Eagle Pitcher Industries, Inc.* (*In re Eagle Pitcher Industries, Inc.*), 999 F.2d 969, 971 (6th Cir. 1992), § 327(a) imposes two strictures: first, a professional must not "hold or represent and interest adverse to the estate," and second, the professional must be a "disinterested person" within the meaning of § 101(14). The Code phrases the requirements in the conjunctive, so the professional must satisfy both as a prerequisite to appointment as an estate professional. This also means, as *Eagle Pitcher*

Case:17-90131-jtg Doc #:53 Filed: 07/14/17 Page 5 of 9

recognized perhaps counterintuitively, that a person may be without an adverse interest, yet still not qualify as a "disinterested person." *Id.*, 999 F.2d at 972.

The concept of disinterestedness within the meaning of § 327(a) has a precise definition, defined in a negative or exclusionary way:

- (14) The term "disinterested person" means a person that—
 - (A) is not a creditor, an equity security holder, or an insider;
- (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
- (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

11 U.S.C. § 101(14). There is no suggestion that Quinnell Law is a creditor, or equity holder, or insider, so the court's focus narrows to subsections (B) and (C).

First, with respect to Mr. Swajanen, after listening to Mr. Quinnell's statements during the hearing on the Application, the UST has apparently abandoned his suggestion that the relationship with Mr. Swajanen disqualifies Quinnell Law under § 327(a). Indeed, the UST evidently saw no reason to challenge Mr. Quinnell's report that Mr. Swajanen has referred only two cases to Quinnell Law, approximately five years ago, and without referral fees. The UST's presentation during the evidentiary portion of the hearing, and in closing arguments, omitted any meaningful discussion of Mr. Swajanen, from which the court will assume the Objection, to the extent premised on Mr. Swajanen's referrals, has been abandoned. Regardless, given the UST's more ponderous (and, as explained below, ultimately successful) argument regarding the firm's relationship with Mr. Sarka, the court need not resolve the aspect of the Objection premised on Mr. Swajanen's relationship, if any, with Quinnell Law.

Case:17-90131-jtg Doc #:53 Filed: 07/14/17 Page 6 of 9

Second, with respect to Mr. Sarka, as the court indicated during the hearing, there is no dispute that Mr. Sarka himself is not a disinterested person -- testimony established that he was a YMCA director within two years of the petition date and thereby disqualified under § 101(14)(B). Nevertheless, the court is not persuaded that Mr. Sarka's disqualification should be automatically or reflexively imputed to Quinnell Law under authorities such as *In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003), for the reasons set forth in *In re Cygnus Oil and Gas Corp.*, 2007 WL 1580111, Slip Op. Case No. 07-32417 (Bankr. S.D. Tex. 2007), *In re Timber Creek, Inc.*, 187 B.R. 240, 244 (Bankr. W.D. Tenn. 1995), and similar authorities. A party's choice of counsel is too important, and too deserving of protection, to apply a *per se* rule of imputed disqualification without a firm direction from Congress requiring such a result.

This aversion to *per se* imputation follows in part from the importance of the relationship between attorney and client, but mostly from the court's reading of the statute, which provides no express basis for indirect or imputed disqualification in § 101(14), except in § 101(14)(C), which expressly mentions direct or indirect relationships. This is precisely the sort of language that Congress would use to create imputed disqualification. The reference to indirect relationships in § 101(14)(C), juxtaposed to the text in § 101(14)(B) which omits any such relationship, signals that Congress intended the court to consider indirect and potentially disqualifying relationships under one part of the statute but not the other. Moreover, § 327 and § 1107 together authorize a debtor-in-possession to retain "one or more attorneys" and it is clear from the hearing on the Application that, as a practical matter given the "ethical wall" Mr. Quinnell has erected around Mr. Sarka, that the Debtor is asking to retain the latter but not the former in this two-person firm.

Moreover, as suggested during the hearing, the court is not persuaded by the UST's reference to M.R.P.C. 1.10(a), 1.7, 1.8(c), and 1.9 which, as Judge Walrath herself acknowledged

Case:17-90131-jtg Doc #:53 Filed: 07/14/17 Page 7 of 9

in *Essential Therapeutics*, 295 B.R. at 208-09, only come into play with actual conflicts. In addition, the meaning of the federally-defined term "disinterested person" is largely a federal question. *Cf.* 28 U.S.C. § 1334(e)(2). The supposedly "Herculean task" of evaluating individual members of a professional firm which evidently motivated the *Essential Therapeutics* decision is considerably less Herculean in a district like ours that has mostly small firms, or with respect to a firm like Quinnell Law, that has two lawyers.

To summarize, then, the court reads § 101(14)(B) as disqualifying Mr. Sarka, but not necessarily Quinnell Law -- a distinct "person" as that term is defined in § 101(41). Rather, the disinterestedness (or not) of Quinnell Law will depend on § 101(14)(C), and a more nuanced, fact-based consideration of potentially disqualifying interests of that entity. Accordingly, because Mr. Sarka is an employee of Quinnell Law, the court must consider whether Quinnell Law's relationship with Mr. Sarka under the circumstances of the case prevents the court from declaring that Quinnell Law is a "disinterested person."

Having heard the testimony and considered the several exhibits offered during the July 11, 2017 hearing on the Application, the court finds that the employment relationship between Quinnell Law and Mr. Sarka, Mr. Sarka's potential exposure as a former member of the YMCA board during the tenure of Ms. Coombs-Gerou, and the former CEO's concomitant financial and perhaps other mismanagement, together disqualify the firm. It certainly requires no stretch of the imagination to conclude that the individuals who served as members of the board during Ms. Coombs-Gerou's tenure as CEO -- including Mr. Sarka -- may have to answer to the Debtor for their seeming failure to detect, deter, or otherwise address what colorably appears be the former CEO's mismanagement. The court need not decide today whether Ms. Coombs-Gerou in fact harmed the Debtor, though there is more than a suggestion of such harm in the record. Rather, it

is enough to conclude, as the court does, that the Debtor may have good reason to investigate whether it has breach of fiduciary duty or other claims against the board members who arguably contributed to the alleged mismanagement by ignoring by-laws, policies, and procedures designed to prevent financial harm -- procedures such as constituting finance and other committees, and instituting regular reporting to the board by executive management, such as the current YMCA board has recently restored. Naturally, the YMCA will rely on its counsel to conduct such an investigation.

Mr. Sarka's tenure on the board was admittedly brief, and the court does not intend through this opinion to impugn his service (or the service of other board members). Instead, the court need only observe that Quinnell Law may be chilled, or may be perceived to be chilled, in investigating the conduct of its current (and only) associate. If, as Mr. Quinnell predicts, any such investigation would exonerate Mr. Sarka, interested parties could be forgiven for harboring doubts about the exoneration of one attorney by the very firm that hired him. In other words, Mr. Sarka's potential liability as a former YMCA board member recruited by the offending CEO during the crucial period of mismanagement, coupled with the duty of debtor's counsel to investigate and perhaps pursue causes of action against board members, could cloud the judgment and disinterestedness of Quinnell Law. As the current employer of a natural target of such an investigation, and as an entity with its own reputational interests, Quinnell Law has "an interest materially adverse to the interest of the estate," even assuming Mr. Sarka is completely blameless. 11 U.S.C. § 101(14)(C).

IV. CONCLUSION AND ORDER

During the hearing, proposed counsel for the Unsecured Creditors' Committee urged the court to cure Quinnell Law's lack of disinterestedness by assigning to the Committee the task of

Case:17-90131-jtg Doc #:53 Filed: 07/14/17 Page 9 of 9

investigating the acts and omissions of the YMCA's former board, and perhaps bestowing

derivative standing to pursue any claims. Nevertheless, by offering its proposal to address

Quinnell Law's lack of disinterestedness, the Committee necessarily concedes the disqualifying

condition in the first instance, and invites the court to wink at the statute. The court cannot

disregard the command of Congress, despite the practical appeal of the Committee's suggestion.

Regrettably, today's decision will deprive the YMCA of its choice of competent, local, and

cost-effective counsel, as the Debtor and Committee counsel argued during the hearing, but the

court is not free to disregard its conclusion that the Debtor's choice of counsel is not disinterested.

NOW, THEREFORE, IT IS HEREBY ORDERED that the Application is DENIED.

IT IS FURTHER ORDERED that the Clerk shall serve a copy of this Memorandum of

Decision & Order pursuant to Fed. R. Bankr. P. 9022 and LBR 5005-4 upon Timothy C.

Quinnell, Esq., Robert F. Wardrop, II, Esq., Michael V. Maggio, Esq., the United States Trustee,

all parties requesting notice of these proceedings, and all entities included on the Debtor's mailing

matrix.

END OF ORDER

IT IS SO ORDERED.

Dated July 14, 2017

A STREET OF THE STREET

Scott W. Dales

United States Bankruptcy Judge

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

2017 WL 2688233 United States Bankruptcy Court, D. New Mexico.

IN RE: WM DISTRIBUTION, INC., Debtor.

No. 17–10535–j11 | Signed June 21, 2017

Attorneys and Law Firms

William F. Davis, Nephi D. Hardman, William F. Davis & Assoc., P.C., Albuquerque, NM, for Debtor.

Leonard K. Martinez-Metzgar, Albuquerque, NM, for U.S. Trustee.

MEMORANDUM OPINION AND ORDER ON APPLICATION TO EMPLOY ATTORNEYS

ROBERT H. JACOBVITZ, United States Bankruptcy Judge

*1 On June 7, 2017, the Court held a final hearing on **Debtor's** Application to Employ William F. Davis & Associates, P.C. (Docket No. 5) (the "Application"). Susan Jesmer d/b/a Native Trading Associates ("Ms. Jesmer"), Donald Packingham, and the United States Trustee (the "UST") filed objections to the Application (Docket Nos. 26, 34, and 40) asserting that William F. Davis & Associates, P.C.'s (the "Davis Firm") simultaneous representation of WM Distribution, Inc. ("WM Distribution") and Sandia Tobacco Manufacturers, Inc. ("STM") is a disqualifying conflict of interest. 1 The Davis Firm appeared at the final hearing for WM Distribution. Dylan O'Riley appeared for Ms. Jesmer. Richard Marquez appeared for Donald Packingham. Leonard Martinez-Metzger appeared for the UST.

FACTS

Relationship between WM Distribution and STM.

WM Distribution is primarily in the business of

distribution cigarettes to vendors in New Mexico and surrounding states. WM Distribution also distributes food

and drinks to those vendors ancillary to its cigarette distribution. WM Distribution has a close working relationship with STM. STM also distributes cigarettes and some food items to vendors in the same territory. Della Packingham, Donald Packingham's estranged wife, is WM Distribution's president and owns 90% of WM Distribution's outstanding shares. Donald Packingham is STM's president and owns 90% of STM's outstanding shares. Donald and Della Packingham's divorce is currently pending in New Mexico state court. Donald and Della Packingham's daughter, Donna Woody, owns 10% of the outstanding shares of both WM Distribution and STM. Donna Woody is vice-president of WM Distribution and STM and manages the daily operations of both companies. The Davis Firm reports to and takes instructions from Donna Woody in connection with its representation of WM Distribution and STM.

WM Distribution and STM primarily distribute two cigarette brands, Sandia and Royal. WM Distribution owns the Sandia trademark. STM owns the Royal trademark. STM works with the various governmental regulatory agencies to obtain necessary licenses and approvals for both the Royal and Sandia brands. The Sandia brand is approximately three times more profitable than the Royal brand. For many years, STM manufactured cigarettes under the Sandia and Royal brands. It ceased manufacturing cigarettes several years ago. Today, Seneca, a company unaffiliated with either WM Distribution or STM, manufactures cigarettes under the Sandia and Royal brands for sale to STM. WM Distribution buys cigarettes from STM. STM also sells cigarettes to others.

WM Distribution purchases cigarettes for resale from STM at a rate of approximately \$50,000.00 to \$60,000.00 each week. WM Distribution scheduled a pre-petition non-priority unsecured debt to STM of \$514,113.60 for unpaid cigarette purchases. STM is WM Distribution's largest unsecured creditor by a large margin and holds approximately 50% of WM Distribution's total unsecured debt.

*2 WM Distribution occupies one third of the space in a warehouse STM rents, a value of approximately \$3,500.00 a month. WM Distribution does not pay STM for WM Distribution's use of the warehouse, nor does WM Distribution reimburse STM for WM Distribution's portion of the utilities costs at the warehouse. There is

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

no licensing agreement between WM Distribution and STM for STM's use of the Sandia brand owned by WM Distribution and STM does not pay WM Distribution any licensing fees. WM Distribution and STM regularly use each other's employees without compensation and without tracking such use. WM Distribution and STM are covered under the same insurance policy for worker's compensation and sexual harassment claims. These interrelations, which have lasted for many years, will require accounting and legal work to determine whether one company has a net claim against the other apart from STM's claim against WM Distribution for unpaid cigarette purchases.

Other creditors with large claims.

WM Distribution previously leased commercial space from Market Center @ Renaissance, LLC ("Market Center"). STM is a guarantor on WM Distribution's lease with Market Center. WM Distribution scheduled an unliquidated debt to Market Center in the amount of \$360,000.00 for unpaid rent. Market Center is WM Distribution's second largest unsecured creditor. WM Distribution's third largest scheduled unsecured debt is almost \$300,000.00 less than its scheduled debt to Market Center.

WM Distribution has two secured creditors in this bankruptcy case. WM Distribution's largest secured creditor is Ms. Jesmer. WM Distribution scheduled a secured debt to Ms. Jesmer of \$63,224.08. WM Distribution listed STM as its co-debtor on that debt. Ms. Jesmer filed a secured claim of \$725,994.73 which it claims is secured by all WM Distribution's assets. Ms. Jesmer identified the basis of that debt as a promissory note and attached a copy of that promissory note (the "Jesmer Note"). The Jesmer Note identifies WM Distribution and STM as the co-makers. Ms. Jesmer contends that STM's bankruptcy filing triggered a default provision under the Jesmer Note providing for an additional \$600,000.00 due under that note, which she seeks to enforce against WM Distribution but not STM. Donald Packingham filed a secured claim of \$49,000.00. Donald Packingham's stated basis for that secured claim is "[p]roperty is owned by Donald Packingham." WM Distribution intends to dispute Ms. Jesmer's claim but has not yet filed an objection to the claim. No deadline for objections to claims has been set in WM Distribution's bankruptcy case.

STM's bankruptcy case.

STM filed a chapter 11 bankruptcy case on September 19, 2016. See Bankruptcy Case No. 16–12335–j11, Docket No. 1. The Court entered an order approving the Davis Firm's representation of STM in its bankruptcy case on October 18, 2016 without objection. See Bankruptcy Case No. 16–12335–j11, Docket No. 16. STM's schedules show \$423,339.02 in total assets and \$15,981,217.69 in total liabilities. Bankruptcy Case No. 16–12335–j11, Docket No. 27.

A large portion of STM's debt is to various federal and state regulatory agencies. STM scheduled a non-priority unsecured debt to Donald and Della Packingham in the amount of \$2,800,000.00. Donald Packingham filed a secured claim in STM's bankruptcy case in the amount of \$2,000,000.00. STM scheduled a non-priority, contingent, unliquidated, and disputed unsecured \$0.00 claim of Market Center. STM identified the basis of the Market Center claim as "[c]ontingent liability for lease of WM, Inc." Bankruptcy Case No. 16–12335–j11, Docket No. 27.

STM scheduled a contingent, unliquidated, and disputed secured debt to Ms. Jesmer of \$117,316.18. Ms. Jesmer filed a secured claim in STM's bankruptcy case of \$86,466.00. The basis for that claim is the Jesmer Note.

Conflicts of interest.

Donna Woody believes it is in the best interest of both WM Distribution and STM for both companies to successfully reorganize. Donna Woody also believes that, at present, it is in both companies' best interest for WM Distribution to continue to buy Sandia and Royal branded cigarettes from STM. If WM Distribution were to purchase its cigarettes directly from the manufacturer or through another intermediary, Donna Woody believes it would hinder STM's ability to reorganize. One reason WM Distribution purchases its cigarettes from STM rather than directly from the manufacturer is that STM is authorized to purchase cigarettes on which taxes have not yet been paid. Donna Woody also testified, however, that she is considering whether WM Distribution at some point should buy cigarettes directly from Seneca (for which taxes have been paid) instead of buying the cigarettes from STM. This could affect STM's and WM Distribution's profitability, as well as how each company structures its chapter 11 plan. As WM Distribution prepares to draft

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

a plan of reorganization, it will need to consider whether its present relationship with STM is in its best **interest** for its reorganization prospects. WM Distribution must be able to openly consider options that could negatively affect STM. Donna Woody has a duty of loyalty to both WM Distribution and STM, which will make that consideration more challenging.

Litigation Over Control of STM

*3 Donald Packingham, as 90% owner of the capital stock of STM, is seeking to terminate the services of the Davis Firm as counsel for STM and relieve Donna Woody of her authority to manage STM and act as its agent with respect to its bankruptcy case. In an adversary proceeding STM commenced, the Court entered a preliminary injunction enjoining Donald Packingham from taking any action to fill the vacant seat on STM's board. See Adversary No. 17–1036, Docket No. 23. The injunction expires when the Court rules on confirmation of a plan of reorganization in the STM bankruptcy case or as otherwise ordered by the Court, on the condition that STM files a plan and disclosure statement by June 19, 2017. Id. STM did so. See Bankruptcy Case No. 16–12335, Docket Nos. 181 & 182.

DISCUSSION

The Davis Firm seeks approval of its employment as WM Distribution's general bankruptcy counsel pursuant to 11 U.S.C. § 327(a). That section provides:

Except as otherwise provided in this section, the trustee, ² with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

11 U.S.C.§ 327(a).

Under this section, proposed **counsel** must satisfy two requirements: 1) **counsel** must not hold or represent an **interest adverse** to the estate; and 2) **counsel** must be

disinterested. ³ See 11 U.S.C. § 327(a); In re 7677 East Berry Ave. Associates, L.P., 419 B.R. 833, 841 (Bankr. D. Colo. 2009) (identifying § 327(a)'s two requirements) (citing In re Cook, 223 B.R. 782, 789 (10th Cir. BAP 1998)). ⁴ Subsection (c) of § 327 clarifies that, in a chapter 11 case,

a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

11 U.S.C. § 327(c) (emphasis added).

Thus, where the only grounds another creditor or the United States trustee raises as an objection to the proposed employment is **counsel's** employment or representation of a creditor, the Court may nevertheless approve the application for employment, provided such **counsel** does not have an actual conflict. *See In re Interwest Bus. Equipment, Inc.*, 23 F.3d 311, 316 (10th Cir. 1994) (explaining that, "if another creditor or the U.S. trustee objects, the bankruptcy judge can **disqualify** a professional *solely* on the basis of simultaneous representation, *if* it finds the joint representation creates an actual conflict.") (emphasis in original).

*4 Counsel who also represents a creditor is disqualified from representing a debtor if there is an actual conflict of interest; potential conflicts of interest do not mandate disqualification. See In re Schwindt, 2013 WL 321297, at *3 (Bankr. D. Colo. Jan. 28, 2013) (observing that "bankruptcy courts are not required to disqualify counsel for 'potential' conflicts of interest."); In re Platinum Oil Properties, LLC, 2009 WL 5201851, at *10 (Bankr. D.N.M. dec.23, 2009) (explaining that § 327 "imposes a per se disqualification if counsel for the estate has an actual conflict of interest, whereas the Court has discretion to disqualify counsel that has a potential conflict of interest.") (citing In re Pillowtex, Inc., 304 F.3d 2456, 2561 (3d Cir. 2002) (remaining citations omitted). Even so, "[t]he requirements of subsection (a) are threshold requirements to be met even if subsection (c) is implicated." Interwest,

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

23 F.3d at 316. Counsel who cannot satisfy § 327(a)'s requirements has a disqualifying conflict and may not represent a debtor in possession, unless the limited exception in subsection (c) applies. Even then, counsel may not represent a debtor in possession if counsel has an actual conflict of interest.

The Bankruptcy Code does not define "actual conflict of interest." 7677 East Berry, 419 B.R. at 844. Courts must examine the surrounding facts and circumstances on a case-by-case basis to determine whether a disqualifying actual conflict of interest bars the requested representation. See In re Dick Cepek, Inc., 330 B.R. 730, 740 (9th Cir. BAP 2006). See also, Bank Brussels Lambert v. Coan (In re AroChem Corp.), 176 F.3d 610, 623 (2d Cir. 1999) ("Whether an adverse interest exists is best determined on a case-by-case basis."). "An actual conflict exists if there is 'an active competition between two interests, in which one interest can only be served as the expense of the other.' "In re Git-N-Go, 321 B.R. 54, 58 (Bankr. N.D. Okla. 2004) (quoting In re BH & P, Inc., 103 B.R. 556, 563 (Bankr. D.N.J. 1989), aff'd in pertinent part, 119 B.R. 35 (D.N.J. 1990)).

Simultaneous representation of two related debtors presents a potential for an actual conflict of interest. Often inter-company transfers will exist, resulting in each debtor holding a claim against the other. Courts often find such dual representation a disqualifying actual conflict. See, e.g., Interwest. 23 F.3d at 318 (affirming bankruptcy court's denial of counsel's employment application seeking to represent three inter-related chapter **11** debtors); In re JMK Construction Group, Ltd., 441 B.R. 222, 234 (Bankr. S.D.N.Y. 2010) (counsel seeking to simultaneously represent multiple chapter 11 debtors holding inter-debtor claims against one another held a disqualifying adverse interest); In re Straughn, 428 B.R. 618 (Bankr. W.D. Pa. 2010) (counsel disqualified from dual representation of debtor corporation and debtor-principal in related chapter 11 cases); In re Al Gelato Continental Desserts, Inc, 99 B.R. 404, 407 (Bankr. N.D. III. 1989) (concluding that counsel who sought to represent related chapter 11 debtors held a disqualifying interest adverse to the estate, and observing that there is "substantial authority disapproving simultaneous representation of related **debtors** holding claims against one another.") (citations omitted); In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1989) (counsel could not represent both the corporation and its principal shareholder in each

respective bankruptcy case). See also, In re Wheatfield Bus. Park, LLC, 286 B.R. 412, 418 (Bankr. C.D. Ca. 2002) ("Where a bankruptcy debtor is a creditor of a related **debtor**, it is presumptively improper for the same attorney (or law firm) to be general **counsel** for the related **debtors**.") (citing *Interwest*, 23 F.3d at 316). However, "the existence of inter-debtor claims does not create a per se prohibition of counsel representing both estates." 7677 East Berry, 419 B.R. at 844 (citing In re BH & P, Inc., 949 F.2d 1300, 1314 (3d Cir. 19910). See also, Interwest, 23 F.3d at 318-19 ("[W]e do not hold such simultaneous representation of related estates in bankruptcy is per se prohibited."); In re BH & P, Inc., 949 F.2d 1300, 1314 (3d Cir. 1991) ("The existence of inter-debtor claims is ... no longer an automatic ground for disqualification of counsel for the trustee.").

*5 The Davis Firm makes two arguments in support of its Application: 1) its simultaneous representation of STM and WM Distribution does not give rise to an actual conflict of interest; and 2) any potential for an actual conflict of interest can be cured by hiring separate conflicts counsel to represent WM Distribution on those matters for which an actual conflict exists. Under the facts and circumstances of this case, the Court disagrees.

There are multiple actual conflicts of **interest** in the Davis Firm's dual representation of WM Distribution and STM. WM Distribution purchases its cigarettes from STM for distribution, and has an outstanding pre-petition debt to STM of over \$500,000. The debt to STM is more than 50% of WM Distribution's total unsecured debt. STM would control the unsecured creditors' class in any **chapter 11** plan WM Distribution proposes.

In addition, WM Distribution owns the Sandia trademark, STM's most valuable cigarette brand, yet WM Distribution has no licensing agreement with STM for its use of the trademark. WM Distribution may need to require STM to pay for its use of the trademark. Or, WM Distribution may determine it is in its best interest to license the use of the Sandia trademark to some other entity. Such a decision could harm STM and negatively affect its reorganization prospects.

WM Distribution occupies some of STM's warehouse, but pays STM no rent or any portion of the utilities expenses. WM Distribution's employees regularly perform work for STM, but without compensation from STM. A single

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

insurance policy covers worker's compensation and sexual harassment claims for both companies. These activities give rise to multiple inter-company claims.

WM Distribution contends that the resolution of any inter-company transfers and shared expenses is simply a matter of accounting, requiring business, not legal judgment and representation of each debtor with respect to any accounting issues could be handled by separate conflicts counsel. "In many cases, the employment of conflicts counsel to handle issues where general bankruptcy counsel has an adverse interest solves most questions regarding the retention of general bankruptcy counsel." Project Orange, 431 B.R. at 375. 5 The concept is that if conflict matters-matters in which general bankruptcy counsel's simultaneous representation of more than one debtor would pose a disqualifying conflict of interest—are carved out of the scope of general bankruptcy counsel's representation of the debtors, and are assigned to separate independent counsel, no actual conflict of interest can arise on the part of general bankruptcy counsel. The conflict matters are outside the scope of its representation. However, such use of conflicts counsel is not appropriate where the adverse interests of the debtors represented by the same general bankruptcy counsel are central to the reorganization efforts of either debtor or to other resolutions of the chapter 11 case or where the adverse interests are so extensive that each debtor should have its own independent general bankruptcy counsel. Cf. Project Orange, 431 B.R. at 375 (use of conflicts counsel is not appropriate where "the proposed general bankruptcy counsel has a conflict of interest with a creditor that is central to the debtor's reorganization.").

*6 Because use of conflicts **counsel** was not at issue in *Interwest*, the Tenth Circuit's decision does not foreclose the possibility of using independent conflicts **counsel** to represent a **chapter 11 debtor** in matters for which a **debtor's** proposed general bankruptcy **counsel** otherwise would hold a **disqualifying** conflict of **interest**. Indeed, the Tenth Circuit went out of its way to hold that there is no *per se* prohibition against simultaneous representation of related bankruptcy estates. *Interwest*, 23 F.3d at 318–19.

Use of conflicts **counsel**, however, is not a viable solution to permit the Davis Firm to represent both WM Distribution and STM. The extent of the areas of **adverse interests** between the two **debtors**, which

include adverse interests that are central to their respective reorganization efforts, renders it inappropriate to use of conflicts counsel in the case. WM Distribution's best prospects for reorganization may negatively affect STM's reorganization prospects if WM Distribution decides it is in its best interest to purchase the Royal and Sandia brand cigarettes directly from Seneca. STM and WM Distribution need separate counsel to advise the companies as to what is in the best interest of each company regarding their continuing business relationship so each company can best formulate its chapter 11 plan. There is no licensing agreement between WM Distribution and STM for STM's use of the Sandia cigarette brand. Negotiation of a licensing agreement between the two companies would require separate counsel on each side of the negotiation. STM holds about half of WM Distribution's scheduled nonpriority unsecured debt and almost one third of its total debt. WM Distribution's treatment of claims held by STM will be an important component of any plan WM Distribution proposes and could also affect the reorganization prospects of STM. There is extensive entanglement in the daily operation of the two companies by their use of common labor and facilities without compensation to the other that will need to be sorted out.

A court should approve a debtor's choice of counsel, "only when that professional's judgment and advocacy would be unclouded by divided loyalty." *Interwest*, 23 F.3d at 316. *See also, Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (stating that § 327(a)'s requirements "serve the important policy of ensuring that all professionals appointed pursuant to section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities."). The areas in which the two companies have adverse interests are such that retention of independent conflicts counsel poses too great a risk that the Davis Firm would nevertheless be unable to give each debtor its undivided loyalty and provide to each debtor untainted advice and assistance in furtherance of their fiduciary responsibilities.

WHEREFORE, IT IS HEREBY ORDERED that the Application is DENIED.

All Citations

Slip Copy, 2017 WL 2688233, 64 Bankr.Ct.Dec. 79

In re WM Distribution, Inc., Slip Copy (2017)

64 Bankr.Ct.Dec. 79

Footnotes

- The UST did not timely file an objection to the Application, but did file a document titled "U.S. Trustee's Comment on Debtor's Application to Employ Attorneys" (Docket No. 40). In a previous order, the Court with the consent of all parties deemed that document to be a timely filed objection to the Application. See Order Resulting From Preliminary Hearing, Docket No. 61.
- 2 A chapter 11 debtor in possession has all the rights of a trustee. 11 U.S.C. § 1107(a). "The debtor-in-possession has the authority to hire an attorney pursuant to 11 U.S.C. § 327." In re Amdura Corp., 121 B.R. 862, 865 (Bankr. D. Colo. 1990).
- 3 The Bankruptcy Code defines "disinterested person" as a person that
 - (A) is not a creditor, an equity security holder, or an insider;
 - (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the **debtor**; and
 - (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

11 U.S.C. § 101(14).

- 4 But cf. In re Project Orange Associates, LLC, 431 B.R. 363, 369–70 (Bankr. S.D.N.Y. 2010) (observing that "[t]he structure of the Bankruptcy Code distills these dual requirements into a single test for analysis of a conflict of interest.").
- 5 See also, Amdura Corp., 121 B.R. at 867 (suggesting that using separate counsel to solve the problem of a disqualifying conflict of interest is worth the Court's consideration).

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