Southeastern Bankruptcy Law Institute

THIRTY-FIFTH ANNUAL
BANKRUPTCY CONFERENCE

Getting Paid in Bankruptcy

PRESENTED BY:

The Honorable Margaret Cangilos-Ruiz
United States Bankruptcy Court for the Northern District of New York[1]

[1] A special acknowledgement and thanks to my law clerks, Dawn Simmons-Norris and Casey A. Johnson, for their work in helping to prepare these materials.

Southeastern Bankruptcy Law Institute's 35th Annual Bankruptcy Conference
Atlanta, Georgia ~ April 23-25, 2009

GETTING PAID IN BANKRUPTCY

Presentation by Hon. Margaret Cangilos-Ruiz

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I. Introduction

The Bankruptcy Code and pertinent rules set forth the basic requirements for counsel to get paid for professional services rendered in connection with a bankruptcy case. The disallowance and denial of counsel fees by bankruptcy courts are most often attributable to counsels' repeated mistakes in failing to comply with these basic rules. The following materials are intended to assist counsel, whether occasionally or regularly appearing in bankruptcy court, to avoid the most common pitfalls so they can get paid for their professional services in chapter 7, 11 and 13 cases.

II. Chapter 7

A. Retention as Debtor's Counsel

No approval by the court is necessary to represent a debtor under chapter 7.

1. Fees for Representation in Chapter 7

The chapter 7 fee agreed to be paid to debtor's counsel in a chapter 7 case should be paid in full prior to filing or the unpaid balance of the fee may be subject to discharge with debtor's counsel treated as a general unsecured creditor.[2] Counsel fees are reviewed oby the court andd any portion deemed excessive is subject to disgorgement. Code section 329(b) provides that if

[2] *See Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1127 (7th Cir. 2003), *cert. denied*, 541 U.S. 1043, 124 S.Ct. 2176 (2004) (prepetition debts to debtor's counsel for legal fees are subject to discharge).

the compensation of debtor's counsel exceeds the reasonable value of such services, a court may order the return of such payments on its own initiative or upon motion filed by a party in interest.[3] Prepetition fees paid to debtor's counsel are separately recoverable under Code section 548 to the extent that the debtor did not receive reasonably equivalent value for the fees paid.[4] Payments made to counsel should be paid prior to or contemporaneous with services rendered or payments may be subject to recovery as preferential.[5]

Counsel should also collect from the debtor the chapter 7 filing fee. If counsel is not proceeding pro bono and the debtor has paid counsel fees for representation in the bankruptcy, a request to waive the filing fee and proceed *in forma pauperis* will most likely be denied.

2. Scope of Services

The retention agreement should set forth the agreed fee and clearly define what services are covered, including preparation of the petition, required schedules, advice and representation at the section 341 meeting. The retention agreement should also clearly define the cost and provision for payment of any ongoing services anticipated during the bankruptcy proceeding. By filing a petition on behalf of a debtor, counsel submits the debtor to the jurisdiction of the court. Many courts require debtor's counsel of record to represent the debtor in all aspects of the case, with counsel permitted to withdraw from representation only by court order.[6]

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[3] 11 U.S.C. § 329(b); *see also* Fed. R. Bankr. P. 2017(a); *In re Prudhomme*, 43 F.3d 1000, 1004 (5th Cir. 1995) (affirming the district court order affirming the bankruptcy court's determination that fees paid to debtor's counsel were excessive).

[4] 11 U.S.C. § 548(a)(1)(B)(i).

[5] 11 U.S.C. § 547(b).

[6] In this regard, local rules of practice should be consulted. *See* proposed Local Bankruptcy Rule 2016-3, Northern District of New York, which is modeled upon similar rules from other jurisdictions: "Attorney Duties. An attorney representing a debtor shall be the attorney of record throughout the debtor's bankruptcy case, unless relieved from representation by order of the court. Unless otherwise determined by the court, an attorney for debtor is required to represent the debtor in all matters related to the bankruptcy case including, but not limited to, defending

3. 2016 Statement

Within 15 days of the order for relief (or as otherwise directed by the court), debtor's counsel must file a disclosure of compensation pursuant to Fed. R. Bankr. P. 2016 ("2016 Statement"). The 2016 Statement requires disclosure of all fees paid and the source of said fees received from or on behalf of the debtor within the 12 months preceding the petition date. The failure of debtor's counsel to disclose fees may result in an order of disgorgement.[7] Debtor's counsel must also disclose any agreements to share compensation with any other entity.[8] If the initial statement is incorrect or incomplete, any change to the information provided is to be submitted in an amended 2016 Statement.[9]

B. Payment for Post-Petition Services to Debtor's Counsel

1. Payable from Non-Estate Property

Debtor's counsel must look to post-petition earnings of the debtor or third parties for payment. After filing, debtor's counsel in a chapter 7 case may not receive fees from property of the estate for services rendered on behalf of the debtor.[10] Motions such as lien-avoidance

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adversary proceedings commenced pursuant to §§ 523 and 727, attending § 341 meetings, opposing motions to lift stay when appropriate and attending contested confirmation hearings." *See also* Local Bankruptcy Rule 2016-1, Bankr. D. Vt.; Local Bankruptcy Rule 2017-1 and 2090-1, Bankr. E.D.N.Y.

[7] *See In re Gore*, No. 07-21103REF, 2008 Bankr. LEXIS 3192, (Bankr. E.D. Pa. Nov. 25, 2008) (court ordered disgorgement when debtors' counsel failed to disclose fees paid to him by the debtors in their first case and he filed debtors' second case within a year).

[8] Fed. R. Bankr. P. 2016(b).

[9] *See In re Johnson*, No. 06-10609, 2008 Bankr. LEXIS 3220 at *8 (Bankr. E.D. La. August 28, 2008) (debtor's counsel violated 11 U.S.C. section 329 and Fed. R. Bankr. P. 2016 by not amending the 2016 disclosure to reflect additional amounts paid to debtor's counsel by the debtor).

[10] *See Lamie v. United States Tr.*, 540 U.S. 526 (2004**)** (Code section 330(a)(1) does not permit compensation of debtor's counsel from estate funds unless they are employed by the trustee under Code section 327 and approved by court).

motions and defense of dischargeability actions benefit the debtor and not the estate, and fees for such services cannot be charged against the estate.

2. Statutory Provisions for Recovery of Fees in Defending/Bringing Certain Actions

The Code provides for the recovery of attorney fees from the opposing party in certain specific instances.

a. Defense of Involuntary Proceeding

Debtor's counsel may recover attorney fees for successfully defending against an involuntary filing as permitted by Code section 303(i)(1).[11] A showing of bad faith in the filing of the involuntary petition is not necessary to recover costs and attorneys' fees under section 303(i)(1), but under section 303(i)(2), proximate damages and punitive damages are recoverable only upon a showing of bad faith.[12]

b. Defense of Motion Alleging Abusive Filing

A debtor may also be awarded attorneys' fees for successfully defending a motion under Code section 707(b) for abusive filing brought by a party other than the United States Trustee, chapter trustee, or bankruptcy administrator.[13] The court must find that the party pursuing the motion violated Fed. R. Bankr. P. 9011[14] or the motion was made "solely for the purpose of

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[11] *See In re Diloreto*, 388 B.R. 637, 652 (Bankr. E.D. Pa. 2008) (court found that the debtor was entitled to attorneys' fees and costs incurred to defend against an involuntary chapter 7 petition filed by the Superintendent of Insurance of the State of New York who later chose not to pursue the action).

[12] *See In re Bayshore Wire Products Corp.*, 209 F.3d 100, 105 (2d Cir. 2000) (a finding of bad faith not necessary under 11 U.S.C. § 303(i)(1) but a finding of bad faith necessary under section 303(i)(2) is necessary under one of the applicable tests, such as the improper use test, the improper purpose test, the objective test, or one applying Fed. R. Bankr. P. 9011 standards).

[13] 11 U.S.C. § 707(b)(5)(A).

[14] For example, the court could find that the motion was filed to harass, caused unnecessary delay, needlessly increased the costs of litigation or the claims were frivolous without evidentiary support. *See* Fed. R. Bankr. P. 9011.

coercing a debtor into waiving a right guaranteed to the debtor under this title."[15] Small businesses with an aggregate claim less than $1,100.00 will not be found in violation of Fed. R. Bankr. P. 9011.[16] If the court does not grant the motion, it may award reasonable costs (including attorneys' fees) sua sponte or pursuant to motion.[17]

c. Defense of Dischargeability Complaint on Consumer Debt under Code section 523(a)(2)

Code section 523(a)(2) denies the discharge of a debt for money, property, services, or an extension, renewal, or refinancing of credit obtained by false pretenses or fraud.[18] If the complained-of debt is determined to be dischargeable, debtor's counsel may get fees.[19] Generally, a court grants fees to debtor's counsel when the creditor moving under Code section 523(a)(2) "proceeds with its case past a point where [the creditor] knew or should have known that it could not carry its burden of proof."[20] The defense of an action taken as a pro bono matter does not preclude the award of attorney fees under section 523(d).[21]

The applicable state law may provide an independent basis to support an award of counsel fees. Based upon Florida law which provides that attorney fee provisions must be

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[15] 11 U.S.C. § 707(b)(5)(A)(ii)(II); This language was added to the Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and to date has not been construed by any court, nor is it explained by the legislative history. *See* House Report No. 109-31, Pt. 1, 109th Cong., 1st Sess. 48-51 (2005) (stating that Code section 707(b) was amended to permit a court to award a debtor costs in contesting a 707(b) motion if the court does not grant the motion and finds that the motion was made "solely for the purpose of coercing a debtor into waiving a right guaranteed under the Bankruptcy Code to such debtor.")

[16] 11 U.S.C. § 707(b)(5)(B); Fed. R. Bankr. P. 9011(b).

[17] 11 U.S.C. § 707(b)(5)(A).

[18] 11 U.S.C. § 523(a)(2).

[19] 11 U.S.C. § 523(d).

[20] *See Capital Chevrolet v. Bullock (In re Bullock)*, 317 B.R. 885, 891 (Bankr. M.D. Ala. 2004) (citing *American Savings Bank v. Harvey*, 172 B.R. 314, 319 (9th Cir. BAP 1994) and finding that the creditor was not substantially justified in bringing the nondischargeability claim).

[21] *See First Card v. Hunt (In re Hunt)*, 238 F.3d 1098 (9th Cir. 2001) (circuit court upheld bankruptcy appellate panel's affirmance of the bankruptcy court order granting attorney fees under 11 U.S.C. section 523(d) where debtor was represented by counsel pro bono).

reciprocal, a bankruptcy court held that a contractual provision which granted a creditor the ability to recover fees for enforcing the contract also granted the debtor the reciprocal right to recover counsel fees upon prevailing in a dischargeability proceeding.[22]

d. Motion for Willful Violation of the Stay

A motion establishing willful violation of the stay allows for recovery of actual damages, including attorneys' fees.[23] In determining if an act is a willful violation, it is not necessary to establish that a party intended to violate the stay, only that the party knew of the stay and intended the act in question.[24]

C. Retention as Special Counsel

The chapter 7 trustee may also choose to retain special counsel to pursue interests of the estate. Special counsel's appointment pursuant to Code section 327 must be approved by the court in order for special counsel to receive compensation from the estate.[25] Approval requires

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[22] *See Cadle Co. v. Martinez (In re Martinez)*, 416 F.3d 1286, 1291 (11th Cir. 2005) (circuit court reversed the district court's order overturning the bankruptcy court's award of fees in an adversary complaint brought under 11 U.S.C. section 523(a)(2) and the bankruptcy court's order was reinstated).

[23] 11 U.S.C. § 362(k)(1); *In re Frankel*, No. 07-00086, 2008 Bankr. LEXIS 2688 at *17 (Bankr. M.D. Pa. July 14, 2008) (court granted attorney fees incurred in bringing a stay violation action).

[24] *See Jove Engineering, Inc. v. IRS*, 92 F.3d 1539, 1555 (11th Cir. 1996) (finding willful violation when the party knew of the stay and intended the actions which violated it); see also *Crysen/Montenay Energy Co. v. Esselen Associates (In re Crysen/Montenay Energy Co.)*, 902 F.2d 1098 (2d Cir. 1990) ("any deliberate act taken in violation of a stay, which the violator knows to be in existence, justifies an award of actual damages").

[25] *See Tese-Milner v. Moon (In re Moon)*, 385 B.R. 541, 550 (Bankr. S.D.N.Y. 2008) (Second Circuit *per se* rule forbids the allowance of any compensation for any professional services before attorney retention approved by bankruptcy court under Code section 327, as it violates the requirement of Code section 330 that such professionals be retained pursuant to Code section 327*); see also In re Albrecht*, 233 F.3d 1258, 1261 (10th Cir. 2000) (fees for services are not recoverable under Code section 503(b)(1)(A) when firm provides services to trustee without first obtaining court approval).

that special counsel must be a "disinterested person," as defined in Code section 101(14).[26] However, Code section 327(c) provides that a person is not *per se* disqualified by the representation of a creditor. Furthermore, Code section 327(e) allows the trustee to hire as special counsel an attorney that has represented the debtor.[27] The retention order controls the nature and extent of the representation, and a court will not approve fees for services rendered outside the scope of the retention order, even if the services may have otherwise been appropriate.[28]

III. Chapter 13

A. Payments to Debtor's Counsel

In chapter 13 cases, debtor's counsel does not need to be appointed. The 2016 Statement requires as to disclosure of the fees paid to date as well as the balance of the agreed fee that remains owing. The statement should list all the services included in the fee.[29] Any portion of the agreed fee not paid to debtor's counsel prior to filing will necessarily be paid through the chapter 13 plan as an administrative expense claim.[30] No disbursements on attorneys' fees will be made prior to entry of an order confirming a chapter 13 plan unless pursuant to a court order on a motion for allowance and payment of an administrative expense claim prior to

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[26] 11 U.S.C. § 101(14A) ("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").

[27] 11 U.S.C. § 327(c) and (e).

[28] *See In re Churco*, No. 07-61442, 2008 Bankr. LEXIS 1173 at *15, *18 (Bankr. N.D.N.Y. April 10, 2008) (even though court found no fault with actual services rendered by special counsel, without expansion of appointment, court could not grant compensation for services outside the scope of the appointment).

[29] Fed. R. Bankr. P. 2016; *see also* 11 U.S.C. § 329.

[30] See 11 U.S.C. § 1326(b)(1).

confirmation.[31] Additionally, any fees sought for services excluded from the initial fee disclosed on the 2016 Statement are payable only upon application and a court order allowing the fees under Code section 330.

1. Getting Paid Through the Plan

If debtor's counsel is not paid all or a significant portion of the chapter 13 attorneys' fees prior to filing, then recovery of fees may well depend upon the debtor's successful performance under a confirmed plan. Structuring payments in a manner that maximizes the potential for 100% payment and minimizes exposure is key.

a. Payment of Fees as Part of Projected Disposable Income

If the trustee or the holder of an unsecured claim objects to the confirmation of a chapter 13 plan, a court cannot confirm the plan unless, pursuant to Code section 1325(b), all of the debtor's projected disposable income will be "applied to make payments to unsecured creditors under the plan."[32] Except as to any prepaid amounts received from the debtor, debtor's counsel is an unsecured creditor as to the balance of fees owing. Calculating a debtor's projected disposable income involves use of Official Form 22C, which was created to calculate current monthly income,[33] an integral part of the calculation determining the applicable commitment period and projected disposable income as outlined in Code section 1325(b)[34]. According to the Committee Note to Form 22C:

> The Chapter 13 form does not provide a deduction from disposable income for the Chapter 13 debtor's anticipated attorney fees. No specific statutory allowance for such a deduction exists, and none appears necessary. Section 1325(b)(1)(B) requires that disposable income contributed to a Chapter 13 plan be used to pay 'unsecured creditors.' A debtor's attorney who has not taken a security interest in

[31] See 11 U.S.C. § 503(b).
[32] 11 U.S.C. § 1326(b)(1)(B).
[33] 11 U.S.C. § 101(10)(A).
[34] 11 U.S.C. § 1325(b)(1) and (4).

the debtor's property is an unsecured creditor who may be paid from disposable income.

It would therefore appear that when calculating plan payments, a debtor can provide that debtor's counsel be paid from disposable income through the plan. However, not all courts accept this reasoning. The Bankruptcy Court for the District of New Jersey held that "unsecured creditors" in Code section 1325(b) refers to general unsecured creditors, not priority unsecured creditors. Thus, attorneys' fees and trustee commissions cannot be paid from disposable income and any amounts for attorney fees should increase the plan payment amount.[35] Knowing how a particular court's interpretation of the foregoing provision should inform debtor's counsel on how to propose treatment of attorneys' fees in the proposed chapter 13 plan.

b. Priority of Attorneys' Fees

Attorneys' fees are an administrative expense under Code section 503(b)(2). They are accorded a second priority under Code section 507(a)(2) after domestic support obligations, which have first priority under Code section 507(a)(1).[36]

c. Relation in Payment to Other Priority Creditors

Notwithstanding the first priority accorded domestic support obligations under Code section 507(a)(1), Code section 1322(a)(2) does not require domestic support obligations to be paid before other administrative claims, such as fees to debtor's counsel.[37] Courts have noted

[35] *See In re Amato*, 366 B.R. 348, 352 (Bankr. N.J. 2007) (rejecting proposed plan which included fees to debtor's counsel in a "pot plan" in place of confirmed plan with increased payments to cover fees to debtor's counsel).

[36] 11 U.S.C. § 507(a)(1)(A) and (B).

[37] *See Alabama Dep't of Human Resources v. Sanders (In re Sanders)*, 347 B.R. 776, 780 (N.D. Ala. 2006) ("….had Congress intended domestic support obligations to be paid before all other § 507 claims in a Chapter 13 Plan, it would not have included the language found in § 1326(b)(1)"); *accord Alabama Dep't of Human Resources v. Boler (In re Boler)*, No. 06-30049, 2008 U.S. Dist. LEXIS 5131at *8-*9 (M.D. Ala. January 24, 2008) ("While domestic support

that Code section 1326 does not require priority payments to be paid in the order specified in Code section 507.[38] However, Code section 1326 requires that any unpaid administrative claim be paid before or at the time of any payment to creditors, less any applicable trustee fees.[39] Therefore, payments to debtor's counsel may be made coincident with those to other creditors. And while all priority claims have to be paid in full, debtor's counsel can structure the plan payments to provide for a larger, disproportionate payment and faster paydown of attorneys' fees. Local rules of practice may govern the timing and amounts paid to debtor's counsel and should also be consulted.

d. Relation to Secured Creditors

Generally, because attorneys' fees are granted administrative expense status under Code section 503(b), they enjoy priority over payments to secured creditors. Attorneys may, therefore, propose plans that provide for payment of debtor's counsel fees before payment of debts to secured creditors. However, Code section 507(b) provides that an administrative expense claim under Code section 503(b) may arise when adequate protection payments are not sufficient to compensate a secured creditor for diminution in value of its collateral.[40] When such a claim is recognized, the question arises as to whether post-confirmation adequate protection payments

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obligations are listed before administrative expenses in § 507, the plain language of § 1326 requires that administrative expenses be paid first").

[38] *See generally United States v. Fowler (In re Fowler)*, 394 F.3d 1208, 1212 (9th Cir. 2005) (discussing the treatment of priority tax claims in chapter 13); *In re Aldridge*, 335 B.R. 889, 892 (Bankr. S.D. Ala. 2005) (explaining how Code section 1326 does not require compliance with the order of priority found in Code section 507).

[39] 11 U.S.C. § 1326(b)(1).

[40] *See In re Carpet Center Leasing Co.*, 991 F.2d 682, 686 (11th Cir. 1993), *cert. denied*, 510 U.S. 1118, 114 S.Ct. 1069 (1994).

take priority over fees to debtor's counsel. Some courts have held that in certain situations, post-confirmation adequate protection payments take priority over attorney fees.[41]

2. Payments upon Conversion or Dismissal

Upon dismissal, except for Code section 503(b) allowed claims, any funds held by the chapter 13 trustee are returned to the debtor.[42] If the case is going to be dismissed, debtor's counsel should move to have fees allowed and paid under Code section 503(b).[43] If a chapter 13 case is dismissed *after* a plan has been confirmed, any funds held by the chapter trustee will be distributed according to the plan.[44]

Upon conversion from chapter 13 to chapter 7, if a plan has not been confirmed, undistributed funds received by the chapter trustee are not property of the estate and are returned to the debtor.[45] Any unpaid fees to debtor counsel are unsecured claims and treated as if they had arisen immediately prior to filing the petition.[46] If the case is going to be converted, debtor's counsel should first have returnable before the court an application to have fees allowed under Code section 503(b) and paid in the chapter 13 case. If a plan has already been confirmed, any funds held by the trustee are distributed according to the plan.[47] Upon conversion to chapter 7,

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[41] *See In re Dispirito*, 371 B.R. 695, 700 (Bankr. D.N.J. 2007) (holding that "actual, necessary costs and expenses of preserving the estate" in Code section 503 includes adequate protection payments due to the creditor under Code section 507(a)(2) arising from the stay of execution against such property, under Code section 362, or the granting of a lien under Code section 364(d), and are granted priority over every other claim allowable under Code section 507(b)); relying on *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006).
[42] *See* 11 U.S.C. § 1326(a)(2).
[43] *See In re Lewis*, 346 B.R. 89, 111-12 (Bankr. E.D. Pa. 2006) (court considered application for fees filed prior to dismissal).
[44] 11 U.S.C. § 1326(a)(2).
[45] *See* 11 U.S.C. § 348(f); *Stamm v. Morton (In re Stamm)*, 222 F.3d 216, 218 (5th Cir. 2000) (undistributed funds held by chapter 13 trustee prior to confirmation were not property of the estate upon conversion to chapter 7).
[46] 11 U.S.C. § 348(d).
[47] 11 U.S.C. § 1326(a)(2).

Code section 507(a)(2) priority administrative expenses for the chapter 7 case are paid before Code section 507(a)(2) priority claims arising in the originally-filed chapter 13 case.

IV. Chapter 11

A. Retention as Debtor's Counsel

Unique to chapter 11 is the requirement that a debtor's retention of counsel be approved by the court. Code section 327 does not impose an express deadline for obtaining court approval for the retention of counsel, but it is well established that "[c]ourt approval of the employment of counsel for a debtor in possession is the sine qua non to counsel getting paid" and that "[f]ailure to obtain court approval of a professional in accordance with § 327 and Rule 2014 precludes the payment of fees."[48]

A number of courts have held that as a court of equity, bankruptcy courts may, in extraordinary circumstances, grant retroactive approval of professional employment where applicants meet a two-part test to determine the propriety of such retroactive approval.[49] First, the bankruptcy court must find, after a hearing, that the applicant satisfies the disinterestedness requirements of Code section 327(a) and, therefore, could have been appointed initially. Second, the court, in the exercise of its discretion, must determine that the particular circumstances presented are so extraordinary as to warrant retroactive approval.[50]

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[48] *In re Monument Auto Detail, Inc.,* 226 B.R. 219, 224 (B.A.P. 9th Cir. 1998) (*quoting In re Weibel, Inc.*, 176 B.R. 209, 211 (B.A.P. 9th Cir. 1994)).

[49] *F/S Airlease, II v. Simon*, 844 F.2d 99, 105 (3d Cir. 1988), *cert. denied*, 488 U.S. 852 (1988) (finding the estate's need to have a plane expeditiously remarketed not the kind of extraordinary circumstances necessary to support nunc pro tunc appointment of a broker who failed to seek appointment and then sought payment of an administrative expense claim in an attempt to end-run around Code section 327).

[50] *In re Jarvis*, 53 F.3d 416, 420 (1st Cir. 1995); *In re Keren Ltd. Pshp.*, 225 B.R. 303, 306-07 (S.D.N.Y. 1998), *aff'd*, 189 F.3d 86 (2d Cir. 1999) *F/S Airlease II, Inc. v. Simon*, 844 F.2d 99, 105-08 (3d Cir. 1987) (*citing In re Arkansas*, 798 F.2d 645, 646, 650 (3d Cir. 1986)); *See Lavender v. Wood Law Firm*, 785 F.2d 247, 248-49 (8th Cir. 1986) (per curiam).

B. Eligibility for Retention as Debtor's Counsel

Code section 327 requires that counsel for a chapter 11 debtor hold no interests materially adverse to the estate and be a "disinterested person" within the meaning of that term as defined in Code section 101(14). Courts have found that to hold or represent an interest adverse to the estate means: (1) to hold or assert any economic interest that would tend to reduce the value of the bankruptcy estate or that would give rise to an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such predisposition to a bias against the estate.[51]

Attorneys are not "disinterested" if they have a prepetition claim against the debtor for services rendered.[52] Such claim constitutes an "interest adverse to the estate."[53] To ensure eligibility to serve as counsel for a debtor post-petition, counsel must draw down their pre-petition retainer to cover services rendered up to the point of filing. Attorneys who fail to pay themselves from their pre-petition retainer prior to filing will either be ineligible for retention or required to waive unpaid prepetition fees to qualify for appointment as post-petition counsel.

The requirements of disinterestedness and absence of an adverse interest apply at the time of retention and throughout the case.[54] A court may deny allowance of compensation for services and reimbursement of expenses of an attorney employed under Code section 327 if, at

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[51] *In re CF Holding Corp*., 164 B.R. 799 (Bankr. D. Conn. 1994).

[52] *See In re Source Enters.,* No. 06-11707, 2008 Bankr. LEXIS 940 (Bankr. S.D.N.Y. March 27, 2008) (court refused all compensation and required disgorgement of all fees received because debtor counsel was a creditor of the debtor when it sought retention and the failure to write off the debtor's fee obligation was not a mere oversight or accounting error, thus causing counsel to hold an interest adverse to the estate).

[53] *In re Source Enters*., 2008 Bankr. LEXIS 940, 49 Bankr. Ct. Dec. (LRP) 200 (Bankr. S.D.N.Y. Mar. 27, 2008) (counsel's creditor status due to $200,000.00 in pre-petition fees which counsel sought to collect from debtor's affiliates presented conflict of interest and justified denial of all fees).

[54] *Rome v. Braunstein,* 19 F.3d. 54, 62 (1st Cir. 1994); *In re Caldor, Inc.,* 193 B.R. 165, 171 (Bankr. S.D.N.Y. 1996).

any time during such attorney's employment under Code section 327, such attorney is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such attorney is employed.[55]

C. Attorney's Initial and Continuing Duty to Disclose

Federal Rule of Bankruptcy Procedure 2014 requires a debtor's application for retention of counsel to state, among other things, "to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." This application must be accompanied by a verified statement of the person to be employed disclosing their connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

> It is abundantly clear that Rule 2014(a) requires a significant level of disclosure of the proposed professional's "connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." It is equally clear that the level of disclosure outlined in the Rule is mandatory, whether or not that disclosure would unearth a conflict of interest.[56]
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> "It is also apparent that the obligation to disclose is not a subjective one, whereby the professional discloses only those "connections" that he/she/it concludes are relevant."[57] "As indicated, the existence of a conflict of interest is not the quid

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[55] 11 U.S.C. § 328(c).

[56] *In re Matco Elecs. Group, Inc.,* 383 B.R. 848, 852-853 (Bankr. N.D.N.Y. 2008) citing *In re Condor Systems, Inc.*, 302 B.R. 55, 70 (Bankr. N.D. Cal. 2003); *In re Granite Partners L.P.,* 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998), *citing In re The Leslie Fay Companies, Inc.,* 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994).

[57] *In re Matco Elecs. Group, Inc.,* 383 B.R. 848, 852-853 (Bankr. N.D.N.Y. 2008) citing *In re FiberMark, Inc.,* Case No. 04-10463, 2006 Bankr. LEXIS 4029, 2006 WL 723495 at *8 (Bankr. D. Vt. March 11, 2006); *In re WorldCom, Inc.*, 311 B.R. 151, 164 (Bankr. S.D.N.Y. 2004); *In re Mercury*, 280 B.R. 35,56 (Bankr. S.D.N.Y. 2002), *aff'd* 122 Fed. Appx. 528 (2d Cir. 2004), citing 1 COLLIER ON BANKRUPTCY P 8.05, at 8-60 (Lawrence P. King et al. eds., 15th ed. Rev. 2001) ("professionals may not make unilateral determinations regarding the relevance of

> pro quo for whether or not disclosure must be made. Sanctions are imposed for the failure to disclose, regardless of the consequences of the non-disclosure."[58]

It is vitally important that counsel disclose all connections without subjective consideration of their relevance.

D. Retention Order

> Code "[s]ections 328 and 330 establish a two-tiered system for judicial review and approval of the terms of the professional's retention. Section 330 authorizes the bankruptcy court to award the retained professional "reasonable compensation" based on an after-the-fact consideration of "the nature, the extent, and the value of such services, taking into account all relevant facts." However, section 328(a) permits a bankruptcy court to forgo a full post-hoc reasonableness inquiry if it pre-approves the "employment of a professional person under section 327 … on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis." Where the court pre-approves the terms and conditions of the retention under section 328(a), its power to amend those terms is severely constrained….[59] These two inquiries are mutually exclusive, as "[t]here is no question that a bankruptcy court may not conduct a § 330 inquiry into the reasonableness of the fees and their benefit to the estate if the court already has approved the professional's employment under 11 U.S.C. § 328."[60]

Unless counsel's retention application unambiguously specifies that it seeks approval under Code section 328, counsel's fees are reviewable for reasonableness under Code section 330.[61] Circuits have adopted different requirements to find pre-approval retention under Code section 328(a). The Third Circuit puts the burden "on the applicant to ensure that the court notes explicitly the terms and conditions if the applicant expects them to be established at that early

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particular connections, or that certain connections to the debtor are too insignificant to disclose. All connections must be disclosed").

[58] *In re Matco Elecs. Group, Inc.,* 383 B.R. 848, 852-853 (Bankr. N.D.N.Y. 2008) citing *Condor Systems, Inc.,* 302 B.R. 55, 70 (Bankr. N.D.Cal. 2003); *In re Granite Partners, L.P.,* 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) *citing In re The Leslie Fay Companies, Inc.,* 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994).

[59] *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Techs., LLC),* 2009 U.S. App. LEXIS 20 (2d Cir. N.Y. Jan. 6, 2009).

[60] *Id.* quoting *In re B.U.M. Int'l, Inc.,* 229 F.3d 824, 829 (9th Cir. 2000).

[61] *Circle K Corp. v. Hamilton, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669 (9th Cir. 2001), *cert. denied*, 536 U.S. 959 (2002).

point."[62] The Ninth Circuit employs a stricter approach, requiring that "[t]o ensure that § 328 governs the review of a professional's fees, a professional must invoke the section explicitly in the retention application."[63] The Sixth Circuit found both the Ninth Circuit's approach and the Third Circuit's approach too strict and adopted a "totality of the circumstances" test, holding that because the Code does not mandate that the application mention Code section 328, "whether a court 'pre-approves' a fee arrangement under § 328 should be judged by the totality of the circumstances, looking at both the application and the bankruptcy court's order."[64] The Sixth Circuit cited factors such as "whether the debtor's motion for appointment specifically requested fee pre-approval, whether the court's order assessed the reasonableness of the fee, and whether either the order or the motion expressly invoked § 328" as considerations in determining if a retention order was pre-approved under section 328.[65] The Second Circuit recently adopted the Sixth Circuit's standard, holding that "pre-approval of a fee agreement under 11 U.S.C. § 328(a) depends on the totality of the circumstances, including whether the professional's application or the court's order referenced section 328(a), and whether the court evaluated the propriety of the fee arrangement before granting final, and not merely preliminary, approval."[66]

E. Fee Applications

To permit the necessary review to determine whether services provided by counsel are necessary and the fees requested for such services reasonable, counsel must file a fee application. Code section 331 sets forth the rule that interim fee applications may be filed only once every

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[62] *Zolfo, Cooper & Co. v. Sunbeam-Oster Co.*, 50 F.3d 824, 862 (3d Cir. 1995).
[63] *Circle K Corp. v. Hamilton, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669 (9th Cir. 2001), *cert. denied*, 536 U.S. 959 (2002).
[64] *Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, 385 F.3d 915, 921-22 (6th Cir. 2004).
[65] *Id.*
[66] *See Riker, Danzig, Sherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Technologies, LLC)* No. 08-1721, 2009 U.S. App. LEXIS 2009 at *13 (2d Cir. January 6, 2009).

120 days, but expressly permits a court to permit fee applications to be filed more frequently. Some courts commonly approve procedures for compensation of professionals appointed under Code section 327 which provide for the filing of monthly fee statements and the conditional payment of such fees by the debtor. These conditional payments are subject to disgorgement should any portion of the fee be ultimately disallowed upon formal application to the court. This compensation procedure permits a debtor to manage cash flow over shorter periods of time and avoids counsel having to "finance" the administration of the debtor's case for four months at a time.

Fee applications are subject to Rule 2016 which requires, among other things, the filing of a detailed statement of the services rendered, time expended and expenses incurred, and the amounts requested. Rule 2016 is supplemented by the U.S. Trustee's Guidelines for Reviewing Applications of Compensation and Reimbursement of Expenses, codified at 28 C.F.R. app. § 58, which is informative as to the specificity with which counsel must report their time expended and services rendered. Local Bankruptcy Rules should also be consulted to ensure compliance with local practice.[67]

F. Court's Review of Fees

Courts may review the reasonableness of attorneys' fees paid prior to the filing of a bankruptcy case under Code section 329(a) and Fed. R. Bankr. P. 2017(a). Code section 329 requires debtor's counsel to disclose to the court the amount and the source of any compensation

[67] Rule 2016 also imposes an affirmative obligation on counsel to file, within fifteen days after the order for relief, the statement concerning compensation required by Code section 329 and to disclose whether counsel has shared or agreed to share compensation with any other entity. Code section 504 expressly prohibits the sharing of compensation, commonly known as fee splitting, among professionals, including counsel. This prohibition excludes partners or associates in the same professional corporation and counsel for petitioning creditors who join in an involuntary case.

paid or agreed to be paid by the debtor during the year that preceded the bankruptcy petition. To the extent the court determines fees to be excessive, the court may cancel the agreement under which they were paid or order the return of such portion of the payment determined to be excessive. Based upon the language of Code section 329, "a court measures terms of professional engagements by debtors using a standard of "reasonableness. However, the definition of reasonableness is fluid and the court is given discretion in determining what services and charges are reasonable."[68]

As discussed above, retention under Code section 328 essentially defeats the discretionary authority of the court and other parties to object to counsel's fees as being unreasonable. Courts may only "allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."[69] Courts have drawn distinctions between developments "not actually anticipated" and developments "incapable of being anticipated."[70] These distinctions underscore the importance of careful consideration of the terms and conditions of employment and an open-minded view of the various possible outcomes of the matter for which counsel is employed.

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[68] *In re Pan Am. Hosp. Corp*. 312 B.R. 706 (Bankr. S.D. Fla 2004).

[69] *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Techs., LLC),* 2009 U.S. App. LEXIS 20 (2d Cir. N.Y. Jan. 6, 2009).

[70] *In re Barron,* 325 F.3d 690, 693 (5th Cir. 2003) (holding that while size and scope of settlement had not actually been anticipated, it did not follow that it was not capable of anticipation); *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Techs., LLC)*, 2009 U.S. App. LEXIS 20 (2d Cir. N.Y. Jan. 6, 2009) (holding that none of the four case developments: divergent positions regarding litigation and settlement strategy … between the Debtor and the Committee, the desire of the former to benefit its equity holders rather than its creditors, the unusually prolonged procedural path of the litigation and the fact that the professional was an obstacle, not an asset, when it came to approval of the settlement, were incapable of being anticipated).

When Code section 328 does not govern debtor's counsel's retention, the court may, and in fact has an independent duty to review fees to determine whether they are reasonable and were incurred for actual and necessary services.[71] A court's authority to review fees earned post-petition by debtor's counsel retained pursuant to Code section 327 is found in Code sections 329 and 330.[72]

The standard of review under Code section 330 is more stringent than under Code section 329, as in addition to being reasonable, fees must also be necessary and beneficial to the estate. Code section 330(a)(3) directs the court determining fees to consider the nature, the extent, and the value of such services, taking into account all relevant factors.[73] These factors include the time spent on such services, the rates charged, whether the services were necessary and beneficial to the estate, whether the services were performed within a reasonable amount of time commensurate with the complexity, importance and nature of the problem, whether the professional is certified and/or experienced and whether the compensation sought is reasonable based on the customary compensation charged by comparably skilled practitioners in non-bankruptcy cases.[74]

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[71] 11 U.S.C. § 330(a)(1).

[72] *See* Fed. R. Bankr. P. 2017(b).

[73] The factors to be considered by a court when determining what is reasonable compensation for services rendered are outlined in Code section 330(a)(3)(A). Services for which compensation is not allowable under Code section 330(a)(4)(A) include unnecessarily duplicative services and services not likely to benefit the debtor's estate or needed to administer the case.

[74] There are several different methods for computing fees for professionals. One method is the lodestar method which multiplies an hourly rate by the number of hours expended. After the lodestar has been determined, the court may increase or decrease the award on the basis of the factors set out in Code section 330 and on the basis of other relevant factors. Factors commonly known as the "Johnson" factors are sometime referred to by courts when determining fee awards. *See Johnson v. Georgia Highway Express*, 488 F.2d 714, 717-19 (5th Cir. 1974) listing the "Johnson" factors as: (1) the time and labor involved; (2) the novelty and difficulty of the questions; (3) the skill requisite to perform the legal service properly; (4) the preclusion of other

Courts differ on the temporal point at which to evaluate whether services were reasonably likely to benefit the estate. The Second Circuit Court of Appeals and Ninth Circuit B.A.P. have held that services are compensable if at the time the services were performed a benefit to the estate was likely.[75] Similarly, the Third Circuit Court of Appeals has denied fees after finding "neither actual benefit to the estate, nor a reasonable likelihood of benefit to the estate."[76] The Fifth Circuit has adopted the ex post facto view that the applicant must show that an actual benefit was provided and has held that the threshold for compensation is whether the services "resulted in an identifiable, tangible, and material benefit to the bankruptcy estate".[77] A problem with the ex post facto determination of necessity as noted by one court is that "professionals who render perfectly competent services to the estate face a risk of non-payment … Such a risk would deter professionals from providing services to the estate, hindering the bankruptcy process. Thus, whether services are "necessary" to the estate should be measured by whether they were reasonably likely to benefit the estate at the time the services were rendered."[78]

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employment by the attorney due to the acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorneys; (10) the political "undesirability" of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases. The *Johnson* factors continue to be applied although *Johnson* has been abrogated. *See e.g. Leasure v. AA Advantage Forwarders*, 2007 U.S. Dist. LEXIS 81456 (W.D. Ky. Nov. 2, 2007); *United States v. Ohio*, 474 F. Supp. 2d 916, 921 n.2 (S.D. Ohio 2007).

[75] *In re APW Enclosure Sys*., 2007 Bankr. LEXIS 3539 (Bankr. D. Del. Oct. 23, 2007) citing *In re Ames Dep't Stores, Inc.,* 76 F.3d 66, 72 (2d Cir. 1996); *Roberts, Sheridan & Kotel, P.C. v. Bergen Brunswig Drug Co. (In re Mednet),* 251 B.R. 103, 108 (B.A.P. 9th Cir. 2000).

[76] *In re APW Enclosure Sys*., 2007 Bankr. LEXIS 3539 (Bankr. D. Del. Oct. 23, 2007) citing *Ferrara & Hantman v. Alvarez (In re Engel),* 124 F.3d 567, 575 n.23 (3d Cir. 1997).

[77] *Andrews & Kurth L.L.P. v. Family Snacks, Inc. (In re Pro-Snax Distribs., Inc.),* 157 F.3d 414, 426 (5th Cir. 1998).

[78] *Mondelli v. Banker*, 2008 U.S. Dist. LEXIS 36348 (D.N.J. May 2, 2008).

G. Sources of Compensation: Retainers and Carve Outs

Both retainers and carve outs are risk-minimizing devices used by counsel to ensure a source of compensation for services rendered to a chapter 11 debtor. Retainers are negotiated by counsel as a term and condition of retention and must be fully disclosed in the debtor's application to retain counsel. The two types of retainers generally negotiated for post-petition services to be rendered in a bankruptcy case are forms of "special" retainers, consisting of either a security retainer or an evergreen retainer.

> Under a security retainer, the money given to the debtors' attorneys is not present payment for future services. Rather, the retainer remains the property of the debtor until the attorney "applies" it to charges for services actually rendered; any unearned funds are turned over by the attorneys.
> …
>
> The evergreen retainer is yet another type of special retainer. The evergreen retainer agreement contemplates that the retainer shall remain intact and that the debtor's professionals' interim compensation shall be paid from the debtor's operating capital. Accordingly, professionals holding evergreen retainers do not look to this sum until such time as a final fee application is presented and approved by the court.[79]

Regardless of which type of retainer counsel may negotiate, security or evergreen, it must be maintained in a client trust fund account and not be drawn upon until counsel obtains an order of the court allowing and authorizing payment under Code sections 330 and 331.

Whereas retainers are negotiated between a debtor and its counsel, carve outs are negotiated between a debtor and a secured creditor. It is axiomatic that expenses for administering a bankruptcy estate such as professional fees are not chargeable against a secured creditor's collateral or claim, but must instead be satisfied from unencumbered assets of the

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[79] *In re Pan Am. Hosp. Corp.,* 312 B.R. 706 (Bankr. S.D. Fla. 2004) citing *In re Benjamin's-Arnolds, Inc.*, 123 B.R. 839, 842 (Bankr. D.Minn.1990); *In re W & W Protection Agency, Inc.,* 200 B.R. 615 (Bankr. S.D. Ohio 1996); *In re Insilco Technologies, Inc.,* et al., 291 B.R. 628 (Bankr. D. Del. 2003).

estate.[80] Code section 506(c) provides an exception to the foregoing rule permitting recovery from secured collateral for reasonable costs and expenses necessary to preserve or dispose of the collateral, but only to the extent that they benefit the secured creditor.[81] As part of the benefit realized by a secured creditor in the continuation of the debtor's business within the context of bankruptcy, a secured creditor will oftentimes consent to a "carve out" of the proceeds of its collateral for fees of debtor's counsel and other professionals.[82]

Consistency of treatment of professionals by a secured creditor is important when it comes to fee arrangements. One court declined to approve a settlement agreement between a debtor and its secured lender that discriminated against the creditors' committee counsel. Specifically, the court took issue with a provision subjecting only the creditors' committee counsel to the risk of disgorgement of fees. The court stated it could not "countenance or find to be in the best interests of the [e]state any scenario under which professionals for different constituencies are treated differently. Either all professionals must be subject to a risk of disgorgement, or none must be."[83]

Administrative expenses, such as debtor's counsels' fees, while entitled to priority pursuant to Code section 507(a)(1), are normally paid from a debtor's unencumbered assets.[84]

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[80] *See In re Visual Industries,* 57 F.3d 321, 324 (3d. Cir. 1995) (administrative expenses may not be charged against secured collateral—general rule).
[81] 11 U.S.C. § 506(c).
[82] *In re Hotel Syracuse, Inc.,* 275 B.R. 679, n4 (Bankr. N.D.N.Y. 2002) The term "carve out" refers to "an agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid out to others, i.e., to carve out of its lien position . . . . Carve outs are . . . common in Chapter 11 cases in favor of debtor's attorneys as part of cash collateral agreements." *In re White Glove, Inc.*, 1998 Bankr. LEXIS 1303, 1998 WL 731611 at *6 (Bankr. E.D. Pa. 1998), citing *Blackwood Associates*, 153 F.3d at 67.
[83] *In re AppliedTheory Corp.,* 2008 Bankr. LEXIS 1373 (Bankr. S.D.N.Y. Apr. 24, 2008).
[84] *In re Hotel Syracuse, Inc.,* 275 B.R. 679 (Bankr. N.D.N.Y. 2002) *citing In re 680 Fifth Ave. Assocs.,* 154 B.R. 38 (Bankr. S.D.N.Y. 1993).

When a carve out exists, attorneys do not compete for available assets with other administrative claimholders. The secured creditor providing a carveout is thought to benefit from the services rendered by counsel which serve to protect and enhance the value of the secured creditor's collateral through the reorganization efforts. The debtor benefits from the carve out as it would otherwise be constrained from using the proceeds of secured collateral for payment of fees and have no other source of payment. Professionals typically negotiate a carve out at the beginning of a chapter 11 case in connection with stipulations between the secured creditor and debtor for debtor's use of cash collateral. If a carve out proves insufficient to cover all allowed fees, then the remaining unpaid fees share pari passu with other administrative 503(b) claims