UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re

DYNACON DEVELOPMENT CORPORATION,

Debtor.

Case No. 97-27874

Chapter 7

MEMORANDUM DECISION ON UNITED STATES TRUSTEE'S OBJECTION TO APPLICATION FOR APPROVAL OF ATTORNEY FEES AND EXPENSES

This matter came before the court on April 22, 1999, upon an objection by the United States Trustee to the application of Ludwig & Shlimovitz, S.C., for approval of attorney fees and expenses. After oral argument on the application and objection, neither party opted to file a written brief. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A) over which the court has jurisdiction under 28 U.S.C. §§ 1334(b), 157(a) and 157(b)(1). This decision represents the court's findings of facts and conclusions of law pursuant to Fed. R. Bankr. P. 7052. For the reasons set forth below, the court will allow attorney fees of $17,762 and expenses of $557.32, for a total of $18,319.32.

BACKGROUND

The debtor filed for chapter 11 bankruptcy protection on August 11, 1997. The application for employment, which was filed on the same date, stated that Ludwig & Shlimovitz, S.C. represented no interest adverse to the debtor as debtor-in-possession or the estate. The application made no reference to the disinterestedness of the attorneys. The application further stated that the firm had no connection with the creditors or any other party in interest, or their respective attorneys. The attorney for petitioner, Jack U. Shlimovitz, also filed a Rule 2016(b) statement with the petition, which included the following:

1. The compensation paid or promised by the Debtor(s), to the undersigned, is as follows:

For legal services rendered, Debtor(s) agrees to pay	$ 0.00
Prior to the filing of this Statement, Debtor(s) has paid	0.00
Balance Due	0.00

. . .

5. The source of payment to be made by the debtor(s) to the undersigned for the unpaid balance remaining, if any, will be from. . . FROM [sic] a mortgage given by Gerald Halaska, President on a parcel of real estate which he owns personally.

The court authorized the appointment of Ludwig & Shlimovitz by order dated August 19, 1997. The debtor converted the case to chapter 7 on December 12, 1997.

The firm's application for compensation currently under review by this court includes time for services performed prior to August 11, 1997. The application shows 35.25 hours at $190 per hour and .40 hours at $175 per hour, for total prepetition compensation of $6,767.50, plus $36.40 in prepetition expenses. Total compensation sought, including compensation for prepetition services, is $24,529.50 and expenses of $593.72 (a $1,000 retainer was paid 3/27/97, apparently not by the debtor, as this was not on the Rule 2016(b) statement). Thus, more than one-quarter of the fees requested were incurred prepetition. Ludwig & Shlimovitz did not disclose in its application for employment that it was a creditor, and it was not listed as a creditor in the schedules.

Although the U.S. Trustee objects to the amount of the applicant's fees, which exceeded its original estimate, and the failure to provide sufficient detail of certain charges, the main thrust of the U.S. Trustee's objection is Ludwig & Shlimovitz' nondisclosure of its creditor status or sufficient detail on the fee arrangement. Because the firm was not a "disinterested person" under 11 U.S.C. § 327, contends the U.S. Trustee, its application for attorney fees and expenses should

be denied. Ludwig & Shlimovitz counters that the court has complete discretion to approve its compensation request. Furthermore, Ludwig & Shlimovitz contends that it never considered itself a creditor of the debtor as it agreed from the inception of its representation that all fees would be paid by Mr. Halaska personally, and none would be paid by the debtor. It argues that this arrangement was disclosed on the Rule 2016(b) statement.

DISCUSSION

In conjunction with 11 U.S.C. § 1107(a), § 327 of the Bankruptcy Code authorizes a debtor in possession, subject to the court's approval, to employ one or more professional persons to represent or assist the debtor-in-possession in carrying out its duties under the Code. Section 327(a) provides, in part:

> 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). Accordingly, pursuant to § 327(a), a debtor in possession may not employ any professional person who either (1) holds or represents an interest adverse to the estate or (2) is not disinterested.

The court cannot determine whether it is appropriate to appoint a professional to represent the debtor unless there is full and forthright disclosure of all relationships with the debtor and interested parties, including any payment arrangements, so any potential for conflicts of interest can be explored. Bankruptcy Rule 2014 addresses this disclosure requirement. Rule 2014(a) provides, in relevant part:

> Application for an Order of Employment. An order approving the employment of attorneys ... or other professionals pursuant to § 327 ... of the Code shall be made only on application of the trustee or committee.... The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth 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.

Fed. R. Bankr. P. 2014(a). These disclosure statements are not discretionary. *See Halbert v. Yousif*, 225 B.R. 336 (E.D. Mich. 1998) (mere fact that attorney may have acted in good faith in failing to disclose certain information in his application for employment did not excuse attorney's disclosure violations). Once a professional person complies with the disclosure requirements of Rule 2014 and satisfies the standards of § 327(a), the professional may be retained by court order.

Sections 328, 330 and 331 of the Code deal with the issue of the professional's compensation. Pursuant to § 330 and Rule 2016(a), an employed professional must apply to the court for compensation and the court may award "reasonable compensation for actual, necessary services" and "reimbursement for actual, necessary expenses." Fed. R. Bank. P. 2016(a).

As § 328(c) makes clear, the need for self-scrutiny and avoidance of conflicts does not end once the professional's employment application is approved. These issues may arise when fees are considered. Section 328(c) provides that:

> Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person 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 professional person is employed.

11 U.S.C. § 328(c). Thus, under § 328(c), the bankruptcy court has discretion to deny compensation and reimbursement to a conflicted professional. *Crivello*, 134 F.3d at 837.

Lastly, § 329 specifically subjects a debtor's attorney to additional scrutiny beyond that imposed under § 327. Section 329(a) provides:

> Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

11 U.S.C. § 329(a). Section 329(a) therefore requires a debtor's attorney to disclose to the court any compensation paid or promised to be paid for services performed in the case and the source of that payment, whether or not the attorney intends to apply for fees in the case and even if a non-debtor third party is paying the fees. *See, e.g., Matter of Kero-Sun, Inc.*, 58 B.R. 770 (Bankr. D. Conn. 1986); *In re Furniture Corp. of Am.*, 34 B.R. 46 (Bankr. S.D. Fla. 1983). Under Rule 2016(b), this disclosure must be made within 15 days of the order for relief. Furthermore, Rule 2016(b) requires the debtor's attorney to file a supplemental statement within 15 days after the attorney receives any previously undisclosed payment or makes a new agreement regarding compensation.

The court is satisfied that there was disclosure of the payment arrangement by Ludwig & Shlimovitz in the Rule 2016(b) statement. Detail might have been lacking, but the disclosure was sufficient to lead any interested party to inquire further. The application for employment did not mention the payment arrangement nor the connection with the debtor's principal, but this was

made up by the Rule 2016(b) statement. The statement discloses that nothing was paid by or promised to be paid by the debtor and that fees would be paid via a mortgage granted the firm by property that was not property of the estate. That was enough to inform all parties of the fee arrangement before employment was authorized.

The next question is whether the fee arrangement results in an adverse interest between the professional and the debtor. The phrase "holds or represents an interest adverse to the estate" has been construed by the Seventh Circuit 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 Crivello, 134 F.3d 831, 835 (7th Cir. 1998) (quoting *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985)). Other than this fee arrangement, discussed below, this court cannot discern any indication, and the U.S. Trustee offered none, that Ludwig & Schlimovitz, S.C., held or represented any interest adverse to the estate at any time during the pendency of the case. Moreover, the court is unaware of any way in which the payment and mortgage by the debtor's principal lessened the value of the estate, created an actual or potential dispute over which the estate is a rival claimant, or resulted in a predisposition for bias against the estate by the attorneys.

Some court have held that an attorney who accepts payment from a third party is disqualified from representing a debtor. *In re Hathaway Ranch Partnership*, 116 B.R. 208 (Bankr. C.D. Cal. 1990) (arrangement creates an impermissible conflict). Generally, those decisions are based at least in part on other facts, such as allegations of misconduct by the third

party or inadequate disclosure by the attorneys of the source of the retainer. *E.g., In re Park-Helena Corp.*, 63 F.3d 877 (9th Cir. 1995); *In re Nat'l Distribs. Warehouse Co.*, 148 B.R. 558 (Bankr. E.D. Ark. 1992); *In re Crimson Invs., N.V.*, 109 B.R. 397 (Bankr. D. Ariz. 1989).

Conversely, other courts have found that where an attorney for the debtor is compensated by a third party, it does not give rise to a per se impermissible conflict of interest. *See In re Lotus Properties LP*, 200 B.R. 388 (Bankr. C.D. Cal. 1996); *In re Palumbo Family Ltd. Partnership*, 182 B.R. 447 (Bankr. E.D. Va. 1995); *In re Missouri Mining, Inc.*, 186 B.R. 946 (Bankr. W.D. Mo. 1995); *In re Kelton Motors Inc.*, 109 B.R. 641 (Bankr. D. Vt. 1989). One bankruptcy court held under similar facts that a firm's receipt of a mortgage to secure its payment of fees did not make a firm interested, and approved the employment application. *In re City Mattress, Inc.*, 163 B.R. 687 (Bankr. W.D.N.Y. 1994). The court noted that as long as attorneys will seek compensation, they are unlikely to attain a state of absolute disinterestedness. Thus, the court approved the fee arrangement, reasoning:

> The adequate assurance of reasonable compensation is a vital safeguard of a professional's independent judgment. Without such assurance, the professional becomes a potential creditor for whom the risk of nonpayment creates an inevitable proclivity for diminished enthusiasm. Creditor status tempts the professional to consider not only the best interest of the client, but also the likely impact upon the professional's own recovery of monies due or to become due. Although some such risk is inherent in the concept of representation by counsel of one's own selection, the court cannot ignore the pressures placed upon attorneys who perform services without assurances of full compensation. Fortunately, most attorneys reflect the highest ideals of their profession by persisting in their diligent representation of bankrupt clients even after circumstances jeopardize the likelihood of compensation for future services. Nevertheless, we should respond favorably to arrangements for reasonable retainers that are fairly designed to minimize professional risks. Such safeguards not only promote the exercise of independent judgment in a particular case, but they also enhance the willingness to tolerate the occasional situation in which compensation cannot be assured.

City Mattress, 163 B.R. at 188.

The bankruptcy court in *Kelton Motors* established a five-factor test to determine whether compensation to a debtor's counsel from a third party is an impermissible conflict of interest. These factors include: (1) the arrangement must be fully disclosed to the debtor/client and the third party/insider; (2) the debtor must expressly consent to the arrangement; (3) the third party payor/insider must retain independent legal counsel and must understand that the attorney's duty of undivided loyalty is owed exclusively to the debtor/client; (4) the factual and legal relationship among the third party payor/insider, the debtor, the respective attorneys, and their contractual arrangement concerning the fees, must be fully disclosed to the Court at the outset of the debtor's bankruptcy representation; (5) the debtor's attorney/applicant must demonstrate and represent, to the court's satisfaction, the absence of facts which otherwise create a lack of disinterestedness, actual conflict, or impermissible potential for a conflict of interest. *Kelton Motors*, 109 B.R. at 658. Several courts have adopted and applied the *Kelton Motors* factors. *See, e.g., In re Lotus Properties LP*, 200 B.R. 388 (Bankr. C.D. Cal. 1996); *In re Rabex Amuru of North Carolina, Inc.*, 198 B.R. 892 (Bankr. M.D.N.C. 1996).

This court is satisfied that the better view is that the mortgage granted the debtor's law firm and the promise of payment by the debtor's principal does not make for a conflict of interest, per se. These matters should be decided on a case by case basis. Here it appears that Mr. Halaska's agreement to pay the attorney fees freed up assets of the corporation, and such agreement will allow a greater dividend to creditors. It is not clear that Mr. Halaska was represented by an attorney, one of the *Kelton Motors* factors, but if there was a question of his not understanding the consequences of the arrangement or who the attorneys were representing, presumably it would have been brought to the court's attention by the objector. The loyalty and

availability of the attorneys during the case was ensured, even though the enterprise eventually failed. Thus, the court holds that the payment arrangement agreed to by Ludwig & Shlimovitz and Mr. Halaska was properly disclosed and imposes no impediment to the retention of the law firm or to the payment for services rendered the debtor. Therefore, as the objection to the amount is insubstantial, the court will allow the postpetition fees and expenses as requested.

A bigger problem is the nondisclosure of prepetition services and the fees incurred for those services. Section 101(14) of Title 11 provides, in relevant part, that a "disinterested person" means a person that

> (A) is not a creditor, an equity security holder, or an insider; ... and
> (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.

11 U.S.C. § 101(14)(A), (E). When either of the tests for disinterestedness under § 327(a) is violated, a professional person is disqualified from representing the estate. The court has determined that subparagraph (E) does not apply because no adverse interest exists, but what about the prepetition services rendered the debtor that were not paid for at the time of filing? The firm argues that the debtor owed it nothing for prepetition services because only Mr. Halaska was liable for that debt, but this does not erase the fact that the debtor incurred the liability for services. A creditor is defined in 11 U.S.C. § 101(10)(A) as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." Section 101(5)(A) provides that a "claim" is a "right to payment." As the work was done for the debtor, the attorneys had a claim against the debtor, which they waived by contract, but this is the type of payment arrangement that must be disclosed. Without that disclosure, which did not occur here, the court and other interested parties cannot determine whether the waiver was valid or perhaps

tainted by conflict. The same policy for disclosure of payment arrangements for prepetition claims against the debtor exists as for postpetition services. It is not uncommon for attorneys with a longstanding relationship with the debtor to waive a claim for prepetition legal fees so they can represent the debtor as a disinterested professional in the bankruptcy case. This waiver is invariably disclosed so the court can consider it in determining disinterestedness. Here, the prepetition legal fees are not waived, they are to be paid by a person with close ties to the debtor. Granted, there is no evidence of any prejudice, conflict, or harm occasioned by the existence of the prepetition fees, the attorneys' interpretation of their status is not completely unreasonable, and the attorneys undoubtedly would have been appointed under the facts of this case, had those facts been known. Nevertheless, failure to disclose this arrangement cannot be condoned. Therefore, the court will exercise its discretion and disallow these fees.

CONCLUSION

For the reasons stated herein, the court will allow Ludwig & Shlimovitz, S.C. fees of $17,762 and expenses of $557.32, for a total of $18,319.32.

Dated at Milwaukee, Wisconsin, May 18, 1999.

BY THE COURT:

Honorable Margaret Dee McGarity
United States Bankruptcy Judge