IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

In re:	CHAPTER 11 Jointly Administered
PLYMOUTH CREAMERIES, INC.	Case No. 96-20017
PLYMOUTH LAND, INC.	Case No. 96-20018
Debtors.	

MEMORANDUM DECISION

Introduction

This matter came before the court on March 18, 1996, upon a motion of the United States Trustee for an order vacating and voiding *ab initio* the court's January 16, 1996 order approving the employment of Attorney Jeffery D. Nordholm and the firm of Ludwig & Shlimovitz, S.C. as counsel for the debtor, Plymouth Creameries, Inc., for failure to make full disclosure as required by Fed. R. Bankr. P. 2014(a) and 2016(b). For the reasons set forth in this decision, the United States Trustee's motion is granted, and Attorney Jeffery D. Nordholm and the firm of Ludwig & Shlimovitz, S.C. are disqualified as counsel for Plymouth Creameries, Inc. and Plymouth Land, Inc., and the order appointing the attorneys for either debtor is vacated *ab initio*.

Facts

Plymouth Creameries, Inc. and its subsidiary, Plymouth Land, Inc. filed voluntary petitions under chapter 11 on January 2, 1996. Attorney Jeffery D. Nordholm of the firm of Ludwig &

Shlimovitz, S.C. was the debtors' counsel of record for the filing. On January 5, 1996, the debtors submitted applications for approval of their employment of Ludwig & Shlimovitz, S.C. along with accompanying affidavits of disinterest by attorney and Fed. R. Bankr. P. 2016(b) statements. The court approved employment of the firm by both debtors on January 16, 1996.

On January 30, 1996, the court held a hearing on the United States Trustee's objection to employ Attorney Nordholm and Ludwig & Shlimovitz, S.C. as attorneys for both debtors on the basis of conflict of interest. Because conflicting interests between the debtors were found to exist, the court held that separate counsel was necessary. As a result, Attorney Nordholm and Ludwig & Shlimovitz, S.C. were removed from representation of Plymouth Land, Inc., and remained as counsel for Plymouth Creameries, Inc.

The order granting the United States Trustee's motion vacated the January 16, 1996 order as to Plymouth Land, Inc., but it did not make their appointment void from the inception of the case. From the facts available to the court at that time, it appeared the attorneys became aware of a possible conflict in connection with interdebtor claims only after an emergency filing had been made in response to creditor pressure and as the attorneys reviewed the debtors' finances to prepare schedules. Difficulty in obtaining financial information, caused by the newness of management and disputes with the corporations' accountant, was a significant factor in not recognizing the

interdebtor conflict earlier. Substantive consolidation came under consideration as facts were developed. However, early in the case, these issues involving conflicting interests were not yet addressed, and it appeared there was no reason at that time to penalize the attorneys for dual representation.

Plymouth Land, Inc. subsequently retained the services of Attorney Paul Lucey of Godfrey & Kahn. In bringing Mr. Lucey up to speed, arrangements for payment of attorney fees were discussed. It was not clear whose idea it was to disclose the fee arrangements to the court, but after the attorneys' conversation, the disclosure was made.

On February 2, 1996, Attorney Nordholm filed a supplement to his Fed. R. Bankr. P. 2016(b) statement and a Supplemented Affidavit of Attorneys. In the 2016(b) supplement, Mr. Nordholm disclosed the existence of an interest bearing trust account titled "Plymouth Creameries, Inc., Trust Account of Jeffery D. Nordholm." The sole authorized signatory on the account was Attorney Nordholm. The 2016(b) supplement also disclosed provisions in a written engagement between Plymouth Creameries, Inc. and Ludwig & Shlimovitz, S.C.:

> The corporation must make monthly deposits into the trust account maintained for the corporation at this law firm. The purpose of these payments is to ensure that there are sufficient funds on hand at the time of confirmation of the plan to pay all administrative claims, such as the claims of professionals who provided services in the case. These professionals not only include this firm but accountants, appraisers and others who may be brought into the case. The amount of the monthly deposit may vary during the course of the case based on the

> projected expenses. The first deposit shall be in the amount of $3,000.00 and be due on February 5, 1996. Deposits in like amount shall be made on the 5th day of every month thereafter until further notice.

(Plymouth Creameries Retainer Letter, p. 3). The engagement letter further informed Plymouth Creameries that all professional fees were subject to court approval before payment. It is not clear whether this also covered services for Plymouth Land, Inc., but apparently it did. Mr. Nordholm stated that retainers for both debtors came from Plymouth Creameries, and Plymouth Creameries was the only income producing entity.

The United States Trustee then moved for an order vacating the court's January 16, 1996 order approving the debtors' applications to employ Mr. Nordholm and his firm in both cases on the grounds that full disclosure was not made by Attorney Nordholm on a timely basis as required by Fed. R. Bankr. P. 2014(a) and 2016(b). The motion also requested that Attorney Nordholm and Ludwig & Shlimovitz, S.C. be removed as attorneys for Plymouth Creameries, Inc.

Discussion

1. Propriety of Trust Account Fee Arrangement

Attorney Nordholm contended that he did not consider the money paid into the account as compensation because it had not yet been approved by the court and it was not commingled with the firm's other funds. Furthermore, such an arrangement is common in non-bankruptcy settings. If the client requested the money,

Mr. Nordholm stated that under Wisconsin Supreme Court Rules, the attorney holding the funds could not refuse the request.

As a general matter, attorneys' appointment and fees paid from the bankruptcy estate are subject to regulation under 11 U.S.C. §§ 327-31 and the Federal Rules of Bankruptcy Procedure, and disbursements from the estate for attorney fees are carefully supervised by the bankruptcy court. When applying for either interim or final compensation, the attorney must file a fee application with the court and all parties in interest must receive notice of the application. Fed. R. Bankr. P. 2002(a)(7), 2016; 11 U.S.C. §§ 330(a), 331. After notice and a hearing the court can award compensation. *Id.* The agreement between the debtor and Ludwig & Shlimovitz, S.C., is inconsistent with this procedure.

A bankruptcy court in the Central District of California faced a similar question in *In re Pacific Forest Industries, Inc.*, 95 B.R. 740 (Bankr. C.D. Cal. 1989). In that case, the debtor's attorney proposed a payment procedure by which the debtor would be required to pay the attorney on a monthly basis for all legal services rendered. The funds were to be held in a client trust account in accord with the state bar rules and were to be distributed only upon order of the bankruptcy court. The United States Trustee objected to the debtor-in-possession's application to employ the attorney and opposed having the funds in the possession of the attorney.

The attorney propounded several compelling arguments in support of his application. *Id.* at 741. Because it is detrimental for a sole practitioner to bear the risk of whether the client can reorganize, the attorney argued that he was merely seeking sequestration, not actual payment. With reasoning similar to Mr. Nordholm's, the attorney contended that the Code did not prevent such an arrangement because it "only deals with the allowance and disbursement of compensation or reimbursement." *Id.* According to the *Pacific Forest* attorney, his "sequestration program" was neither compensation nor reimbursement.

The bankruptcy court, although sympathetic, rejected the attorney's position. The court noted that the payment of professionals is considered and treated differently from other service payments. *Id.* at 743. Only those who administer the reorganization of the debtor are required to be employed under § 327 and whose employment is subject to court approval:

> It is clearly the intent of Congress that professionals involved in the reorganization effort itself be carefully scrutinized, that their dealings be open to the public, that they maintain the distance from the debtor that is not possible for an employee, and that they not drain the debtor of the capital that it needs to fund its reorganization.
>
> Whether Congress intended it or not, the fact that attorneys for the debtor-in-possession will not be paid on a regular basis keeps the attorney alert to the ongoing reorganization chances of the debtor.

Id. The court explained the policy which supported the present statutory fee payment scheme. The Code's fee payment procedure provides incentive to the attorney to have greater concern for

the debtor-in-possession's relationship with the estate than for any benefits the debtor may attain through delaying reorganization or acting in a self-serving manner. The court found that the fee arrangement proposed by the attorney would impede such a relationship:

> [The attorney] states that a reason for seeking the sequestration provision is because attorneys cannot trust their clients to be open with them, to run the business in the best possible manner, or even to be honest. Unfortunately, this is a true statement in too many cases. However, it is not appropriate to protect the attorney (who clearly can choose his client) and not the other creditors who may have had no such informed option. Removing the incentive of the attorney to carefully oversee the dealings of his client is not a benefit to the estate nor to the bankruptcy system as a whole.

Id. The court further expressed concern that the fee arrangement proposed by the attorney would not make debtors more trustworthy or attorneys more diligent, but would instead lull attorneys into a false sense of security which would harm the entire estate. *Id.* at 744.

Finally, the court took issue with the attorney's interpretation of the Code provisions. The court noted that it can be argued that the placing of money in a client trust account is not payment or disbursement because the attorney does not have use of the money. However, pursuant to Code provisions, a bankruptcy court may allow and disburse interim fees to the applicant only after notice and a hearing. 11 U.S.C. §§ 330(a), 331, 503. The court concluded it was clearly the purpose of the provisions that the debtor have control of the money during a

reorganization until the court orders otherwise. *Pacific Forest*, 95 B.R. at 745.

In a more recent decision, *In re Perrysburg Marketplace Co.*, 176 B.R. 797 (Bankr. N.D. Ohio 1994), the United States Trustee objected to the debtor-in-possession's application to employ a law firm because of its proposed postpetition payments to the firm. The DIP planned to make monthly payments in the amount of the firm's monthly fees and expenses into a trust account held by the firm. The court concluded that the firm's proposed terms of retention were "fundamentally at odds with the Congressional intent expressed in Bankruptcy Code sections 330, 331 and 503." *Id.* at 799.

The court further found that § 363(b)(1) proscribed the proposed fee arrangement. *Id.* Section 363(b)(1) requires notice and a hearing prior to a debtor's use of property of the estate other than in the ordinary course of business. Because only the court and the United States Trustee were provided notice of the application, the procedure failed to satisfy the requirements of § 363.

Finally, the *Perrysburg Marketplace* court pointed out that even if the proposed payment plan was permissible under the Code, its terms were not reasonable:

> [A] debtor in Chapter 11 needs all the control over post-petition revenues that it can get. Reorganizing businesses have to negotiate and make adequate protection payments to secured creditors; to satisfy skittish employees by maintaining payroll, benefits, and working conditions; to keep taxing authorities satisfied, by avoiding accrual of post-petition

> liabilities; and, usually, to meet current trade expenses on a cash-payment basis. These cash needs remain constant throughout the case, and are critical to its success. Locking substantial funds into escrow for the benefit of counsel for any period of time more than the first months of the case deprives the debtor of that much more flexibility in meeting these needs, and particularly in meeting the "emergency" or "unanticipated" costs that crop up in Chapter 11 cases with distressing frequency.

Id. at 799-800 (quoting *In re Fitzsimmons Trucking, Inc.*, 124 B.R. 556, 558 (Bankr. D. Minn. 1991)). Consequently, the court denied the debtor-in-possession's application to employ the law firm as its attorney.

This court is persuaded by the reasoning found in *Pacific Forest* and *Perrysburg Marketplace*. The statutory scheme laid out by Congress in the bankruptcy fee application procedure ensures that attorney fees paid from the estate are prudential. Ludwig & Shlimovitz, S.C. has sought to elevate their interests above those of the intended beneficiaries of the bankruptcy process: the estate and its creditors. The fee arrangement proposed by the firm may be prudent from a business standpoint and may be common in other areas of law practice, but is contrary to the letter and spirit of the Bankruptcy Code.

Having determined that Ludwig & Shlimovitz, S.C.'s fee arrangement was improper, the court now turns to whether or not the firm's initial lack of disclosure of the arrangement warrants retroactive disqualification.

2. Disclosure Requirements and Disqualification

The Bankruptcy Code vests the court with the authority to review all professional fees paid to the debtor's attorney. Disclosure of fees is a fundamental concept in various Code provisions. After filing the petition, the debtor's attorney must file a statement with the court pursuant to § 329(a) disclosing all compensation "paid or agreed to be paid." Section 329 of the Bankruptcy Code provides, in relevant part:

> 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). Fed. R. Bankr. P. 2016(b) implements § 329 by requiring the attorney to file a disclosure statement identifying any fee arrangements and compensation paid or promised to the attorney within fifteen days after the order for relief. It also contains a requirement that the disclosure be supplemented should any additional fee arrangement or payment be made.

Section 329 emerged from Congress's concern with the problems inherent in permitting fiduciaries to set their fees without court supervision:

> This section, derived in large part from Bankruptcy Act section 60d, requires the debtor's attorney to file with the court a statement of the compensation paid or agreed to be paid to the attorney for services in

> contemplation of and in connection with the case, and the source of the compensation. Payments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny.

H.R. Rep. 595, 95th Cong., 1st Sess. 329 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 39 (1978), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5758, 5825. The disclosure requirements further serve to diminish "the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure." *In re Wood & Henderson*, 210 U.S. 246, 253 (1908).

Section 327 initially authorizes the trustee or debtor-in-possession to hire an attorney for the bankruptcy estate with the court's approval. In applying for a court order approving the employment of counsel, Fed. R. Bankr. P. 2014(a) requires that the application contain the following:

> 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, <u>any proposed arrangement for compensation</u>, 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. . . .

Fed. R. Bankr. P. 2014(a) (emphasis added).

The First Circuit Court of Appeals in the case of *In re Martin*, 817 F.2d 175 (1st Cir. 1987), found that fee agreements and mortgages entered into immediately prepetition pertaining to fees to be charged during the pendency of the case did not

necessarily create an absolute conflict of interest.

Nonetheless, the court recognized the importance of disclosure:

> There must be at a minimum full and timely disclosure of the details of any given arrangement. Armed with knowledge of all of the relevant facts, the bankruptcy court must determine, case by case, whether the security interest coveted by counsel can by tolerated under the particular circumstances. . . .
>
> What counts is that the matter not be left either to hindsight or the unfettered desires of the debtor and his attorney, but that the bankruptcy judge be given an immediate opportunity to make an intelligent appraisal of the situation and to apply his experience, common sense, and knowledge of the particular proceeding to the request. If a lawyer is desirous of benefiting from such an arrangement, he has a responsibility to leave no reasonable stone unturned in bringing the matter to a head at the earliest practical moment.

Id. at 182. *See also In re Park-Helena Corp.*, 63 F.3d 877, 881 (9th Cir. 1995) ("A fee applicant must disclose 'the precise nature of the fee arrangement,' and not simply identify the ultimate owner of the funds."). Ludwig & Shlimovitz, S.C. undermined the court's ability to immediately evaluate the terms and conditions of the firm's employment. It is not up to the attorney to decide what is important with respect to the fee arrangement; all pertinent information must be disclosed so the court can determine what is important and what is not.

At the time Ludwig & Shlimovitz, S.C.'s application for employment was filed, no disclosures were made to the court regarding the existence of the trust account and accompanying fee arrangement. It was only after Mr. Nordholm conferred with Mr. Lucey that the disclosure was made. Mr. Nordholm stated that he did not deem the arrangement important enough to include in the

initial disclosure filed with the court, an explanation this court finds unpersuasive. Even if the proposed deposits to the trust account did not constitute payment, the procedure is still an "arrangement for compensation" which must be disclosed in the application for employment. Fed. R. Bankr. P. 2014(a). Notwithstanding his protestations, the arrangement is important; otherwise, Mr. Nordholm would not want it. The debtor's money would theoretically be available to the debtor, but the imposition of the attorney as sole signatory on a trust account is a considerable barrier to access. The debtor or the debtor's principal must ask the person responsible for his economic survival to turn over money, thereby creating uncertainty for this critical person's payment. The debtor may believe that if the attorney is uncertain of payment, perhaps he will not work as hard in protecting the debtor's interests. The debtor might even believe he would be abandoned for violating the fee agreement at a time when he could not afford another attorney. Also, if the attorney has an opportunity to talk the debtor or the debtor's principal out of the withdrawal, the debtor's access may be legally unrestricted but, practically, it is not.

This court finds that Attorney Nordholm's initial nondisclosure of the fee arrangement was an intentional omission. A deficiency in disclosure as significant and self-fulfilling as the one committed by Ludwig & Shlimovitz, S.C. will not be tolerated by this court. Because full disclosure of its fee arrangement with the debtors was not made prior to their

appointment as attorneys for the debtors, Attorney Nordholm and Ludwig & Shlimovitz, S.C. are disqualified from representing the debtors from the inception of both cases.

3. Nondisclosure and Entitlement to Fees

The fee arrangement established by the attorneys is not allowable, but that is not the reason for the *ab initio* disqualification. The arrangement was revealed only a month into the case - before any required deposits were made. The mistake could have been fixed without harm early in the case. The reason for the disqualification is the nondisclosure of the trust account arrangement. Had another attorney not become closely involved, it might never have been discovered.

The United States Trustee asked for the employment of the attorneys to be declared void *ab initio*. There is only one reason for retrospective as well as prospective disqualification; the United States Trustee wishes to foreclose payment of any fees to the attorneys from the inception of the cases to the time of the attorneys' disqualification in each case. There is no fee application before the court at this time, but this court is not blind to the effect of its order. Thus, the question is: Is the failure to disclose the fee arrangement a wrong of such magnitude that total denial of fees is appropriate? Unfortunately, it is. Creating an undisclosed arrangement that drains several thousand dollars a month from a debtor with a relatively small operation is not a trivial matter. Under abundant case law where an

attorney has failed to be forthright in disclosing financial arrangements, complete denial of compensation is an appropriate remedy. *See, e.g., In re Pierce*, 809 F.2d 1356, 1363 (8th Cir. 1987); *In re Maui 14K, Ltd.*, 133 B.R. 657 (Bankr. D. Haw. 1991); *In re Crimson Inv., N.V.*, 109 B.R. 397, 401 (Bankr. D. Ariz. 1989); *In re Kero-Sun, Inc.*, 58 B.R. 770 (Bankr. D. Conn. 1986). This is not to say that the attorney's representation was tainted in any way. On the contrary, before his disqualification Mr. Nordholm successfully defended the debtor against the United States Trustee's motion to appoint a chapter 11 trustee, and he did a terrific job. Furthermore, removal of competent counsel in the middle of a case may not be in the debtor's best interest. The court must, nevertheless, enforce an overriding policy that protects the integrity of the bankruptcy system and supersedes the facts of this particular case.

Accordingly, this court will enter an order vacating its prior orders employing counsel and disqualifying Mr. Nordholm and Ludwig & Shlimovitz, S.C. from employment by both debtors from the date the petitions were filed, January 2, 1996.

Dated at Milwaukee, Wisconsin, April 15, 1996.

BY THE COURT:

___/s/_____
Honorable Margaret Dee McGarity
United States Bankruptcy Judge