Attorneys' Fees in Chapter 11 Reorganizations: A Case for Modified Procedures

BRENDA HACKER OSBORNE*

INTRODUCTION

Most attorneys expect to be paid for their work. In bankruptcy, however, an attorney might not receive compensation for work performed in good faith while representing the debtor in possession ("DIP"). Recent court decisions have applied provisions of the Bankruptcy Code ("Code") pertaining to conflicts of interest inconsistently [1] These cases have denied fees and disqualified professional persons without providing consistent bases for their decisions. Consequently, an attorney may spend hundreds of hours representing a client only to have a court decide that the attorney will receive no compensation from the bankruptcy estate.

Uncertainty regarding compensation may force many attorneys to tailor certain decisions about the bankruptcy representations in order to increase their chances of compensation. Many of these decisions should be left to the clients. For example, an attorney must be careful not to aid the client in any action that the court might later not compensate. This is no simple task in Chapter 11 bankruptcies, where existing equity holders may have a continuing interest and role to play in the reorganized entity How much should the owners' interests be considered? This is not a decision for the DIP's attorney to make. Yet, attorneys may feel compelled to make this type of decision in order to receive compensation for their work.

To take this pressure off attorneys, and to allow clients to make the business decisions, this Note advocates implementing greater disclosure procedures throughout the representation. This would allow the court, creditors, and other interested parties to examine the DIP's and attorney's actions as they are taking place and to object immediately to any undesirable actions. Under current bankruptcy procedures, objections to fees based on conflicts of interest need only be raised when an attorney is petitioning for fees either at an interim period or at the conclusion of the representation. The court, in responding to an objection, does not decide that the attorney's work is compensable until the work is complete.

---

* J.D. expected, May, 1994, Indiana University School of Law—Bloomington. I wish to thank Professor Bruce Markell for his suggestions and patience in reading various drafts of this Note.

1. In reconciling the competing bankruptcy goals of vindicating creditors' claims and providing debtor relief, "courts simply aren't unanimous on how these conflicts ought to be reconciled—and sometimes it is hard to find internal consistency, even within a single court." John D. Ayer, *Professional Responsibility in Bankruptcy Cases*, *in* BANKRUPTCY ETHICS REVISITED 2-5 (1992).

Implementing new procedures for disclosure and review during the bankruptcy would provide greater guidance for the DIP's counsel throughout the representation. New procedures would facilitate approval of client conduct before counsel expends large amounts of time on the representation. With increased guidance, an attorney is less likely to waste time on work that the court will not compensate and is more likely to allow the DIP to make important business decisions that the client normally makes outside of bankruptcy

Part I of this Note discusses the Bankruptcy Code's procedures for representing a DIP, the courts' inconsistent application of these procedures, and the role of counsel in representing a DIP Part II explores the reasons that attorneys in bankruptcy proceedings make business decisions. Part III proposes a solution to the problems referred to throughout the Note—increasing disclosure requirements and providing greater opportunity for review

I. REPRESENTING THE DEBTOR IN POSSESSION

A. Procedures for Approval

The Bankruptcy Code permits the DIP, with court approval, to employ one or more attorneys to represent or assist the DIP in carrying out its duties.[2] To employ an attorney, the DIP must submit an application for employment to the court for approval.[3] The attorney should submit a verified personal statement with the application. The statement should describe all interests the attorney has in the case and reveal all relationships the attorney has with interested parties.[4] The judge then examines the statement and either approves the attorney's retention or disapproves and disqualifies the attorney

In examining the statement, the court looks for any relationships or interests that might create a conflict for the attorney and interfere with the attorney's duty to fairly represent the DIP [5] When representing any client, an attorney must be free from conflicts of interest.[6] In bankruptcy, this is especially important.[7]

---

2. 11 U.S.C. §§ 327(a), 1107(a) (1988).

3. BANKR. R. 2014.

4. BANKR. R. 2014(a). The attorney must set forth any connections with the debtor, creditors, any other party in interest, along with their respective attorneys and accountants, the trustee, and any party employed by the trustee. *Id.*

5. *In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160 (Bankr. D. Ariz. 1984). "[T]he trustee [DIP] may employ one or more attorneys that do not hold or represent an interest adverse to the estate, and that are disinterested persons " 11 U.S.C. § 327(a).

6. *In re* WPMK, Inc., 42 B.R. 157, 161 (Bankr. D. Haw. 1984) ("This court has said on more than one occasion that attorneys have a duty to exercise independent professional judgment free from compromising influences and loyalties."); Paine v. Chrysler (*In re* Paine), 14 B.R. 272, 274 (Bankr. W.D. Mich. 1981) (citing to common law rule that an attorney, as early as the seventeenth century, was prohibited from representing conflicting interests).

7. One historical purpose behind the specific prohibitions of § 327 is to keep the bankruptcy from being controlled by those with conflicting self-interests:

Both the rules of professional responsibility and certain provisions of the Code, which incorporate specific no-conflict-of-interest requirements, govern conflicts of interest in bankruptcy.[8] Courts use the approval process for representing the DIP and the power to disqualify or limit the compensation of DIP-employed professionals to enforce the rules against conflicts of interest.[9] For a court to approve an attorney under the specific Code requirements, the attorney must be "disinterested" and must not hold an "adverse interest" to the estate.[10] Though these requirements may appear rather straightforward, courts have inconsistently applied them, creating confusion for the bankruptcy attorney.

B. Inconsistent Court Decisions in Approval Process

The courts have produced a variety of inconsistent decisions concerning the approval process. For example, courts have inconsistently applied Code provisions pertaining to prepetition fees. Under § 101(14)(A),[11] an attorney who is a creditor of the debtor is not "disinterested" and thus does not meet the requirements of § 327 for approval. However, courts have not been consistent in deciding whether being owed prepetition fees will be enough to disqualify an attorney under § 327 For example, in *Pierce v. Aetna Life*

> [V]ital functions which in the past have been performed by inside groups or by protective committees seeking personal profit, will be vested in the trustee No longer will the basic, all-important phases of reorganization be performed by groups which have a selfish interest to protect and promote.

In re Kendavis Indus. Int'l, Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988) (quoting H.R. REP. NO. 1409, 75th Cong., 1st Sess. 38 (1937)); *see also In re* Diamond Mortgage Corp., 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990) ("The basic principles underlying the conflict of interest prohibition take on an added dimension when applied to those representing a bankruptcy estate. Thus, the rules are more strictly applied in the bankruptcy context ").

8. *In re* Roberts, 46 B.R. 815, 832-37 (Bankr. D. Utah 1985), *aff'd in part and rev'd in part on other grounds*, 75 B.R. 402 (Bankr. C.D. Utah 1987). "Taken together, the provisions of Sections 327(a) and 101(13) [now 101(14)] and Canons 1, 4, 5, 6, and 9, of the present Codes of Professional Responsibility prohibit attorneys practicing before this Court from representing conflicting interests. This prohibition is not new." *Id.* at 837.

9. 11 U.S.C. §§ 327-328 (1988).

> In order to effectively police participation by professionals in bankruptcy cases, particularly those who seek compensation out of the assets of the estate, the Bankruptcy Code provides the court with a variety of powerful weapons including most importantly total or partial disqualification and reduction or denial of fees.

Diamond Mortgage, 135 B.R. at 88.

10. 11 U.S.C. §§ 327, 1107(b). To be "disinterested," an attorney must not be a creditor, equity security holder, or insider of the debtor; must not be or have been within two years of the bankruptcy filing a director, officer, or employee of the debtor; and, must not have an interest materially adverse to the interest of the estate, any class of creditors, or equity security holders. 11 U.S.C. § 101(14) (Supp. IV 1992). "Adverse interest" is not defined by the Code, but to "hold an interest adverse to the estate" has been defined by the courts in the following manner:

> (1) [T]o 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 Glenn Elec. Sales Corp., 89 B.R. 410, 413 (Bankr. D. N.J. 1988); *Roberts*, 46 B.R. at 827.

11. 11 U.S.C. § 101(14)(A).

Insurance Co. (In re Pierce),[12] the Eighth Circuit affirmed the lower court's decision that counsel was not disinterested because counsel was a creditor of the debtor and held a mortgage in the debtor's property to secure payment of post-petition services.[13] In the case of *In re Heatron, Inc.*,[14] however, the Bankruptcy Court for the Western District of Missouri ruled that being a creditor of the debtor does not disqualify counsel from representing the DIP.[15] *In re Heatron* "seems to be an aberration, though it is often authoritatively cited."[16]

Courts have also split on how to apply the "disinterested" requirement. Some courts view the requirement as a standard to be applied with discretion when examining the interests and relationships of the attorney.[17] These courts are more concerned with the effects the relationship or interest has on the attorney's ability to represent the DIP—whether the interest would color the independent and impartial attitude of the attorney—not whether the interest or relationship exists.[18] Other courts, however, have said that the existence of a questionable interest or relationship is sufficient to require disqualification without looking at the effects the relationship or interest has on the attorney's performance.[19]

Courts have also split over the question of whether an attorney may engage in multiple representation. For example, may an attorney represent the DIP and the debtor or debtor's owners in the same proceeding? One court said that such dual representation is permissible as long as the attorney is not forced into a position where she must choose between conflicting duties,[20] while another court said that dual representation without conflicts is impossible.[21]

---

12. *Pierce*, 809 F.2d 1356 (8th Cir. 1987).

13. *Id.* at 1362; *see also Roberts*, 46 B.R. at 820-23.

14. *Heatron*, 5 B.R. 703 (Bankr. W.D. Mo. 1980).

15. *Id.* at 705.

16. Patti Williams, *Bankruptcy Code Section 327(a)—New Interpretation Forces Attorneys to Waive Fees or Wave Good-Bye to Clients*, 53 MO. L. REV. 309, 316 (1988); *see also In re* Microwave Prods. of Am., Inc., 94 B.R. 971 (Bankr. W.D. Tenn. 1989); *In re* Best Western Heritage Inn Partnership, 79 B.R. 736 (Bankr. E.D. Tenn. 1987); Fondiller v. Robertson (*In re* Fondiller), 15 B.R. 890, 891 (Bankr. N.D. Cal. 1981), *appeal dismissed*, 707 F.2d 441 (9th Cir. 1983). *But see In re* Jaimalito's Cantina Assocs. Ltd. Partnership, 114 B.R. 1, 2 (Bankr. D. D.C. 1990); *In re* Glenn Elec. Sales Corp., 89 B.R. 410 (Bankr. D. N.J. 1988); *In re* Pulliam, 96 B.R. 208, 212 (Bankr. W.D. Mo. 1986).

17. *Roberts*, 46 B.R. at 828 (citing to cases which conclude that the disinterestedness standard is merely a guideline for courts to follow when exercising discretion).

18. *In re* O'Connor, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985) (agreeing that the test for disinterestedness should be applied rigidly, but not blindly).

19. *In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 753 (Bankr. N.D. Tex. 1988); *In re* Chou-Chen Chems., Inc., 31 B.R. 842, 851 (Bankr. W.D. Ky. 1983); *In re* King Resources Co. 20 B.R. 191, 204 (Bankr. D. Colo. 1982). The definition of "disinterestedness" in 11 U.S.C. § 101(14)(E) is "broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code." 2 COLLIER ON BANKRUPTCY ¶ 327.03, at 327-38.1 (15th ed. 1985).

20. *In re* Hoffman, 53 B.R. 564 (Bankr. W.D. Ark. 1985). The court states that a disqualifying conflict does not necessarily exist in every case of dual representation. Whether dual representation is permissible is a question to be determined on a case-by-case basis since in some situations it is too cumbersome to always require separate counsel. *Id.* at 566; *see also In re* Lyons Transp. Lines, Inc., 144 B.R. 32 (Bankr. W.D. Pa. 1992).

21. *In re* 765 Assocs., 14 B.R. 449, 451 (Bankr. D. Haw. 1981) (stating that any advice an attorney representing the DIP partner renders to general partners is improper). *See generally* Ayer, *supra* note

One area where courts are in agreement involves the disclosure requirements for initial approval. When examining the Application for Employment of the attorney, a court looks at the attorney's past actions and relationships with interested parties in the bankruptcy proceeding. In the verified Statement of Connections accompanying the application, the attorney must disclose all such past actions and relationships that a court would find relevant to its decision of whether to approve or disapprove the attorney.[22] Courts agree that the burden rests on the attorney to disclose every interest and relationship that might be relevant, not just those the attorney thinks the court will consider important.[23] Good faith does not matter when the court determines, with the benefit of hindsight, whether the attorney adequately disclosed all factors that might have created a conflict of interest.[24] Courts have consistently held that they will only consider whether the factor is disclosed, and even if an undisclosed relationship does not result in a conflict of interest, failure to disclose that relationship may be enough to justify denial of fees.[25]

C. Inconsistent Court Decisions Involving Future Actions

Inconsistencies in court decisions applying the Code's "disinterested" and "no adverse interest" requirements are not limited to initial approval of the attorney Courts are not in complete agreement on how to handle future actions and relationships that develop during the bankruptcy—actions that might create a conflict of interest for the attorney. If a court decides that such future actions and relationships create a conflict, there may be cause for disqualification:

> Nothing in the Bankruptcy Code specifically gives the court power to remove a professional previously retained by the estate who no longer satisfies the requirements of § 327(a). Nevertheless, there is little doubt that the court has inherent power to remove a professional who would be disqualified from employment by the estate on a prospective basis. In effect the approval of the court contemplated by § 327(a) implies continuous approval.[26]

1, at 2-15 to 2-17 (1992) (discussing dual representations in bankruptcy).

22. *See supra* note 4 and accompanying text.

23. The court has no duty to search the record to find conflicts, so it is the attorney's duty to bring any possible conflicting interests or relationships to the court's attention. *In re* Glenn Elec. Sales Corp., 89 B.R. 410 (Bankr. D. N.J. 1988); *In re* Roberts, 46 B.R. 815, 839 (Bankr. C.D. Utah 1985), *aff'd in part and rev'd in part on other grounds*, 75 B.R. 402 (D. Utah 1987).

24. *Roberts*, 46 B.R. at 839; *see also In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160, 168 (Bankr. D. Ariz. 1984).

25. *In re* Marine Power & Equip. Co., 67 B.R. 643, 648 (Bankr. W.D. Wash. 1986) ("Lack of disclosure of relevant information necessary for an informed ruling on a debtor's application for the employment of an attorney is grounds for the denial of a fee application."); *Roberts*, 46 B.R. at 847; *Guy Apple*, 45 B.R. at 163 ("Failure to disclose the facts giving rise to a conflict of interest may be grounds for denial of compensation wholly apart from the act of representing conflicting interests."); *In re* Arlan's Dep't Stores, Inc., 615 F.2d 925, 934-37 (2d Cir. 1979) (noting that the lower court judge ultimately based his decision on a lack of full disclosure).

26. *In re* Diamond Mortgage Corp., 135 B.R. 78, 89 n.7 (Bankr. N.D. Ill. 1990) (citations omitted).

Consequently, even though a court initially approves the employment of an attorney to represent the DIP, the court reserves the right to disapprove counsel's employment or to deny counsel's compensation if a disqualifying conflict of interest develops.[27] There is no guarantee that, after a court approves an attorney and the attorney begins working for the DIP, the court will not disqualify the attorney in the future. There is also no guarantee that, even with approval, a court will compensate an attorney for all the work done for the DIP.[28]

One reason for inconsistent decisions concerning counsel's future actions and relationships is that courts disagree over what constitutes a "conflict" for the purposes of the § 327 conflict prohibition. Some courts have ereated a distinction between types of conflicts by dividing them into groups of "actual" and "potential" conflicts.[29] These courts hold that only actual conflicts mandate disqualification or denial of fees.[30] A conflict is not actual unless it is likely to inhibit the attorney's professional judgment by forcing the attorney to choose between conflicting duties and interests.[31]

The problem with making this distinction is that a court may approve an attorney after finding that no actual conflict exists yet later disqualify her or deny her compensation once a potential conflict becomes an actual conflict.[32] For example, in the case of *In re Diamond Mortgage Corp.*,[33] counsel for the DIP was approved after the bankruptcy court decided that the existence of counsel's prepetition claim against the debtor was only a potential conflict. When counsel applied for final compensation, however, the court did not grant the full request. The court found that over the course of the representation, counsel's potential conflict ripened into an actual conflict. For this reason, the court limited counsel's fees.[34]

Under present bankruptcy procedures, the concept of potential conflicts of interest is harmful "not only to the interests of the Debtors, but to the

---

27. *Roberts*, 46 B.R. at 835, 845 (stating that a court can disqualify counsel from a case solely on the basis of an appearance of impropriety).

28. *See* 11 U.S.C. § 328(c); *Roberts*, 46 B.R. at 845.

29. *In re* O'Connor, 52 B.R. 892, 897 (Bankr. W.D. Okla. 1985) (discussing the reasons an attorney is in the best position to determine whether a conflict exists).

> An actual conflict of interest has been defined as "an active competition between two interests, in which one interest can only be served at the expense of the other." In contrast, a potential conflict of interest has been defined as "one in which the competition is presently dormant, but may become active if certain contingencies occur."

Diamond Mortgage, 135 B.R. at 90 (citations omitted).

30. *In re* Martin, 817 F.2d 175 (1st Cir. 1987); *Diamond Mortgage*, 135 B.R. 78. *But see In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988).

31. *Diamond Mortgage*, 135 B.R. at 92; *In re* Marine Power & Equip. Co., 67 B.R. 643, 653 (Bankr. W.D. Wash. 1986); *In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160, 166 (Bankr. D. Ariz. 1984).

32. "In determining whether to sanction an attorney whose conflict of interest is only potential, the following factors will be considered: 2. The foreseeability or likelihood that the potential conflict will become an actual conflict[.]" *Diamond Mortgage*, 135 B.R. at 92.

33. *Id.* at 78.

34. *Id.* at 93.

attorneys in the case."[35] The DIP is harmed when its counsel is disqualified after working on the case.[36] Attorneys are harmed since they essentially put in hours of work for free. Reserving a decision on whether an actual conflict exists until after work has been completed is unfair, especially because attorneys are not provided with clear means to avoid being disqualified or denied fees.

At least one court has rejected interpretations of § 327 that find a difference between actual conflicts and potential conflicts in an attempt to eliminate this unfairness. Under the analysis in *In re Kendavis Industries International, Inc.*,[37] once a conflict is apparent, it is deemed a conflict; it is not merely a potential one that could develop into an actual one. *Kendavis* thus provides a bright-line rule for interpreting § 327 where any conflict will result in disqualification.[38]

This holding still does not solve the problem, and courts which recognize a difference between potential and actual conflicts are probably taking the more realistic approach to the approval process. In *Kendavis*, the court found that counsel had an implied agreement with shareholders of the debtor which created a conflict of interest. The *Kendavis* court did not decide that the totality of evidence showed an implied agreement with shareholders until the representation had already taken place.[39] *Kendavis* illustrates that even without recognizing a distinction between actual and potential conflicts, it is difficult to determine at the beginning of the bankruptcy proceeding—during the initial attorney approval stage—that an implied agreement creating a fatal conflict of interest exists. An implied agreement between any party in bankruptcy and an attorney representing the DIP is almost impossible to show without actually examining the attorney's conduct during the reorganization.

Kendavis traps attorneys in a no-win situation. The *Kendavis* court ruled that the relationships an attorney has with shareholders and management—relationships that courts would describe as creating "potential" conflicts are "actual" conflicts. Yet, the court admitted that the attorney is expected to have some sort of relationship with these possibly adverse parties since "in reality . . an attorney for a debtor corporation expressly or

---

35. *In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 753 (Bankr. N.D. Tex. 1988); *see also Marine Power*, 67 B.R. at 653 ("The public policy is to avoid even potentially conflicting situations.") (citation omitted).

36. Disqualification after representation of the debtor has begun has the inequitable effect of denying the estate benefits "obtained by the retention of counsel already familiar with the debtor's affairs." *In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160, 167 (Bankr. D. Ariz. 1984); *see also Diamond Mortgage*, 135 B.R. at 92 (citing *In re* Quakertown Glass Co., 73 B.R. 468, 470 (Bankr. E.D. Pa. 1987)).

37. *Kendavis*, 91 B.R. 742.

38. As the court stated:

> [W]henever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any control party, to protect the interest of that party, counsel holds a conflict. That conflict is not potential, it is actual, and it arises the date that representation commences.

Id. at 754; *see also In re* Vanderbilt Assocs., Ltd., 111 B.R. 347, 356 (Bankr. D. Utah), *rev'd*, 117 B.R. 678 (D. Utah 1990).

39. *Kendavis*, 91 B.R. at 751.

impliedly accepts certain obligations of advice or aid to equity holders, management directors, and the like."[40] Under this decision, the extent to which an attorney can act on these "obligations" without creating a conflict with the attorney's duty to the DIP is uncertain.

D. Role of Counsel in Representing the Debtor in Possession

An attorney representing a DIP in a Chapter 11 reorganization is representing an entity that has been established for the benefit of others. "[I]n the bankruptcy context[,] attorneys are representing debtors who are equivalent to trustees acting in a fiduciary capacity on behalf of the [interested parties] in the case."[41] Management, which ran the debtor company before filing the bankruptcy petition, takes the role of DIP and continues to run the company after the petition has been filed. The DIP is a separate entity from, and has different obligations than, the debtor company even with the same management in control.

In representing the DIP, as with representing any client, an attorney's duty is to use her independent, professional judgment to act in the best interest of the DIP.[42] To act in the best interest of the DIP is to act in the best interest of the bankruptcy estate since the DIP's duty is to the estate.[43] Many courts have defined the DIP's duty to the estate as the duty to maximize its value.[44] A pure maximization goal, however, may have shortcomings.[45]

Because bankruptcy is a collective proceeding,[46] representing the best interests of the estate means taking into consideration the competing interests of multiple parties involved in the bankruptcy. Shareholders of the debtor entity are included in this group of parties whose interests are to be considered. To some, this may come as a surprise because it is commonly believed that in bankruptcy, creditor interests are the only interests of concern.[47] The DIP has an obligation to creditors, but "the view that

---

40. *Id.* at 755.

41. *In re* Marine Power & Equip. Co., 67 B.R. 643, 648 (Bankr. W.D. Wash. 1986); *see also id.* at 654; *In re* Colonial Ford, Inc., 24 B.R. 1014, 1021 (Bankr. D. Utah 1982) ("If the case is in Chapter 11, the debtor will be a debtor in possession, and hence the trustee or fiduciary for the estate.").

42. MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.1 (1992).

43. DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 208-10 (1992).

44. *In re* Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987); *In re* Vanderbilt Assocs., Ltd., 111 B.R. 347, 352 (Bankr. D. Utah), *rev'd*, 117 B.R. 678 (D. Utah 1990); *see also* BAIRD, *supra* note 43, at 208-09.

45. For criticisms of estate maximization principle, see Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 780-87 (1993) [hereinafter *Corporate Governance*].

46. DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 749 (2d ed. 1990).

47. Many cases support this notion by stating that the DIP's role in bankruptcy is to maximize the value of the estate for the benefit of creditors. *Central Ice Cream*, 836 F.2d at 1072; *Vanderbilt Assocs.*, 111 B.R. at 352. The DIP does have a duty to maximize the value of the estate for creditors' benefit, but this does not mean that creditors must be served to the detriment of equity. No courts have held that

managers owe fiduciary duties only to creditors fails to recognize the very real interest that shareholders can have in the management of [insolvent] companies."[48] In any reorganization, shareholders have residuary interests in the estate after the creditors' claims have been satisfied.[49] In reorganizations of small companies, shareholders may have even greater and more powerful interests when existing owners provide certain value to the entity that another owner is not capable of providing.[50] The added value may be in the form of capital, supplies, or expertise.[51] Thus, even though creditors' interests are superior, the interests of the bankruptcy estate may be best served by considering owners' interests as well.

Courts have not decided how much a DIP should take owners' interests into account:

> "We" (meaning: the sovereign, the polity, the system[] haven't really made up our mind how far the trustee/DIP should be able to go in protecting the debtor, at the creditors' expense. It would be possible to design a system of bankruptcy that served the interests of creditors only. Up to now, we have been unwilling to go that far. But we seem to have a bit of a bad conscience about it. We'll let the debtor go a ways, but not too far. And we have a way of changing the rules from case to case—sometimes even in mid-case.[52]

Thus, as will be discussed in following sections, an attorney has little guidance in counseling the DIP in forming a plan in which owners' interests are considered. Finding the "right" plan—one that does not give undue weight to owners' interests—is especially important to an attorney since court decisions have shown that the "wrong" plan may have grave implications for the attorney's compensation.

---

the DIP must select a mode of maximization that harms equity in order to satisfy creditors faster, when another alternative exists which serves creditors' as well as equity's interests.

48. *Corporate Governance*, *supra* note 45, at 708. "We conclude that the better view is that management 'owes' fiduciary duties to both the creditors and the shareholders of an insolvent company." *Id.* at 709.

49. Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 143 (1990) [hereinafter *Bargaining over Equity's Share*] (stating that in 21 of 30 settlement cases studied where the debtor company was insolvent, "creditors agreed to allow shareholder recoveries ranging from $400,000 to $63 million"); *see also Corporate Governance*, *supra* note 45, at 683-84.

50. "[I]n the reorganization cases of small businesses in which managers are also the principal shareholders, equity frequently dominates the bargain. The dependence of the business upon the continuing services of the shareholder-manager is the primary bargaining leverage used to accomplish this feat." *Bargaining over Equity's Share*, *supra* note 49, at 149.

51. *See* BAIRD & JACKSON, *supra* note 46, at 231, 246-54. If the existing ownership can provide such additional value then the owner will have bargaining leverage in the reorganization. *Id.* at n.15. To obtain the highest value for the bankruptcy estate, the interests of the owner will have to be considered.

52. Ayer, *supra* note 1, at 2-5 to 2-6.

II. ATTORNEYS MAKING BUSINESS JUDGMENT DECISIONS

A. Business Judgment Decisions in Bankruptcy

Determining how much shareholders should be involved in the reorganization is a business, not a legal, decision; it requires business experience or education to make. Thus, those who understand the debtor company are better able to make this decision.[53] By definition, an attorney who meets the "disinterested" and "no adverse interest" requirements in order to represent the DIP probably is not the individual who possesses the most experience with the inner workings of the debtor entity Though the attorney will have or develop an understanding of the debtor entity, the client probably hired her to provide legal guidance, not to make business decisions. The attorney who represents the DIP is not in the best position to make decisions about shareholders' interests.

Courts may force attorneys into the role of business consultant and decision-maker; attorneys assume these roles to avoid disqualification and to obtain full compensation for work performed. In two recent cases, courts denied fees requested by attorneys representing DIP's because the attorneys followed the DIPs' business decisions. In the case of *In re Liberty Trust Co.*,[54] the court denied the requested attorneys' fees once the court found that the attorneys' actions taken on behalf of the DIP could only have benefitted the DIP's principals—not the DIP The attorneys had followed the decisions about the reorganization made by the company's owner and manager acting in the role of DIP [55] Thus, the court denied the attorneys' fees because the attorneys followed the client's decision. This suggests that counsel should have exercised their own judgment about the reorganization, instead of following the objectives set forth by the DIP The case of *In re Office Products of America, Inc.*[56] involved a similar situation. Management serving as the DIP opposed reconverting the Chapter 11 reorganization to a Chapter 7 liquidation. Counsel for the DIP supported their client's position. The court, however, ruled that fighting the reconversion only benefitted management and shareholders, not creditors and the estate. Consequently, the court denied compensation for counsel representing interests of the DIP's principals.[57] This case suggests that to obtain full compensation, counsel should have exercised their own business judgment and decided whether to fight the reconversion instead of merely following the DIP's wishes.

---

53. *In re* Colonial Ford, Inc., 24 B.R. 1014 (Bankr. D. Utah 1982).
54. *Liberty Trust*, 92 B.R. 706 (Bankr. W.D. Tex. 1988).
55. *Id.* at 707.
56. *Office Prods.*, 136 B.R. 983 (Bankr. W.D. Tex. 1992).
57. *Id.* at 991.

B. Procedures for Compensation of Fees from the Estate

The procedure for compensating an attorney out of the estate involves filing an application for compensation with the court.[58] The attorney filing the application may be seeking interim or final compensation.[59] An attorney may apply for interim compensation once every 120 days.[60] The application must provide a "detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested."[61] The court will only grant reasonable compensation for actual and necessary services and expenses.[62]

Once an application is filed, any party of interest may object to the request for payment. These objections may be based on claims that the attorney's action during the bankruptcy proceeding created a conflict of interest for the attorney or that the attorney's work has not benefitted the estate and, therefore, should not be compensated. At this point, the court will examine the attorney's actions throughout the representation and will re-evaluate the attorney's relationships with interested parties in the bankruptcy. If the court finds that the attorney's actions created a conflict of interest or did not benefit the estate,[63] the court may deny some or all compensation for counsel's completed work.[64] If the attorney makes a request for fees before the bankruptcy representation is complete, the court may even disqualify counsel from the case.[65] Thus, the court does not review an attorney's work until the attorney makes a request for fees or another party files a motion against the attorney Contrary to one court's statement, this does not "effectively police participation by professionals in bankruptcy cases";[66] effective policing would involve court supervision before counsel and the DIP act on a decision in the reorganization, not after their work is complete.

---

58. 11 U.S.C. §§ 330-331 (1988).

59. *Id.*; BANKR. R. 2016.

60. 11 U.S.C. § 331 ("[A]ny professional employed under section 327 or 1103 of this title may apply to the court not more than once every 120 days or more often if the court permits.").

61. BANKR. R. 2016(a).

62. 11 U.S.C. § 330(a) ("After notice to any parties in interest . and a hearing, the court may award reasonable compensation for actual, necessary services based on the nature, the extent, and the value of such services, the time spent on such services, and the cost of comparable services "); *see In re* Westside Creek Ltd. Partnership, 93 B.R. 177, 180 (Bankr. E.D. Ark. 1988) ("A fee application should be specific enough to identify the legal services rendered so that, the Court can determine the difficulty of the case and what results were achieved for the estate.").

63. *In re* Reed, 890 F.2d 104 (8th Cir. 1989) (disallowing fees for services performed for the debtor which do not benefit the estate).

64. Ayer, *supra* note 1, at 2-5 (discussing the "'case sanction' where the attorney is seeking an award of fees from the bankruptcy estate, and the judge uses a finding of professional malpractice to cut the fee request").

65. 11 U.S.C. § 329 (1988); BANKR. R. 2017.

66. *See In re* Diamond Mortgage Corp., 135 B.R. 78, 88 (Bankr. N.D. Ill. 1990); *supra* note 9. Describing total or partial disqualification as a "weapon to be used against professionals" suggests a fight against intentional violations of Code provisions. Should we assume, in interpreting and applying Code remedies for conflicts of interest, that all violations are intentional? Or, should we assume that violations are unintentional mistakes resulting from misguidance?

C. Lack of Guidance from Court Decisions Applying Compensation Procedures

In recent decisions, courts have not hesitated to deny compensation for attorneys' completed work that the courts have construed as creating a conflict of interest or as not benefitting the estate.[67] The courts' leniency in granting motions for denial of fees is a disincentive for qualified attorneys even to enter the bankruptcy arena.[68] This disincentive is contrary to the goals of Congress which, in setting the Code's compensation provisions, intended to attract qualified attorneys to bankruptcy [69] The courts' leniency also provides a wonderful tactical measure for interested parties to use against the DIP in litigation.[70] It would not be surprising to find the threat of filing a motion against an attorney's request for compensation being used as a bargaining tool for a party to gain power in the reorganization.

The concern for an attorney is not so much that there is a possibility of disqualification or denial of fees after spending time working for the DIP The concern is that after obtaining approval of the court to represent the DIP, an attorney has little guidance on how to avoid future disqualification or denial of fees. For example, in the case of *In re Liberty Trust Co.*,[71] the attorneys representing the DIP followed all the bankruptcy procedures for initial approval to represent the DIP They had engaged in what "they believed to be the required, diligent representation of their client as instructed by the client's owner and manager."[72] The court denied the attorneys $4000 of their requested final compensation from the estate even though the court never provided any indication during the bankruptcy that there might be problems with the representation.[73]

---

67. *See, e.g., Reed*, 890 F.2d 104; *In re* Grabill Corp., 110 B.R. 356 (Bankr. N.D. Ill. 1990); *In re* Holden, 101 B.R. 573 (Bankr. N.D. Iowa 1989); *In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).

68. A ruling denying fees should not be made lightly since each decision increasing the number of such rulings "inevitably discourages competent and honest counsel from accepting such representations in the first place, or from diligently discharging their duties for fear of reprisals later in the case." *In re* Office Prods. of Am., Inc., 136 B.R. 983, 988 (Bankr. W.D. Tex. 1992); *see also In re* Guy Apple Masonry Contractor, Inc., 45 B.R. 160 (Bankr. D. Ariz. 1984).

69. Congress, in passing the provisions for § 330, wanted compensation for bankruptcy work to be comparable to compensation for non-bankruptcy work. Congress' purpose was to attract qualified attorneys to the bankruptcy field. Without the incentives of comparable compensation in bankruptcy:

> [b]ankruptcy specialists, who enable the system to operate smoothly, efficiently, and expeditiously, would be driven elsewhere, and the bankruptcy field would be occupied by those who could not find other work and those who practice bankruptcy law only occasionally almost as a public service.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 329-30 (1977).

70. Disqualification motions, "which are collateral to the merits of a case, have substantially increased in number and are used for purely tactical reasons." *In re* Roberts, 46 B.R. 815, 846 (Bankr. D. Utah 1985), *aff'd in part and rev'd in part on other grounds*, 75 B.R. 402 (D. Utah 1987); *see also* Armstrong v. McAlpin, 625 F.2d 433, 437 (2d Cir. 1980), *judgment vacated*, 449 U.S. 1106 (1981).

71. *Liberty Trust*, 92 B.R. 706 (Bankr. W.D. Tex. 1988).

72. *Id.* at 707.

73. *Id.* at 706.

In a similar example, the court in the case of *In re Office Products of America, Inc.*[74] disallowed $10,315 of compensation for work the court construed as benefitting the debtors, but not the estate. This court said that there was a certain point in the proceedings in which the DIP should have known that its interest in a reorganization was futile.[75] Consequently, any efforts of the attorneys to represent the DIP in the reorganization after this point were uncompensable.[76] Again, the court gave the attorneys little indication during the proceeding that it would not compensate them for their diligent representation of the DIP

Lack of guidance during the representation puts a tremendous burden on an attorney to take only those actions she foresees the court approving and compensating. Thus, counsel takes a risk when representing a DIP If the attorney guesses incorrectly and engages in some action the court does not approve, either because the court construes it as having created a conflict of interest or because the court does not believe it benefitted the estate, the attorney faces a retroactive punishment for guessing incorrectly [77]

In the case of *In re Kendavis Industries International*, the court, as a means of disciplining counsel for inappropriate actions, disgorged fifty percent of counsel's previously awarded fees.[78] In this case, the Creditors Committee[79] objected to counsel's fee application and moved for a disgorgement of fees. The Committee stated that counsel represented the interests of the debtor's principals rather than those of the DIP, resulting in a fatal conflict of interest.[80] The attorney defended his actions as being "reasonable, and in the best interests of the estate."[81] The court held for the Committee, stating that because the debtors were insolvent, the stockholders held no recognizable economic interest in the reorganization. Therefore, the attorney's efforts to create a plan that benefitted the stockholders did not benefit the estate.[82] In the court's view, the DIP made the wrong business judgment decision when it weighed the stockholders' interests too heavily [83]

---

74. *Office Prods.*, 136 B.R. 983 (Bankr. W.D. Tex. 1992).

75. *Id.* at 990.

76. *Id.*

77. *See In re* O'Connor, 52 B.R. 892, 900 (Bankr. W.D. Okla. 1985) ("[T]o permit the accrual of legal fees and expenses only to grant a motion to disqualify debtor's counsel at some future date, strikes us as most inequitable indeed.").

78. *Kendavis*, 91 B.R. 742, 748-49 (Bankr. N.D. Tex. 1988).

79. For a discussion of Creditors Committees, see 11 U.S.C. § 1102.

80. *Id.*

81. *Id.* at 749.

82. *Id.* The owners of a bankrupt firm may have a continuing interest in the reorganization even if the firm is insolvent. If the owners can provide certain value to the reorganized firm that another owner is not capable of providing, considering the owners' interests would be in the best interest of the firm. *See supra* notes 50-51 and accompanying text; *see also* Ayer, *supra* note 1, at 2-9 ("[A] number of courts have insisted that even where the debtor is insolvent, equity has a place at the table and must be included in negotiations.").

83. *Kendavis*, 91 B.R. at 749. The court also said that the attorney made the wrong decision in objecting to the creditor's plan of reorganization because any objections could only benefit the stockholders. *Id.* at 750. The court seems to suggest that objections by the attorney were misplaced since no non-insider creditors objected to the plan. But no non-insider creditor would object to a plan that provides for one hundred percent repayment of non-insider creditors! *See also In re* Guy Apple Masonry

It seems obvious that in *Kendavis* an actual relationship existed between the debtors' attorney and the controlling owners, resulting in a conflict of interest for the attorney The implications of the *Kendavis* decision, however, are troubling for a number of reasons. First, with the aid of hindsight, courts can easily construe legitimate actions made for the benefit of the estate as being biased in favor of the existing owners, thus creating a conflict of interest.[84] Second, even if a court does not find a conflict of interest, the court may deny fees based on an *appearance* of divided loyalty [85] One of the *Kendavis* court's reasons for disallowing fees was an appearance of divided loyalty [86] Consequently, even if an attorney represents only the DIP, a court may still find that the attorney, as a result of her actions, actually represented the debtor. If, however, the *Kendavis* court's statement is true that counsel for the DIP has some relationship with "equity holders, management directors, and the like[,]"[87] then it is difficult to determine where to draw the line between an appearance of impropriety and the fulfillment of legitimate obligations in the representation.

The question remains for attorneys representing the DIP· How much can they take the debtor's interests into account without representing conflicting interests? One court recognized that an attorney must be extremely careful since any action of the attorney is suspicious: "It is all too easy for an attorney to drift into a relationship with management who is restructuring the debtor which may be entirely adverse to the interests of the debtor in possession."[88] This warning provides little guidance when attorneys try to balance the competing demands of all the parties involved in the bankruptcy proceeding. The warning may also be misdirected since the real problem may not lie with the attorney but with the client who is disloyal to its relationship with counsel that is based on trust. One court denied part of the fees of counsel for the DIP but stated that the real reason for failings in the representation may have been the client's dishonesty [89] The client had arranged for a third party to act as an outside advisor, thus violating bankruptcy standards. The debtor and outside advisor were not forthright with the attorney about the arrangement; they were careful not to actually lie to the attorney, but were also careful not to disclose too much. Even if the attorney

---

Contractor, Inc., 45 B.R. 160, 167 (Bankr. D. Ariz. 1984).

84. In *Kendavis*, the court admitted that each piece of evidence, taken alone, would have been insufficient to establish that the attorney represented the controlling stockholders. Nonetheless, the court felt that the totality of the evidence could only lead to that conclusion. *Kendavis*, 91 B.R. at 751.

85. *In re* Roberts, 46 B.R. 815, 837 (Bankr. D. Utah 1985) ("[T]he penalty serves a prophylactic purpose. It strikes not only at actual evil [fraudulent conduct], but at the tendency of divided loyalty to create evil."), *aff'd in part and rev'd in part on other grounds*, 75 B.R. 402 (Bankr. D. Utah C.D. 1987); *see also* 11 U.S.C. § 328(c).

86. *Kendavis*, 91 B.R. at 753 (stating that even if the law firm arguably did not represent the controlling shareholders, "their actions throughout the case point to an inescapable appearance to the contrary").

87. *Id.* at 755; *see supra* text accompanying note 40.

88. *In re* Vanderbilt Assocs., Ltd., 111 B.R. 347, 356 (Bankr. D. Utah), *rev'd*, 117 B.R. 678 (D. Utah 1990).

89. *In re* Sky Valley, Inc., 135 B.R. 925, 938 n.18 (Bankr. N.D. Ga. 1992).

had attempted to better supervise the client, the court admitted that he may have been "rebuffed by the actual, behind-the-scenes control" of the third party.[90]

One bankruptcy court recognized that a client may direct counsel to take action that may not benefit the estate.[91] This leaves the attorney the option of either ignoring the client's wishes or working with no assurance of compensation. In the case of *In re Grabill Corp.*,[92] the court decided to limit but not deny all of the attorney's compensation. Otherwise, it "would effectively penalize [the attorney] for following [the client's] directions."[93] The court came to this conclusion even though the attorney's work was of no benefit to the estate.

Management, in the role of DIP, has its own concerns during the bankruptcy that may affect the DIP's view of the reorganization. Namely, management's career interests are at stake; "[m]anagement is seen as self-evidently interested in their own salaries and prerequisites, in preservation of the company and therefore their jobs, and in their reputation as effective managers."[94] In small business reorganizations where shareholders are also managers, those managers often retain their positions in the surviving entity.[95] In large business reorganizations existing managers are not as likely to keep their jobs after the reorganization since they are easily replaced.[96] Considering these pressures on management, counsel for the DIP not only must guard against unintentional violations of the "disinterested" and "no adverse interest" requirements, but may also have to fight against intentional violations as the DIP tries to take actions that serve management's own interests.[97]

Present Code procedures do not alleviate the pressure on attorneys to walk the fine line between adequately representing the estate in a successful reorganization and over-emphasizing equity owners interests, to the point that the representation fails. Once an attorney is initially approved, the court does not review the attorney's work until either the attorney petitions for fees or an interested party files a motion against the attorney. In both of these situations, the court examines the work after it is complete. The court decides after the fact whether the attorney has acted appropriately For an attorney to successfully obtain compensation, the attorney must have accurately predicted during the bankruptcy which actions and plans the court would approve or disapprove. Forecasting how a plan adopted today will work out and be viewed by a court tomorrow is not an easy task.

Forcing an attorney to predict the success of a plan may encourage the attorney to counsel the DIP to make safe, conservative business decisions

---

90. *Id.*
91. *In re* Grabill Corp., 110 B.R. 356 (Bankr. N.D. Ill. 1990).
92. *Id.* at 361.
93. *Id.*
94. *Corporate Governance*, *supra* note 45, at 710.
95. *Bargaining over Equity's Share*, *supra* note 49, at 149.
96. *Id.* at 149-50.
97. *Id.* at 151 & n.54 (discussing how management can serve its self-interest in a reorganization).

throughout the reorganization, even when conservative approaches may not be in the best interest of the estate. For example, suppose the DIP proposes a plan to invest $1 million, with a fifty percent chance of yielding $2 million and a fifty percent chance of yielding nothing. The Creditors Committee wants to liquidate the debtor and distribute the proceeds. Which plan should counsel favor?[98] Without assurances that the court will not find the attorney's choice to favor the DIP's plan as placing the debtor's interests before those of the estate, most attorneys would choose the creditors' plan. Counsel would thereby encourage the DIP to follow the plan that is most likely to benefit counsel in the end, even if another plan might be *more* beneficial to the estate. In essence, counsel is making business decisions about the reorganization that favor counsel's interests. Until courts provide more guidance as to how far debtors' interests can be considered, attorneys will continue to make business decisions by influencing their clients to take actions that the attorney believes the court will approve. Under current procedures, attorneys have little incentive to take risks that, if successful, will benefit the estate, but if unsuccessful, might damage their chances of receiving compensation.

D. Lack of Guidance from Rules of Professional Responsibility

The rules governing professional conduct provide little guidance for an attorney trying to make decisions that benefit the estate in the collective proceeding, while simultaneously trying to avoid the appearance of a conflicting interest.[99] One reason for this is that compliance with the Model Rules of Professional Conduct ("MRPC") requires a clear understanding of the client's identity and interests. For example, the Comment to Rule 1.3 says:

> A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and may take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer should act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf.[100]

In bankruptcy the identity and interests of the DIP are not clearly defined and may change throughout the proceeding.[101]

---

98. Ayer, *supra* note 1, at 2-7 to 2-8.

> A superficial review of the facts will cause many readers to favor the creditors because any other result will permit the debtor to "gamble with other peoples' money." But one could just as well say that too-rapid liquidation may permit the creditors to foreclose the debtor out of a valuable opportunity.

Id. at 2-8.

99. *See* Carol W. Gustavson, *The Ethical Role of a Debtor's Attorney in a Consumer Bankruptcy Filing*, 6 GEO. J. LEGAL ETHICS 684 (1993).

100. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.3 cmt. (1992).

101. *See* John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355, 387 (1986); *see also supra* text accompanying notes 76-77.

Another reason the MRPC provide little guidance is that, except for Rule 1.13,[102] the MRPC are written for traditional two-party legal proceedings[103] where counsel serves in an adversarial role.[104] Bankruptcy, however, is a complex bargaining process involving more than two parties who are not clearly aligned one against another;[105] "the corporate debtor will be a complex of constituencies, including not only creditors but also a board of directors, management, and shareholders."[106] An attorney's duty is to help the client, the DIP, sort through the interests of these multiple parties.[107] This is not an easy task because "[t]hese parties may be divided on some issues; even when united, their views may change from circumstance to circumstance, or from time to time."[108]

One rule an attorney may be forced to violate in order to obtain compensation is MRPC 1.2. Under this rule, an attorney has a duty to allow the client to set the objectives of the representation while the attorney determines the means.[109] Does setting the objectives include controlling decisions about whose interests the reorganization will serve? If so, an attorney has a real dilemma. The DIP and the attorney may have different opinions of what actions create a conflict or are in the best interests of the estate.[110] What the client believes is in the best interest of the estate may not be in the best interest of the attorney with regard to compensation. To be compensated, the attorney will want to follow her own business judgment decision. To be in compliance with Rule 1.2, however, the attorney may need to follow the DIP's decisions.

Is there a violation of professional ethics if the attorney decides not to follow the client's wishes? Could the DIP bring suit against counsel for such a violation?[111] Even if not, there is nonetheless tension between the client and the attorney The conflict is not over the legal means to be employed; the

---

102. Rule 1.13 embodies the entity-client theory for counsel representing a corporation. Counsel, when representing an organization, "represents the organization acting through its duly authorized constituents." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(a) (1992).

103. *In re* Paine, 14 B.R. 272, 275 (Bankr. W.D. Mich. 1981) (referring to American United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138 (1940)).

104. *See* Lawrence E. Mitchell, *Professional Responsibility and the Close Corporation: Toward a Realistic Ethic*, 74 CORNELL L. REV. 466, 471 (1989).

105. "In ordinary cases, you usually know who is your friend and who [is] your enemy. In bankruptcy, it isn't always so clear. In some cases, creditors find themselves allied against the debtor. But often, creditors break ranks." Ayer, *supra* note 1, at 2-5; *see also In re* Vanderbilt Assoes., Ltd., 111 B.R. 347, 352 (Bankr. D. Utah) (noting that, in bankruptcy proceedings, "many parties in interest are unrepresented"), *rev'd*, 117 B.R. 678 (Bankr. C.D. Utah 1990).

106. *In re* Colonial Ford, Inc., 24 B.R. 1014, 1021-22 (Bankr. D. Utah 1982).

107. *Id.* at 1022.

108. *Id.*, *see also* Ayer, *supra* note 101, at 386-87.

109. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 (1992).

110. *See supra* note 97 and accompanying text.

111. The Model Rules contain a disclaimer that the Rules should not provide the basis for civil liability. MODEL RULES OF PROFESSIONAL CONDUCT Scope (1992). But some have argued that the "Model Rules should be 'rules of the lawyer's legal obligations and not expressions of hope as to what a lawyer ought to do.'" Ann Peters, Note, *The Model Rules as a Guide for Legal Malpractice* 6 GEO. J. LEGAL ETHICS 609, 611 (1993) (quoting Geoffrey C. Hazard, Jr., *Legal Ethics: Legal Rules and Professional Aspirations*, 30 CLEV. ST. L. REV. 571, 574 (1982)).

conflict is over the issue of which business decisions are in the best interests of the estate.

III. SOLUTION

There is a way to remove the uncertainties now linked to conflicts of interest and compensation of attorneys representing DIP's. The solution is to modify bankruptcy procedures to encourage DIP attorneys, and to require other interested parties to raise conflict of interest issues as soon as they arise. As the *Kendavis* court discussed, current procedures do not allow bankruptcy courts to adequately monitor conflicts of interest:

> [H]ow can a bankruptcy court monitor conflicts of interest when these matters come before the court in less than obvious ways? Unless a court is extremely experienced in bankruptcy tactics and negotiations, or unless a party in interest brings the matter before the court with a "smoking gun," no effective manner exists to monitor this problem.[112]

Raising conflict of interest concerns when they arise will permit courts to target potential problems in their infancy before they develop into full grown conflicts. Counsel and the DIP will then have the opportunity to change their course of action before counsel completes hours of work that the court will not approve or compensate.

A. Additional Procedures

First, the court may require parties in interest to raise concerns about the counsel's representation of the DIP as soon as they arise. Under existing procedures, if an interested party has an objection to counsel's representation of the DIP, that party does not have to voice those objections immediately. A bankruptcy court cannot effectively monitor conflicts of interest "when these matters come before the court in less than obvious ways[,]" that is, when "a party in interest brings the matter before the court with a 'smoking gun[.]'"[113] The party can serve its own interests by saving the objection until the most opportune moment and then bringing it to the court's attention.[114]

Requiring interested parties to bring objections to the court as soon as the parties become aware of them will warn counsel for the DIP that, without modifications, additional work put into the proposal will meet with objections when counsel later petitions for fees. Armed with such knowledge, counsel can better advise the DIP on the proper course of action to take with regard to the proposal. In addition, requiring immediate objections negates the threat

112. *In re* Kendavis Indus. Int'l, Inc., 91 B.R. 742, 756 (Bankr. N.D. Tex. 1988).
113. *Id.*
114. *See supra* note 70 and accompanying text.

of an opposing party filing a motion against an attorney's request for fees as a means of gaining greater bargaining strength.[115]

To further protect against denial of fees, the DIP's counsel needs a procedure under which she can have actions reviewed which other parties might unfairly characterize as serving conflicting interests. Concerns over client confidentiality and reorganization tactics that would be foiled by disclosure limit those actions that counsel can reveal to other interested parties. Still, counsel should be able to take some precautions with less sensitive matters in order to protect herself from future attacks when she petitions for fees.

For example, if counsel believes that creditors could perceive the DIP's suggested plan as involving a conflicting interest for counsel, counsel could submit a statement to the court indicating her concern and could file a motion for review of the issue. The statement and motion would trigger heightened scrutiny The court could then conduct an in camera review for sensitive matters or pass on the statement to all interested parties for their review This would shift the burden to the other interested parties to investigate the issue and object to the action within a specified period or else lose the objection later when counsel petitions for fees.

As discussed previously, a bankruptcy court could not require counsel for the DIP to file a statement with the court every time counsel has concerns. Being given the option, however, counsel can weigh the value of not voicing her concerns initially against the risk involved in waiting until she petitions for fees to resolve conflict of interest challenges.

An advantage to providing procedures for disclosure throughout the representation is that it allows counsel for the DIP to leave business decision-making to the client. If the DIP wants to consider shareholders' interests in a reorganization plan, and counsel for the DIP questions whether such a level of shareholder involvement is appropriate, counsel can obtain review of her concerns. Instead of counsel guessing as to how other parties will view the DIP's plan, and influencing the DIP's actions based upon that guess, counsel has a clear indication of the other parties' views beforehand.[116]

B. Incorporating Procedures Under the Code

Congress does not need to alter Bankruptcy Code provisions to encourage the DIP's counsel, and to require other interested parties, to raise conflict issues when they occur. Bankruptcy courts already have this power under § 105.[117] This section provides the court with general equitable powers to

---

115. *See supra* note 70 and accompanying text.

116. To understand the impact of disclosure procedures on business decision-making, see the example *supra* note 100 and accompanying text. DIP's counsel could favor the DIP's proposal over the Creditors Committee's proposal without the risk of losing fees. Thus, counsel's desire to be paid will not dictate a conservative approach to the reorganization that might not be in the best interest of the estate.

117. 11 U.S.C. § 105(a) (1992).

enforce the provisions of the Bankruptcy Code.[118] They are given the authority to issue any necessary orders, processes, or judgments.[119]

Bankruptcy courts may exercise equitable powers if the powers are tied to "another Bankruptcy Code section and not merely to a general bankruptcy concept or objective."[120] Ordering disclosure complies with this requirement. The bankruptcy court is responsible for initially approving counsel, ruling on conflicts of interest, and awarding attorneys' fees. Requesting that concerns regarding these areas be brought to the court's attention immediately, rather than haphazardly, aids the court in its designated functions, not just in furthering general bankruptcy policy

Bankruptcy courts' equitable powers are not unlimited, however. Courts may not use the powers to contravene specific provisions of the Code.[121] Again, ordering disclosure complies with this requirement. There are no specific provisions that prohibit bankruptcy courts from granting a motion by the DIP or from issuing a general order requiring parties to reveal conflict concerns when they arise.

CONCLUSION

The problems in current bankruptcy procedures not only impact attorneys' ability to receive compensation, they also affect the efficient disposition of bankruptcy cases. Attorneys who spend time on work for which a court will not permit compensation prolong the bankruptcy proceedings. Furthermore, litigation collateral to the bankruptcy, involving claims of conflicts of interests and denial of fees, wastes judicial resources. Increased disclosure permits collective discussion on issues confronting the DIP's counsel before major problems develop. The increased guidance from these collective discussions will help prevent counsel from getting involved in situations that create a conflict in the representation and will keep counsel from wasting efforts on work that does not benefit the estate. The costs of implementing disclosure procedures are minimal if courts use their equitable powers under § 105. Advantages to the orderly disposition of the bankruptcy process far outweigh any costs that may result.

---

118. "The use of 'neccssary or appropriate' is in keeping with congressional intent that bankruptcy courts deal with all pbases and aspects of a bankruptcy proceeding." Regan v. Ross, 691 F.2d 81, 84 n.10 (2d Cir. 1982); *see, e.g.*, Sundstrom Mortgage Co. v. 2218 Bluebird Ltd. Partnership (*In re* 2218 Bluebird Ltd. Partnership), 41 B.R. 540, 544 (Bankr. S.D. Cal. 1984) (stating that bankruptcy courts have inherent power under § 105 to sanction parties in order "to protect the orderly administration of justice and maintain the authority and dignity of the Court").

119. 11 U.S.C. § 105(a).

120. 1 COLLIER BANKRUPTCY MANUAL ¶ 105.01 (3d ed. 1993).

121. *E.g.*, Childress v. Middleton Arms, Ltd. Partnership (*In re* Middleton Arms, Ltd. Partnership), 119 B.R. 131, 132 (M.D. Tenn. 1990) (stating that a bankruptcy court may not use its equitable powers to approve a debtor's application to employ a real estate agent when such approval contravenes the "disinterested" requirement of § 327(a)), *aff'd*, 934 F.2d 723 (6th Cir. 1991); *In re* French, 111 B.R. 391, 394 (Bankr. N.D.N.Y. 1989) (stating that § 105 may not be used to circumvent § 327's express provisions).