11 U.S.C. § 503(b)(3)
Attorney fees

In re North Valley Auto Center, Inc. Case No. 691-62502-fra7

3/27/96 FRA Unpublished

The trustee filed an objection to a proof of claim filed by a law firm for work it did with respect to the bankruptcy. The firm's fees and expenses were claimed as an administrative expense under 11 U.S.C. § 503(b)(3) and (4) as being necessary expenses which made a substantial contribution to the case.

The firm had been hired to represent the DIP's president who was also the major shareholder and major guarantor of the DIP's debt. Knowing that they could not represent both the shareholder and the DIP because of the inherent conflict of interest, another attorney applied and was approved by the court to represent the DIP. The firm transferred a $5,000 retainer it had received from the shareholder to the DIP's attorney. However, even though the DIP had retained independent counsel, the shareholder's attorneys continued to do much of the work that would ordinarily have been done by the DIP's attorney.

The attorney fees and expenses included in the proof of claim could be broken down into two types according to the court: 1) management of the case and matters ordinarily performed by a DIP's attorney, such as preparation of schedules, and 2) negotiation of a settlement with the DIP's major creditor. The court stated that in order to be a "necessary" expense under § 503(b)(3), and thus compensable from the estate, the work must have been essential to the continuance of the case and it must have been necessary that it be performed by the creditor or shareholder's attorney, rather than by the DIP's. To hold otherwise, the court stated, would allow an attorney to escape the requirements of § 327 simply by resorting to § 503(b)(4).

The court held that the first type of work for which compensation was sought did not meet the "necessary" test because the record did not show that it was necessary that the shareholder's attorneys perform that work and not the DIP's. The second type of work performed, a settlement with the DIP's major creditor, benefitted the shareholder as corporate guarantor, but, according to the court, the benefit to the DIP was only incidental. As such, the court held that the estate should not be charged for those fees. The proof of claim was denied in its entirety.

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF OREGON

In Re:	)	Bankruptcy Case No.
	)	691-62502-fra7
NORTH VALLEY AUTO CENTER, INC.,	)	
	)	
	)	MEMORANDUM OPINION
Debtor.	)	

Dale Monteleone was president and a shareholder of North Valley Auto Center, an automobile dealership in Grants Pass, Oregon. He was also a guarantor of debt owed by the dealership to its principal creditor. He has moved for allowance as an administrative expense his claim for attorneys fees paid in connection with this case, and the United States Trustee has objected. I find that the services rendered do not qualify as expenses payable by the estate, and deny the motion.

BACKGROUND

This case was commenced under Chapter 11 of the Bankruptcy Code on May 30, 1991. The Petition for relief was filed on Debtor's behalf by Boyd & Wade, P.C., Mr. Monteleone's attorneys. The attorneys made it clear from the outset that they had been hired by Mr. Monteleone, and that he intended that they represent his interests. Since they could not then be regarded as

"disinterested", they were ineligible to be employed as attorneys for the Debtor in Possession. 11 U.S.C. § 327(a). Another attorney submitted an application for employment, which the Court approved. A $5,000 retainer originally paid to Boyd & Wade was delivered to the new attorney. In its Statement of Affairs (Doc. # 21) the DIP stated that no funds had been paid to Boyd & Wade, and that "for services rendered to Mr. Monteleone which are for the exclusive benefit of the DIP, reimbursement will be sought for Mr. Monteleone."

Although the DIP had obtained independent counsel, much of the work ordinarily performed by the DIP's or Debtor's counsel was done by Mr. Monteleone's. For example, the schedules were prepared by Monteleone's attorneys. A motion for extension of time to file the schedules (File Doc. #9) included a supporting affidavit from Mr. Monteleone's attorney stating that "due to time constraints and the disparity of clerical assistance between the firms, I have agreed with [DIP's attorney] that Boyd & Wade, P.C., will undertake the responsibility for preparing and filing schedules and statements due June 14, 1991." The affidavit goes on to note that, since the case was filed on May 30, "all of the time spent on this case has been devoted to negotiation of a cash collateral agreement with U. S. National Bank of Oregon."

The case was converted to Chapter 7 on October 18, 1991 (Doc. #44). Judging from the Court's docket and files much of the Debtor's brief life as a DIP was spent in negotiations with U. S. Bank, its principal secured creditor. These negotiations ended with a settlement that called for the sale of the dealership and payment

of all but $10,000 of the proceeds to the Bank. The $10,000 was intended, according to the Bank's attorney, to be "available to other creditors and administrative expenses." Part of the settlement involved a settlement agreement between Mr. Monteleone and the Bank. This agreement was submitted to the Court (along with the agreement between the DIP and the Bank) with the motion seeking approval of the sale.

The agreement reveals that Mr. Monteleone was indebted to the Bank as a guarantor of the DIP's debt to the Bank. The parties estimated that, after sale of the DIP's assets, the remaining debt would be "not less than $626,400.00. . . ." The agreement provided for the discharge of this debt by the sale or refinance of real property Mr. Monteleone owned, and payment of the proceeds to the Bank.

The application now before the Court documents that Mr. Monteleone's attorneys were thoroughly engaged in virtually every aspect of the case, including the settlement.

ANALYSIS

The work performed by Mr. Monteleone's attorneys fall into two broad categories:

(1) Management of the case, and matters ordinarily taken on by a debtor or debtor in possession's attorney, such as preparation of schedules; and

(2) Negotiation of a settlement with U. S. Bank.

Neither category is subject to reimbursement under the circumstances of this case.

Employment of professionals for a debtor in possession is

governed by 11 U.S.C. § 327. The Code expressly prohibits employment of an attorney who is not a "disinterested person," as defined by Code [1] § 101(14). There is no dispute here that Mr. Monteleone was not a disinterested person; it follows that attorneys obligated to protect his interests are not disinterested, and thus ineligible for employment by the DIP. Recognition of this principle by the parties is implicit in their decision to employ the second attorney.

While the Code recognizes that debtors in possession and their shareholders have inherently conflicting interests, it does not prohibit payment by the estate of the shareholder's legal fees. Code § 1102 allows for formation of a committee of equity security holders. Such attorneys may be compensated from the estate. Code § 328. Crucial to allowance of attorneys fees for committees (apart, of course, from the existence of the committee) is court approval of the employment of the attorney in advance, or allowance of an application for employment *nunc pro tunc.* No such application has been made in this case.

Mr. Monteleone relies on Code § 503(b)(3), which allows claims for

> The actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by . . . (D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title.

If an application for fees under §504(b)(3) or (4) is to be

[1] All references to the Code refer to Title 11 of the U.S. Code, unless otherwise specified.

allowed, two tests must be satisfied:

-- The work performed was necessary under the circumstances; and

-- The work constituted a "substantial contribution" to the case.

The necessity test has two aspects. First, the work must have been essential to the continuance of the case. The first prong is satisfied by the work done by the applicant respecting commencement of the case and continued operation of the DIP under the cash collateral order negotiated with the Bank.

The second part of the test is that the work must, for whatever reason, have necessarily been performed by the creditor or shareholder's attorneys, rather than the DIP's. The Code's requirements regarding employment of counsel by debtors in possession enable the court to control administrative expenses and prevent unauthorized work by outside counsel. In re Sound Radio 145 B. R. 193 (Bankr. N. J. 1992). Attorneys and those who engage them should not be able to escape compliance with § 327 simply by resorting to § 503(b)(4) unless circumstances of the case leave no suitable alternative. *See,* In re Downtown Investment Club III, 89 B. R. 59, 64 (9th Cir. BAP 1988).

The record does not support any finding that it was necessary that Mr. Monteleone's attorney, as opposed to the DIP's, perform these services. The mere fact that Boyd & Wade had superior clerical assistance did not, by itself, justify shifting basic services from an attorney subject to court supervision to one who is not. A shareholder or creditor may cause his attorneys to do essential work in circumstances where it could not otherwise be

accomplished, and be reimbursed under § 503(b). However, where no exigency or other justification exists, a controlling shareholder cannot permit work to be shifted from counsel employed under § 327 to others whose employment was not approved, and then be reimbursed. This is especially so where the attorneys to whom the work was shifted were disqualified from employment under § 327. To hold otherwise would undermine the requirement that Debtors, DIPS and Trustees be represented by disinterested persons.

Much of the activity reflected by the application surrounds the eventual settlement and sale of the DIP's assets. An integral part of the settlement was the agreement between the Bank and Mr. Monteleone. It appears to me that the principal beneficiaries of these efforts were Mr. Monteleone and the other guarantors, and that the benefit to the estate was incidental. The estate should not be charged with the guarantor's legal fees. In re Saroca Corp., 46 B.R. 533. (Bankr. Maine 1985).

To summarize: Work done in the place of the Debtor in Possession's attorney was not necessary, as the term applies under Code § 503. Efforts to bring about a settlement with the main secured creditor were primarily for the benefit of the guarantor who hired the attorneys in the first place. Accordingly, none of the fees sought are reimbursable. An order will be entered denying the motion. This Opinion includes the Court's findings of fact and conclusions of law, which will not be separately stated.

FRANK R. ALLEY, III
Bankruptcy Judge