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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In re:	
PACIFIC RESEARCH & DEVELOPMENT CORPORATION, a Utah corporation, d/b/a Lumé International	Bankruptcy Number 92B-24501
Debtor.	[Chapter 7]

MEMORANDUM DECISION REGARDING FIFTH AND FINAL APPLICATION FOR COMPENSATION OF DEBTOR'S COUNSEL

David E. Leta, Esq. and Lynn Pace, Esq., of Snell and Wilmer, Salt Lake City, Utah, appeared representing the Applicant.

J. Kevin Bird, Esq., of Bird and Fugal, Provo, Utah, appeared representing the chapter 7 trustee.

Gale K. Francis, Esq., Assistant Attorney General, appeared representing the Tax Commission of the State of Utah.

The Fifth and Final Application for Compensation of Debtor's Counsel (Application) is at issue in this converted chapter 11 case. The taxing authorities of the states of Texas, Oklahoma and Utah objected to the Application, asserting that Debtor's counsel had performed services that did not benefit the estate, had undisclosed conflicts of interest, and that certain of the fees were incurred for the benefit of corporate insiders. A brief review of the contentious chapter 11 portion of this case is necessary to place the Application and the objections in context.

HISTORY

Pacific Research & Development Corporation (PRD) was a multi-level marketing entity engaged in production and distribution of personal care products. Through 1989 sales of PRD's products increased at a rapid pace, but because users began to experience skin irritation from certain of PRD's products, sales began to decrease in the fall of 1989.

In early 1990, Joseph E. McPherson, Sr. became sole owner of PRD's stock. In May of 1991, Susan Franceschi, an attorney and the daughter of Joseph E. McPherson, Sr. became PRD's president. PRD's other directors and officers were McPherson family members.

PRD's sales decreased from approximately $18,160,000 in 1990, to $5,357,000 in 1991.[1] PRD attempted unsuccessfully to reorganize outside bankruptcy, but filed a chapter 11 petition on July 9, 1992. The court approved the employment of the law firm of Snell & Wilmer (Applicant) to represent PRD.

PRD conducted its multi-level marketing business throughout the United States and in portions of Canada. In so doing, it incurred debt for unpaid sales taxes to most of the states and some Canadian provinces. PRD's insiders were contingently liable for certain of the tax claims. PRD listed portions of the sales tax debt as disputed and asserted the correct amount it owed to the various taxing authorities was $470,326. However, the amount of unpaid pre-petition sales tax was eventually determined to be approximately $578,000.

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[1] PRD's net income for the pre-bankruptcy period was as follows:

1989	$ 1,121,739
1990	[$64,566]
1991	[$ 1,129,847]
1992 (1st 7 mo.)	[$422,768]

PRD's amended schedules of assets and liabilities[2] reflected two secured claims with a collective balance of approximately $71,000 held by McPherson family members. Joseph E. and Marta McPherson Sr. were listed as holding a claim originally in the amount of $109,250 secured by collateral valued at $1,328,348. Carlos Franceschi (Susan Franceschi's husband) was listed as having a claim originally in the amount of $21,000 secured by collateral valued at $459,260.

Early in the case the treatment of claims of insiders became an issue. Parties perceived preferential treatment was to be afforded to McPherson family members as a result of the insiders' secured claims,[3] and because of pre-petition payments insiders had received. As a result, on January 12, 1993, the court appointed an Examiner upon the joint motion of PRD and the unsecured creditors committee. The Court directed the Examiner to review the books and records of PRD, value its inventory, and determine whether any recoverable or avoidable payments had been made to PRD's insiders.

The Examiner found the cost of inventory was $563,800, but the liquidation value was $42,200: therefore the most effective way to realize the underlying value of the inventory was to continue operations so as to use as many of PRD's supplies and products as possible. The Examiner disclosed that during the one year preference period, $109,212 was paid to insiders but the payments represented new value that would probably preclude an avoidance

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[2] PRD's schedules indicated it was obligated to secured creditors Brighton Bank and First Professional Bank, holding first and second positions, respectively, in PRD's equipment. These non-insider secured claims totalled less than $30,000. A portion of the secured debt allegedly was personally guaranteed by Joseph E. McPherson, Sr.

[3] PRD moved to have the court approve a stipulation between PRD, Carlos Franceschi, and Joseph E. and Marta McPherson Sr., for post-petition use of cash collateral that provided, among other things, a weekly payment to insiders of 1% of PRD's daily receipts, not to exceed $100 per day. The motion was denied by the court because PRD failed to prove that the insider creditors were entitled to the benefits provided in the stipulation.

action. The Examiner also determined that during the first six months of 1992, insiders were paid approximately $155,128 in salary and wages, and that during the chapter 11 case, a substantial amount in salaries and wages were paid to McPherson family members.

PRD drafted its first plan of reorganization based upon a sale of the business to a third party who would acquire the business for $100,000, plus the payment of a royalty over time. The purchaser withdrew the offer and PRD did not pursue that plan.

PRD eventually gained court approval of a Modified Second Amended Disclosure Statement in December of 1993. The related Plan had the support of the unsecured creditors' committee but was vigorously opposed by various state taxing authorities. The Plan generally provided that unclassified priority tax claims would be paid from revenue generated from the continued operation of PRD's multi-level marketing business. In order to be paid within six years of the date of assessment, PRD had to begin servicing priority tax debt no later than September of 1996 and had to conclude the payments by October of 1999.[4]

PRD's Plan provided that the secured claims of Brighton Bank in the approximate amount of $6,400 and First Professional Bank in the approximate amount of $25,000 (less application of escrowed amounts) would be paid in full by selling a portion of the equipment securing the claims, and payment of the balance in equal monthly installments until the claims were paid in full. General unsecured claims, listed in PRD's schedules at $2,226,000, would receive approximately 25% of their claims.

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[4] PRD's exhibit M indicated tax creditors' claims would be paid in minimum quarterly installments that were sufficient to pay $470,326 (PRD's estimate of its tax indebtedness). The tax debt, however, was liquidated in the significantly higher amount of approximately $578,000.

The Plan also provided that the Reorganized Debtor would be governed by Susan Franceschi as president, with other members of the McPherson family as the remaining officers and directors. Joseph E. McPherson Sr.'s stock interest would be canceled. Upon the effective date, 50% of the Reorganized Debtor's authorized but unissued common voting stock would be issued to insiders in exchange for their claims against the estate. The stock, however, would be held in escrow until December 31, 1999, or until unsecured creditors had been paid 25% of their allowed claims. The rather elaborate and unusual escrow provided that if a material default occurred in performance of the Plan, the escrowed stock in the defaulting Reorganized Debtor would be issued to unsecured creditors and the insiders claims would be reinstated.

During the chapter 11 case, the level of PRD's sales declined but PRD maintained a positive cash flow, based upon a cash accounting analysis, through the use of its surplus inventory and accumulated depreciation. PRD asserted, however, that it would enjoy a significant increase in sales once it was no longer under the cloud of the chapter 11 filing. It projected that satisfaction of the debt according to the Plan would occur based upon significant anticipated increases in sales resulting in a return of approximately $880,000 to creditors, or, even more optimistically, a return to creditors of approximately $1,440,000.

The court denied confirmation of PRD's Plan. Although PRD now had a successful product that was in demand, its multi-level marketing method of selling its product failed to produce credible evidence that its increased revenue projections could be met in light of its historic negative net income. PRD could not prove it could comply with its statutory duty to provide full payment to priority tax creditors in the amounts and under the time limits required by 11 U.S.C. § 1129(a)(9)(C). In light of the priority tax creditors' objections to confirmation, their statutory inability to vote for or against the Plan, and PRD's declining revenue during the pendency of the chapter 11 proceeding, the court found the Plan unfeasible.

On May 17, 1994, almost two years after filing and subsequent to the denial of confirmation of the Plan, PRD filed a Motion to Sell Operating Assets and Assign Executory Contracts (Sale Motion). The Sale Motion provided that all of PRD's current operating assets, including cash on hand, would be sold "where is, as is," free from all liens and encumbrances (unless expressly assumed) with valid liens to attach to the proceeds. The buyer would be a new but as yet unformed corporation called "New Pacific." McPherson family members would be the managers of New Pacific with the same percentage ownership set forth in the Plan. The consideration to be given in exchange for PRD's assets would consist of the assumption and payment of the claims of Brighton Bank and First Professional Bank as set forth in the Plan, and the subordination of the McPherson and Franceschi secured claims. The proposed sale did not require New Pacific to make any cash down payment, but required minimum monthly cash payments totalling $688,000 to be concluded on December 1999, and to be paid on an increasing sliding scale as follows:

Months	Min. Monthly Pmt.
1-2 months	$ 4,625
13-24	$ 6,200
25-36	$ 8,050
37-48	$10,200
49-60	$12,675
61-72	$15,583

The minimum monthly cash payments were allegedly sufficient to pay priority and secured claims, with a meaningful repayment to unsecured creditors. New Pacific would also pay 100%

of its monthly net operating income, after certain expenses, sufficient to return 25% to unsecured creditors.

The Sale Motion provided minimum terms for competing higher and better offers. Any buyer other than New Pacific would be required to tender $76,000 by cashiers check prior to the Sale Motion hearing to be applied toward the first payments due under the offer, or alternatively, to obtain written consent to the subordination of the McPherson and Franceschi secured claims. Any buyer other than New Pacific would be required to increase the minimum purchase price of $688,000 by at least $150,000. Any buyer other than New Pacific was required to submit reasonable evidence of an ability to operate at a profit.

Although the unsecured creditors committee supported the Sale Motion, the state of Texas and others objected that the Sale Motion was an obvious attempt to circumvent the requirement of 11 U.S.C. § 1129(a)(9)(C) and to accomplish a liquidating Plan in the guise of an 11 U.S.C. § 363 motion. The state of Texas further objected that the sale was for no cash down, was to an uncapitalized shell corporation not even in existence that was to be owned and run by insiders, and that insiders were subordinating non-secured claims that they would likely lose in any event in liquidation. A renewed motion to convert the case from chapter 11 to chapter 7 was filed by many of the taxing authorities and scheduled for hearing at the same time as the hearing on the Sale Motion.

The evidence adduced at the hearing on the Sale Motion and the motion to convert was somewhat contradictory. It did establish that the proposed sale was to a yet-to-be-formed corporation controlled by insiders. The evidence also indicated that payments would commence in September of 1994 and cease in December of 1999, a period of approximately sixty-four months rather than the projected seventy-two months. The shortened period would eliminate those months in which significantly larger payments were made, resulting in a difference between a minimum payment of $688,000 versus $564,000. The minimum payment would also be required to satisfy $30,000 to $40,000 in unpaid administrative expenses. Since the then allowed priority tax claims were $578,000, the Sale Motion would not provide sufficient funds to satisfy tax claims. Susan Franceschi, however, testified it was her intent as one of the prospective purchasers to extend the payments for a full seventy-two months: a date past October or December of 1999.

The Sale Motion as proposed did, in fact, set more stringent requirements for competing bids of buyers other than New Pacific. Although New Pacific did not offer any cash down payment, any buyer other than New Pacific was required to pay $76,000 in cash prior to the Sale Motion hearing, ostensibly to pay secured insider claims if no subordination was negotiated. Any buyer other than New Pacific was required to increase New Pacific's bid by at least $150,000, or almost 20% of the $688,000 purchase price. The testimony providing the rationale for the additional $150,000 in purchase price indicated the additional funds were not designed to increase the return to creditors. Instead, the additional $150,000 was allegedly intended to: 1) pay insider claims of $76,000; 2) pay non-insider secured claims (allegedly guaranteed by McPherson Sr.) even though the New Pacific purchase price supposedly contained sufficient funding to satisfy non-insider secured claims; and 3) ensure funding for an operating cushion for the prospective purchaser even though New Pacific had no capitalization except for the cash it would have obtained from PRD through the sale. Any buyer other than New Pacific was required to submit reasonable evidence that it had the ability to operate at a profit, even though New Pacific was not required to present such proof and, indeed, the last year that PRD operated at a profit was 1989.

Those parties who had received notice of the Sale Motion responded with inquiries into gross sales levels, but no one expressed concern about minimum terms of competing offers. Susan Franceschi candidly testified that the intent of the Sale Motion to was accomplish through the mechanics of a 11 U.S.C. § 363 sale what which could not be accomplished through a Plan.[5]

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[5] The following testimony was given in response to questioning by the court:

Q. [by the Court] Ma'am, when the proposed purchase was negotiated, who negotiated the terms for the debtor?

A. Well, I think that these are the people who negotiated the terms. There was myself, Mr. McPherson, who is a director. We discussed our concept with the attorneys, and the attorneys, while they are not officers, attempted to give us some guidance in terms of separating ourselves from, you know, our private interest, but those are the only parties that participated.

Q. In negotiating it for the debtor --

A. Yes.

Q. ---is that correct? Who negotiated the terms of the purchase agreement for the prospective purchasers?

A. It was the same parties.

. . .

Q. [by Mr. Leta] Ms. Franceschi, the judge just asked you some questions about negotiation. This is basically an offer proposed by existing management and shareholder to keep the company running; it is not?

A. Yes.

Q. Okay. Did existing management attempt, in formulating this offer, to propose terms that would be at least as favorable as those terms which they had proposed on behalf of the debtor as part of a reorganization?

A. Yes. We actually used the plan as a guide in proposing this offer.

Q. In other words, the shareholders didn't attempt, in making this offer, to do a better deal for themselves than they had proposed to creditors as part of the reorganization of the company?

A. No. What we did in this effort was as follows. When the plan was not confirmed, we were faced with a situation where we needed to decide what to do, and we knew that there were problems associated with the strength of the empirical evidence we could collect that would establish increased sales, and that might not be a problem with some plans, but it was a problem here because there's a large tax debt. The tax debt must be paid within a certain period of time, and it must be paid with interest unless there's a concession by tax creditors, which we did not obtain, so we knew we going to have that hurdle.

We examined the feasibility of trying to develop other markets that might be more mainstream or documented in the context of this case, and we determined that those would not produce the results that we had observed would probably be necessary. We didn't think we could in the context of this case.

So we took that information, and in light of the confines of the Code, we basically copied the Plan but with some different components that would pay the creditors back but not run into the same problems we had

(continued...)

At the July 14, 1994, hearing the Sale Motion was denied and the motion to convert the case to a chapter 7 was granted. Kevin Bird (Trustee) was subsequently appointed as chapter 7 trustee. The Trustee then moved for court approval of a sale of the estate's non-exempt assets free and clear of liens and encumbrances, for approval of a letter agreement, and the approval of assumption and assignment of executory contracts and unexpired leases. The purchase offer was from Applied Resource Technologies, Limited (ARTL), a new Colorado corporation with Susan Franceschi, and other McPherson family members, as directors. The purchase offer sought to acquire substantially all the assets of PRD for $15,000 cash down payments at closing, the assumption and satisfaction of any remaining indebtedness to certain non-insider secured creditors (allegedly guaranteed by insiders), and the waiver of all claims against PRD held by the insiders. The purchase offer also provided for a monthly royalty payment to the estate. The royalty payment for the first three months would be the greater of $1,000 per month or a graduated percentage payment based upon monthly revenue, with $2,000 per month for the remaining 69 months or the same revenue based graduated royalty payment. After notice and a hearing at which the Applicant appeared representing ARTL, and not PRD, the Trustee's motion was granted.

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[5](...continued)
with the Code.

So we basically used the plan to mirror our intentions, and it was merely a method by which we could -- considered might be an option to pay the creditors. That was the intention. That was the thinking behind formulation -- formulating the offer.

Q. Was it management's's intention to try, through another method, to pay as much back to creditors as they hoped to be able to pay under the plan?

A. Absolutely.

(Tr. of testimony 7/14/94 at 69-71.)

On November 23, 1994, the Applicant filed its Fifth and Final Application of Attorneys for Debtor for Allowance of Compensation and Reimbursement of Expenses.[6] The Application sought chapter 11 administrative expenses of $15,599.50 in fees (discounted by $2,750) and $2,230.11 in reimbursement of costs; and chapter 7 administrative expenses of $3,608.00 in fees and $252.02 in reimbursement of costs. The Application reflected that the Sale Motion resulted in $9,954.00 in fees charged to the estate.

ISSUES

The states of Texas, Oklahoma and Utah raise two issues in their objections to the Application. First, they assert the $9,954 in fees incurred by the Applicant relating to the Sale Motion are not compensable pursuant to 11 U.S.C. § 330(a)[7] because they were not beneficial to the estate and should be denied. Second, they assert that from the Sale Motion onward, the Applicant represented the interests of insiders. In so doing, the Applicant lost its status as a disinterested entity as required by § 327(a) and therefore compensation may not be allowed pursuant to § 328(c).

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[6] The Application recites prior allowances and payments of $128,117.91 of which $87,905.78 had been paid as of the date of the Application. The court's records reflect that the court has granted total compensation of $128,317.21 representing four prior fee applications. An additional $4,033 in fees requested as part of Applicant's third fee application was reserved pending further hearing before the Court by Order dated December 9, 1993. The Order stated that Applicant "may reapply for allowance and reconsideration of such compensation in connection with its next fee application." Although Applicant's fourth fee application filed on May 17, 1994, states that "[t]he Court has taken allowance of $4,033.00 in fees under consideration," no further application for these fees has been requested.

[7] Future references are to Title 11 of the United States Code unless otherwise noted.

JURISDICTION

This court has jurisdiction over this proceeding pursuant to 28 U.S.C. § 157(b)(2)(A). This is a core matter involving the administration of the estate and the court is entitled to enter a final order. The issues are before the court pursuant to 28 U.S.C. § 1334(b) and Local Rule 404 of the United States District Court for the District of Utah referring bankruptcy cases and proceedings to this court for hearing and determination.

BENEFIT TO THE ESTATE

The eligibility of counsel to receive compensation from the bankruptcy estate is governed by § 330(a)(1), which provides the court "discretion to award a reasonable fee for 'actual, necessary services'." *Rubner & Kutner, P.C. v. United States Trustee (In re Lederman Enterprises, Inc.*, 997 F.2d 1321, 1323 (10th Cir. 1993). The threshold inquiry, however, is whether the legal services benefitted the estate. *Lederman*, 997 F.2d at 1323 (the beneficial nature of the services is an element of whether the services were necessary and benefit must be established before the court may consider the reasonableness of the fees). Beneficial services are defined as "those which 'foster and enhance, rather than retard or interrupt the progress of reorganization'." *In re James Contracting Group, Inc.*, 120 B.R. 868, 872 (Bankr. N.D. Ohio 1990) (citation omitted).

The court's initial inquiry under *Lederman* must be whether the work performed in pursuing the Sale Motion benefitted the estate. In *Lederman* the Tenth Circuit considered the benefit and necessity of work performed in the context of the debtor's attempt to confirm a plan. *Lederman*, 997 F.2d at 1323-1324 (where it is apparent to counsel from the beginning of the case that the debtor cannot propose and carry out a plan, the work performed by debtor's counsel is not necessary and cannot be compensated). The work performed must be "reasonably calculated to produce a benefit to the estate." *In re Hunt*, 124 B.R. 263, 267 (Bankr. S.D. Ohio 1990) (attorney should not expect full compensation for time and effort expended on plan and disclosure statement, underlying feasibility of which was nonexistent when plan offered).

PRD argued in its Sale Motion, and also at the hearing on this Application, that PRD's operating assets had little or no market value in liquidation and a sale would maintain the significant going concern value of the assets. There is no dispute that, if PRD had proved that New Pacific could perform on the offer, more funds would have been generated through the Sale Motion than if the mere liquidation value as determined by the Examiner were realized. The analysis does not stop there, however. It is insufficient merely to find that a sale of PRD's assets would have been beneficial for the estate. Instead, for the fees to be allowed, the Applicant must not only prove that granting the Sale Motion would have been beneficial to the estate, but that there was a likelihood that the Sale Motion would be granted. For the following reasons, the Applicant has failed to prove any tangible benefit to the estate because it has failed to prove that from the outset, there was any reasonable calculation that the Sale Motion would be granted.

In its memorandum in support of the Sale Motion, PRD cited *In re Lionel Corp.*, 722 F.2d 1063 (2nd Cir. 1983) for the proposition that the court may grant a sale of substantially all the debtor's assets outside the protection afforded to creditors through confirmation of a plan, if there exists a good business reason for the proposed sale. *Lionel*, (while declining to follow the "perishable" test), rejected a § 363 sale as a matter of fact because the debtor had not established a sound business reason for the sale, but also as a matter of law because the § 363 sale "ignores the equity interests required to be weighed and considered under Chapter 11." *Lionel*, 722 F.2d at 1071.[8] The court in *Lionel* recognized that although denial of the sale could result in delay, "[t]he need for expedition, however, is not a justification for abandoning proper standards." *Lionel*, 722 F.2d at 1071 (quoting *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 450, 88 S. Ct. 1157, 1176 (1968)). In *Protective Committee*, 88 S. Ct. at 1176, the Supreme Court found that the lower court abandoned proper standards by failing to allow certain valuation testimony which effectively excluded stockholders from participation in the confirmation process and relinquished their rights by default. Thus, *Lionel* established that in evaluating whether a § 363(b) sale of major assets can be accomplished outside the safeguards of disclosure, solicitation and acceptance, the court must consider not only the business reason for the sale, but whether the sale abrogates the substantive and procedural rights of creditors that are built into the process of confirming a plan.

Even if the evidence presented at the Sale Motion weighed in favor of some of the factors set forth in *Lionel*[9] and proved a sound business reason for the § 363 sale, the

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[8] In addition to *Lionel*, PRD cited several other cases in support of its Sale Motion. None of the cited cases contemplated a § 363(b) sale of substantially all of a debtor's assets *after* confirmation of a plan had been denied.

[9] In *Lionel*, the court suggested the following relevant factors in considering a § 363(b) sale of the debtor's assets outside a plan of reorganization:

1) the proportionate value of the asset to the estate as a whole,
2) the amount of elapsed time since the filing,
3) the likelihood that a plan of reorganization will be proposed and confirmed in the near future,
4) the effect of the proposed disposition on future plans of reorganization,

(continued...)

Applicant's reliance on *Lionel* to support the Sale Motion was misplaced. The Applicant failed to consider the second prong of the *Lionel* test: that a sale of substantially all the assets of a debtor outside a plan would be denied where the § 363 sale ignores the substantive and procedural protections afforded creditors without an interest in the property sold, that are protected by the plan confirmation process.

PRD failed to explain how its proposed § 363 sale could accomplish indirectly what PRD could not accomplish directly under § 1129. PRD cited no case law that would allow the statutory protections afforded to priority tax creditors under § 1129 to be ignored in the guise of a § 363 sale. As in *Lionel*, where the court could not ignore "the equity interests required to be weighed and considered under Chapter 11," in this case the court could not ignore the rights of priority creditors even though the rights of parties having an interest in the property sold may have been protected. *Lionel*, 722 F.2d at 1071. The court stated in its ruling denying the Sale Motion and converting the case to chapter 7:

> [T]here is simply no provision in Chapter 11 that allows for liquidation of assets under Section 363(b) if it is impossible for the debtor to meet the standards of Section 1129. Blindly applying the criteria set forth in the case law to approve a sale would ignore that the basis of the motion is to sidestep the protection creditors have in Chapter 11.

(Tr. of ruling 7/14/95 at 9.)

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[9](...continued)

> 5) the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property,
> 6) which of the alternatives of use, sale or lease the proposal envisions and,
> 7) most importantly perhaps, whether the asset is increasing or decreasing in value.

Lionel, 722 F.2d 1063, 1071.

As the *Lederman* test indicates, it should have been apparent to the Applicant that the court would not approve the Sale Motion based upon the *Lionel* test. An objective reading of *Lionel* would have lead a reasonable attorney to determine that the Sale Motion would not be approved. While some courts have been reluctant to second guess the decisions and choices made by the debtor's attorney,[10] this Court determines that the Applicant must be able to show at least some authority in the case law for attempting to sell all of the assets of the estate outside the ordinary course of business and outside a plan, in a manner that would circumvent the protections the Code affords creditors, after the Plan had been denied. At the point the Applicant began to pursue the Sale Motion following the denial of confirmation, its services ceased to be beneficial to the estate and will not be compensated. *See In re Office Products of America, Inc.*, 136 B.R. 983, 990-991 (Bankr. W.D. Tex. 1992) (court denied fees incurred by the debtor's attorney once it became apparent that pursuit of the plan could not satisfy § 1129(a) and the services of counsel ceased to be necessary). The court will disallow fees related to the Sale Motion in the amount of $9,954 because the Applicant has failed to prove that the services were "necessary" as required by § 330(a)(1).

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10 *In re Washington Mfg. Co.*, 101 B.R. 944, 956 (Bankr. M.D. Tenn. 1989) the court stated:

> [t]he Court is not inclined to engage in overly critical retrospection "or to 'second guess' actions and decisions undertaken by attorneys in good faith as the situation appeared to them at the time such actions or decisions were necessary." . . . . Rather, the Court is inclined to determine any benefit, or lack thereof, to the estate based upon a totality of circumstances.

CONFLICT OF INTEREST

The objection of the State of Texas (Texas), and those that joined therein, argue that at some point after confirmation of the Plan was denied, the Applicant's efforts were openly and primarily directed to aiding insiders, despite the opposition of the primary body of creditors with an interest in the case -- the priority tax creditors. Texas's objection complains that the conflicting dual representation is evidenced by the Sale Motion that included self-serving terms that were designed to benefit insiders and that had the effect of chilling any possible bidding by third parties.

The Applicant adamantly denies that it represented insiders in advancing the Sale Motion. In its supplemental memorandum in support of the Application, the Applicant asserts that nothing in the Sale Motion was 'undisclosed,' that the terms of the transaction were structured to maximize the benefit to the estate to the detriment of PRD's insiders, and that the Applicant repeatedly reminded PRD's representatives of their fiduciary duties to creditors. The Applicant points to testimony of Susan Franceschi that in attempting to formulate the offer, insiders proposed terms that would be at least as favorable as those terms which they had proposed on behalf of PRD as part of a reorganization, and that the insiders used the Plan as a guide in proposing the offer.

The issue can be framed as follows: when the Applicant prosecutes a sale proposed by unrepresented insiders imposing terms and conditions that are more onerous for other buyers than for the insiders, and proposing terms and conditions similar to a plan that has been denied confirmation, has the Applicant lost its disinterested status even though the sale represents a better return to creditors than would occur in liquidation?

To be awarded compensation under § 330(a) the Applicant must first have been found to be disinterested and employed under § 327(a). *Mitchell v. Federated Department Stores, Inc. (In re Federated Department Stores, Inc.)*, 44 F.3d 1310, 1320 (6th Cir. 1995) (application of Shearson Lehman, Inc.) (a valid appointment under § 327(a) is a condition precedent to the decision to grant or deny compensation under § 330(a) or § 328(c)). The definition of "disinterested person" contained in § 101(14)(E) is "broad enough to exclude anyone with some interest or relationship that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules." *In re Black Hills Greyhound Racing Ass'n,* 154 B.R. 285, 292 (Bankr. D.S.D. 1993) (citing *In re BH & P Inc.*, 949 F.2d 1300, 1309 (3rd Cir. 1991)).

Although the Applicant may once have been determined to be disinterested as required by § 327(a), the court may deny the allowance of compensation for services pursuant to § 328(c) if the Applicant subsequently represents an interest adverse to the interest of the estate during the Applicant's employment. *In re Office Products of America, Inc.* 136 B.R. 983, 986 (Bankr. W.D. Tex. 1992) (compensation may be denied if at any time during employment by the debtor in possession, the law firm ceases to be disinterested). The case law is unambiguous that potential conflicts arise by dual representation of a debtor and its officers, directors, or dominant shareholders. *In re EWC, Inc.*, 138 B.R. 276, 284 (Bankr. W.D. Okla. 1992) (concurrent representation of the debtor in possession and its sole shareholder may be a conflict of interest); *In re Rusty Jones, Inc.* 134 B.R. 321, 343-44 (Bankr. N.D. Ill. 1991) (simultaneous representation of both a debtor and a debtor's shareholder may under some circumstances create a conflict of interest under §§ 327 and 328).

The Applicant's denial that it represented insiders and assertion that it maintained its disinterested status does not end the inquiry. *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (in determining whether any competing interest of a court-appointed professional created a meaningful incentive to act contrary to the best interest of the estate or the reasonable perception of one, the test is not subjective but contemplates an objective screening for even the appearance of impropriety). Even though the Applicant attempted to instruct insiders regarding their fiduciary duties or desired to benefit the estate by proposing the Sale Motion, the court must look through the Applicant's actions to determine if the facts indicate representation of an entity with an interest adverse to the interest of the estate that destroys the Applicant's once disinterested status. *In re EWC,* 138 B.R. at 284, (even though a professional may not cause actual harm to the estate, the disinterested requirement is intended to prevent the appearance of conflict irrespective of the integrity of the person or firm under consideration) (citing *In re Martin,* 817 F.2d 175, 181 (1st Cir. 1987)). Though the evidence of the Applicant's representation of an interest adverse to the estate may be circumstantial, the court may review the totality of the evidence to determine if the Applicant represented an adverse interest. *In re Kendavis Industries International, Inc.*, 91 B.R. 742, 751 (Bankr. N.D. Tex. 1988) (circumstantial evidence indicated professional actually represented the interest of a family who were the primary and controlling shareholders, directors, officers and employees of the debtor at the expense of the estate).

The most compelling evidence of whether the Applicant represented an interest adverse to the estate in advocating the Sale Motion are the terms of the Sale Motion itself. If, as argued, the Sale Motion was structured as a final attempt to provide the maximum return to creditors without any predisposition in favor of insiders, no interest adverse to the estate was present. If, however, the terms of the Sale Motion indicate that its underlying basis was to advance the interest of insiders at the expense of the estate, an adverse interest was advocated by the Applicant. As explained in *In re Diamond Mortgage Corp.*, 135 B.R. 78, 94 (Bankr. N.D. Ill. 1990):

> By judicial definition, however, "holding an interest adverse to the estate" has come to mean:
> 1. to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate . . . ; or
> 2. to possess a predisposition under circumstances that render such a bias against the estate.

The facts rather clearly indicate the terms of the Sale Motion contained a predisposition to favor insiders, and not to promote the highest offer possible for PRD's assets. The most obvious differences between the purchase proposed by New Pacific and the requirements for other bidders are as follows:

1. Buyers other than New Pacific were required to make a $76,000 cash down payment in order to *satisfy* the secured claims of insiders or to obtain subordination of insider secured claims. Not only were buyers other than New Pacific required to produce cash when New Pacific was not, the more onerous terms went to the direct benefit of insiders.

2. Buyers other than New Pacific were required to increase the offer by $150,000. If the true intent of the Sale Motion was to maximize the return to creditors, and not chill other offers, it was inconsistent to require such a large incremental bid. Considering the lack of credible testimony to provide a rationale for the $150,000 increase and that the additional funds were not intended to increase the return to creditors, it can reasonably be concluded that the increase was designed to discourage others from bidding.

3. No requirement was imposed upon New Pacific that it prove profitability, but buyers other than New Pacific were required to *prove* they could operate at a profit.

A sale structure that potentially chilled higher offers was adverse to the estate because it tended to lessen the value of the bankruptcy estate and reduced the possibility of achieving the highest and best offer for the assets of the estate. It is impossible to ascertain if in fact the bidding was actually affected, and it is futile to attempt to determine if others may have come forward to bid on less onerous terms. The mere fact that no inquiries were made of PRD by prospective purchasers regarding the terms for outside bidders does not mean the sale was not chilled by the terms of the Sale Motion. As stated in *Interwest Business Equipment, Inc. v. United States Trustee (In re Interwest Business Equipment, Inc.)*, 23 F.3d 311, 317 (10th Cir. 1994), where the applicants contended that confirmation of reorganization plans evidenced a lack of conflict, "[w]e also find it is impossible to know if the terms of the confirmed plans were affected by the joint representation." *Interwest*, 23 F.3d at 317. Likewise in this case, it is impossible to know if the terms for non-insiders bids had been similar to those for New Pacific, if others would have bid. It is also impossible to determine if the Applicant had not been so closely affiliated with the interests of insiders, if the Sale Motion would have contained terms more beneficial to the estate.

The Applicant knew from the beginning of the case that parties were concerned with the potential preferential treatment of insiders, and accordingly should have exercised caution to eliminate any such treatment. The obvious dissimilarity in the structure of the Sale Motion between the offer of New Pacific and the requirements for other offerors is difficult to explain except that the Sale Motion was designed to discourage other bidders and to keep the ownership, employment and control of the assets in the hands of insiders. The Applicant's subsequent representation of ARTL in negotiating and advocating the sale of PRD's assets after conversion does not further the Applicant's assertions that it represented only the interest of PRD during the chapter 11 case.

The court finds that not only did the Applicant represent the interests of insiders in preparing and advocating the Sale Motion, but that the insiders interests were adverse to the estate. Representation of such an adverse interest establishes "that a conflict actually existed or, at least, . . . the appearance of impropriety." *In re Roberts*, 75 B.R. 402, 405 (D. Utah 1987). The court concludes that fees related to the Sale Motion in the amount of $9,954 will also be denied pursuant to § 328(c) because the Applicant represented an interest adverse to the estate.

CHAPTER 7 FEES

The objecting parties request the court deny all fees incurred by the Applicant subsequent to the Sale Motion, including $3,608.00 in fees and $252.02 in costs incurred after the case was converted to chapter 7 because, as determined above, the Applicant was not disinterested. The requirement that an attorney be disinterested under § 327(a) applies only to the trustee's employment of professional persons. In the context of a chapter 11 proceeding, the debtor in possession has the rights, powers, and duties of a trustee pursuant to § 1107(a), including the obligation to hire disinterested professionals. In Chapter 7, there is no requirement that the attorney for a debtor be disinterested. *In re Hoffman*, 53 B.R. 564, 565 (Bankr. W.D. Ark. 1985) (citing *In re Roberts*, 46 B.R. 815 (Bankr. D. Utah 1985), *rev'd on other grounds*, 75 B.R. 402 (D. Utah 1987).

Since the Applicant was not employed under § 327(a) to represent PRD as a chapter 7 debtor, the provisions of § 328(c) are inapplicable. The only standard applicable to the chapter 7 fees requested by the Applicant are those set forth in § 330(a) that allows "actual, necessary services" and reimbursement of actual, necessary expenses for the debtor's attorney.[11] Upon review of the itemized submission for the chapter 7 fees and expenses, the court finds the services performed were beneficial and represent actual, necessary services; that the fees charged are reasonable; and that the expenses allocated to the chapter 7 case are subject to reimbursement.

DISGORGEMENT

The objecting parties suggest the court should consider disgorgement of the Applicant's fees that have been previously awarded. The 10th Circuit has ruled that § 328(c) gives a bankruptcy court discretion where an attorney loses the disinterested status during the course of the case. In *Gray v. English,* 30 F.3d 1319, 1324 (10th Cir. 1994), the court stated

> The permissive "may deny" language does not require the court to deny legal fees or disgorge previously paid fees in all cases. In exercising the discretion granted by the statute we think the court should lean strongly toward denial of fees, and if the past benefit to the wrongdoer fiduciary can be quantified, to require

[11] A different outcome may result under the Bankruptcy Reform Act of 1994 made applicable to cases filed on or after October 22, 1994. Congress has chosen to delete the reference in § 330(a) to "debtor's attorney" and by this omission has potentially precluded an attorney for a chapter 7 debtor from receiving compensation from the estate. Section 331, Interim Compensation, retains the reference to "debtor's attorney", but limits the right to receive interim compensation to professionals appointed under § 327 or § 1103. Although the legislative history of the Reform Act does not explain this anomaly, it appears that Congress may have intended to limit the right to receive interim and final compensation to attorney's for a chapter 11 debtor in possession, and to preclude payment of compensation to an attorney for a chapter 7 debtor. The result is equally unclear where, as occurred in this case, an attorney for a chapter 11 debtor is appointed under § 327, but later continues to represent the debtor after the case is converted to a chapter 7.

> disgorgement of compensation previously paid that fiduciary even before the conflict arose.

Like *Grey*, there is no evidence in this case that the Applicant benefitted as a result of the dual representation of the insiders and PRD, or that this is a "case of embezzlement or self-dealing in trust assets." *Grey*, 30 F.3d at 1324. The court declines to grant the objecting parties suggestion that fees previously awarded be disgorged.

CONCLUSION

The $9,954 in fees requested by the Applicant for representation regarding the Sale Motion are denied, equally upon the grounds that the services were not beneficial to the estate, and because the Applicant represented an interest adverse to the estate. The court determines that the remainder of the chapter 11 and chapter 7 fees and costs are otherwise allowed and may be paid from the estate to the extent funds are available. Based thereon, it is hereby

ORDERED, that chapter 11 fees in the amount of $15,599.50 and reimbursement of costs in the amount of $2,230.11 will be allowed, less $9,954.00 in fees incurred related to the Sale Motion, and it is further

ORDERED, that chapter 7 fees in the amount of $3,608.00 and reimbursement of costs in the amount of $252.02 will be allowed, and it is further

ORDERED, that prior orders of the court relating to previous fee applications are final.

DATED this 3 day of April, 1995.

JUDITH A. BOULDEN
United States Bankruptcy Judge

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